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| Fair value measurement of non-financial physical assetsValuer-General VictoriaGuidance note |

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| July 2015Valuer General VictoriaLand VictoriaDepartment of Environment, Land, Water and Planning570 Bourke StreetMelbourne VIC 3000Phone: (03) 8636 2515Fax: (03) 8636 2596Email: valuer.general@delwp.vic.gov.auWeb: www.delwp.vic.gov.au>Property and land titles>ValuationLogo© The State of Victoria Department of Environment, Land, Water and Planning 2015This work is licensed under a Creative Commons Attribution 4.0 Australia licence. You are free to re-use the work under that licence, on the condition that you credit the State of Victoria as author. The licence does not apply to any images, photographs or branding, including the Victorian Coat of Arms, the Victorian Government logo and the Department of Environment, Land, Water and Planning logo. To view a copy of this licence, visit [http://creativecommons.org/licenses/by/4.0](http://creativecommons.org/licenses/by/3.0/au/deed.en)/**Accessibility**If you would like to receive this publication in an alternative format, please telephone the DELWP Customer Service Centre on 136186, email customer.service@delwp.vic.gov.au or via the National Relay Service on 133 677 [www.relayservice.com.au](http://www.relayservice.com.au).**Disclaimer**This publication may be of assistance to you but the State of Victoria and its employees do not guarantee that the publication is without flaw of any kind or is wholly appropriate for your particular purposes and therefore disclaims all liability for any error, loss or other consequence which may arise from you relying on any information in this publication. |

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1 Purpose

The purpose of this guidance note is to outline accounting requirements and provide guidance for valuers and the Victorian public sector entities when valuing non-financial physical assets for general purpose financial reporting. The guidance is not intended to be definitive; rather, it is a guide for assessing fair value for financial reporting to ensure that the asset valuation across the Victorian public sector is consistent and complies with the relevant accounting pronouncements.

The guidance is applicable to public sector agencies including State Government agencies. They apply equally to for-profit and not-for-profit entities within the public sector.

2 Introduction

Non-financial physical assets are a significant proportion of the Victorian public sector’s assets. These assets are used to meet government objectives and outcomes. The correct valuation of these assets enable an entity to correctly account for the future economic benefits embodied in the assets. This in turn provides the entity with relevant and reliable information for decision-making on the resource allocation, performance measurement and accountability of its assets.

The terms ‘non-current asset(s)’ or ‘asset(s)’ are used in this guidance note to mean non-financial physical assets or property, plant and equipment that are expected to be used for more than 12 months.

The valuation of non-current assets must comply with the following accounting pronouncements:

(a) AASB 116 *Property, Plant and Equipment*, which permits an entity to choose either the cost or revaluation model to measure its property, plant and equipment subsequent to initial recognition.

(b) AASB 140 *Investment Property* requires all investment properties to be measured using either the cost or fair value model.

(c) AASB 13 *Fair Value Measurement*, which prescribes a single source of guidance for the fair value measurement.

It should be noted that the revaluation model under AASB 116 and the fair value model under AASB 140 are consistent with the requirements of AASB 1049 *Whole of Government and General Government Sector Financial Reporting* and the Australian Bureau of Statistics Government Finance Statistics (GFS) requirements. This is reflected in the State’s Financial Reporting Direction, FRD 103F *Non-Financial Physical Assets* and FRD 107A *Investment Properties*, which requires all non-current assets and investment properties respectively to be measured at fair value unless the entity has received prior approval from the Minister for Finance to measure the assets at cost.

For assets that are permitted to be valued at cost. i.e. assets under construction, the assets must be assessed to ensure that they are carried no more than their recoverable amount. If an asset is carried at more than its recoverable amount i.e. the carrying amount exceeds the amount to be recovered through use or sale of the asset, the asset is impaired and AASB 136 *Impairment of Assets* requires the entity to recognise an impairment loss.

3 Implementation and delivery

It should be noted that the primary purpose of undertaking the fair value valuation on a regular basis is to ensure that the non-financial physical assets reflect their fair value in the financial statements. These in turn are audited by the Victorian Auditor-General’s Office and the process demonstrates accountability and stewardship of the resources entrusted to the entity/department in the delivery of its objective.

Therefore, the goal is to develop and deliver a robust methodology for fair value measurement that can withstand a rigorous audit process and also provide key information critical to the development of a robust asset management framework.

By design it includes:

• developing an appropriate valuation that fully complies with all key aspects of AASB 13, AASB 116, AASB 136, AASB 140 and other relevant AASBs;

• determining the method and templates to undertake the actual calculations;

• gathering and documenting sufficient and appropriate evidence to support the underlying assumptions;

• production and sign off of final reports and methodologies;

• ability to respond quickly to any audit queries; and

• the implementation of an annual process to assess and adjust for any changes in condition, pattern of consumption, useful life and residual value.

It is important to note that responsibility for the valuation ultimately rests with an entity’s management and this means that management must put appropriate governance processes in place to ensure that the valuation of its assets are undertaken in a timely and sufficiently robust manner.

This may include:

• meeting regularly with the valuer and obtaining updates on progress;

• establishing a process to ensure all communications between management, valuer and auditor are directed to the correct people in a timely manner;

• establishing a range of policies that will feed directly into the valuation process – these may include thresholds, assumptions and methods of depreciation;

• liaising with both the auditor and valuer to ensure a consistent understanding of the methodology and process, and address any audit issues as a matter of priority;

• providing essential data to the valuer to ensure the data provided is complete and accurate;

• reviewing the underlying methodology and assumptions for reasonableness and documenting the results for review; and

• reviewing the final valuation report and results for reasonableness and obvious errors. The process also needs to be documented for audit evidence.

4 Accounting requirements

4.1 AASB 116 *Property, Plant and Equipment*

4.1.1 Application

AASB 116 applies to the accounting for property, plant and equipment, except where another accounting standard requires or permits another accounting treatment.

4.1.2 Requirements

The main requirements of AASB 116 are as follows.

(a) *Recognition of an asset* – cost of an item shall only be recognised as an asset if it meets the following asset definition and recognition criteria:

(i) that it is probable future economic benefits of the item will flow to the entity; and

(ii) the cost of the item can be measured reliably.

(b) *Measurement at recognition* – an asset shall be recognised initially at cost, being the fair value at the acquisition date.

(c) *Measurement after recognition* – an entity shall choose either the cost or revaluation model to measure its assets subsequent to initial recognition. The revaluation model requires the entity to revalue the assets:

(i) to fair value for the entire class to which the assets belong; and

(ii) with sufficient regularity to ensure that the carrying amount does not differ materially from the asset’s fair value at the end of the reporting period.

This guidance note focuses on the measurement of an asset after its initial recognition at fair value.

(d) *Depreciation* – the depreciable amount of an asset shall be allocated systematically over the asset’s useful life.

(i) Depreciation method – should reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity. Common depreciation methods include straight line, diminishing balance and units of production method.

(ii) Componentisation – where an asset comprise of separate parts whose lives and associated depreciation charges are material, the components of the asset should be separately identified and depreciated.

4.2 AASB 140 *Investment Property*

4.2.1 Application

AASB 140 applies to the accounting for investment property.

4.2.2 Requirements

The main requirements of AASB 140 are as follows.

(a) *Recognition of an asset* – cost of an item shall only be recognised as an asset if it meets the following asset definition and recognition criteria:

(i) that it is probable that future economic benefits of the item will flow to the entity; and

(ii) the cost of the item can be measured reliably.

(b) *Measurement at recognition* – an asset shall be recognised initially at cost, inclusive of transaction costs being the fair value at the acquisition date.

(c) *Measurement after recognition* – an entity shall choose either the fair value or cost model to measure its assets subsequent to initial recognition. The fair value model requires the entity to measure all of its assets at fair value.

This guidance note focuses on the measurement of an asset after its initial recognition at fair value.

4.3 FRD 103F *Non-Financial Physical Assets*

4.3.1 Requirements

The main requirements of FRD 103F are as follows.

(a) *Asset classification* – non-financial physical assets must be classified:

(i) initially by the ‘purpose’ for which the assets are used in accordance to the prescribed ‘Purpose Groups’, based upon Government Purpose Classifications; and

(ii) subcategorised into the ‘nature’ of the assets (for example buildings, plant and equipment).

(b) *Fair value measurement* – non- financial physical assets, subsequent to its initial recognition, must be measured using the revaluation model, being fair value.

The fair value measurement is not required for the following:

(i) prior written approval from the Minister for Finance to measure assets at cost;

(ii) assets under construction or development are to be measured at cost; and

(iii) leasehold improvements, additions or modifications to ‘fit out’ buildings, where the buildings will not revert to the State at the end of the lease agreement, must use depreciated cost.

(c) *Highest and best use* *(HBU)* – in measuring an asset’s fair value, an entity’s current use is its HBU, unless the annual assessment of the HBU suggests that a different use by market participants would maximise the value. Refer to 4.5.3(e) and 4.6 for a more detailed discussion of HBU.

(d) *Timing of revaluation* – each class of assets that uses the revaluation model must undertake the following:

(i) *Annual fair value assessment* – an entity must annually assess that the asset’s carrying amount reflects its fair value at the end of the reporting period. Fair value indicators such as Valuer-General Victoria’s (VGV) land and building indices, ABS infrastructure indices (if appropriate), review of the HBU and other relevant indicators can be used for the fair value assessment.

(ii) Interim revaluations are less detailed than a comprehensive valuation and may involve any, or a combination of, indices, desk top valuations using sampling, site visits using sampling and other professional methodologies.

Therefore, it is important for management to document and ensure that appropriate indices and any other adjustments made take into account the specific conditions of the asset (e.g. land values may experience significant and volatile changes in fair value in certain areas like CBD) reflect a representative fair value of the asset.

For generalised property, relevant and reliable fair value indicators should be generally available and are regularly published in the market. For specialised assets, management may need to make a selection of appropriate indicators, in conjunction with VGV to ensure suitability and appropriateness.

When the annual fair value assessment results in a compound movement in fair value since the last revaluation (scheduled, interim or managerial) that is:

• less than 10 per cent – entity does not need to change the carrying amount of the asset;

• greater than 10 per cent and less than 40 per cent (referred to as material) – entity must perform a managerial revaluation. This involves the entity changing the carrying amount of the asset to the compounded fair value based on management (or internal) expertise; and

• 40 per cent or more (referred to as exceptionally material) – entity must consult VGV (unless otherwise approved) for the need to perform an interim revaluation. An interim revaluation follows the same process as the five year scheduled revaluation.

FRD 103F Appendix B provides more guidance on annual fair value assessment, managerial and interim revaluations.

(iii) Five year scheduled revaluations – must be performed every five years based on the prescribed schedule of the relevant ‘Purpose Group’ in FRD 103F.

(e) *Approved valuer* – is Valuer-General Victoria (VGV) unless another independent professional valuation agency is approved by the Chief Reporting Officer as per FRD 103F.

4.4 FRD 107A *Investment Properties*

4.4.1 Requirements

The main requirements of FRD 107A are as follows:

(a) *Fair value measurement* – investment properties must be measured at fair value unless it has received prior written approval from the Minister for Finance to measure these assets at cost.

(b) *Highest and best use (HBU)* – in measuring an asset’s fair value, an entity’s current use is its HBU. This is unless the annual assessment of the HBU indicators suggests that a different use by market participants would maximise the value.

(c) *Annual fair value assessment* – an entity must annually assess that the asset’s carrying amount reflects its fair value at the end of the reporting period, after taking into consideration all fair value indicators which include VGV land and building indices, the HBU and other relevant indicators.

4.5 AASB 13 *Fair Value Measurement*

4.5.1 Objective

AAS 13 sets out:

(a) In a single accounting standard a framework for measuring fair value and provides a definition and disclosure requirements for fair value.

(b) The fair value measurement for both assets and liabilities. This guidance note focus is only on the fair value measurement of assets.

4.5.2 Fair value definition

AAS 13 defines fair value as ‘the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date’ (paragraph 9).

The fair value definition is based on the ‘exit price’ and not the ‘entry price’ of the asset. Exit price is generally akin to the price that the market will pay for the asset, while entry price is the price that the purchaser will pay for the asset.

4.5.3 Key elements in fair value measurement

The standard requires the following to be taken into account when measuring the fair value.

(a) *Characteristics of the asset* from the market participants’ perspective. Examples of such characteristics include the:

(i) condition and location of the asset; and

(ii) any restrictions on the sale or use of the asset.

(b) *Market* where the asset is to be transacted, at either the:

(i) principal market for the asset; or

(ii) most advantageous market in the absence of the principal market.

An entity need not undertake an exhaustive search for all possible markets to identify the principal or most advantageous market. In the absence of evidence to the contrary, an entity’s principal market is one it would normally undertake the transaction in.

(c) *Market participant* with whom the entity would enter into a transaction in the market.

(d) *Price* that would be received to sell the asset in an orderly transaction in the principal (or most advantageous) market under current market conditions (i.e. an exit price), regardless of whether that price is directly observable or estimated using another valuation technique.

The price the market uses to measure fair value:

(i) excludes transaction costs, which are the costs to sell an asset that are directly attributable and essential to the disposal of the asset; and

(ii) includes transportation costs that would be incurred to transport the asset from its current location to the market. Transportation costs are excluded from the definition of transaction costs

(e) *Highest and best use (HBU)* of the asset by the market participants’ ability to generate economic benefits by using the asset in its HBU or by selling it to another market participant that would use the asset in its HBU.

HBU is determined from the market participants’ perspective in pricing the asset and takes into account the use of the asset that is:

(i) Physically possible – by considering the physical characteristics of the asset (e.g. the location or size of the asset).

(ii) Legally permissible – by considering any legal restrictions on the use of the asset (e.g. the zoning regulations applicable to a property).

(iii) Financially feasible – by considering whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

FRD 103F provides HBU indicators to assist an entity in determining whether the current asset use is its HBU. Refer to section 4.6 for more detail.

(f) *Valuation techniques* used must be appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs. Valuation techniques include the market approach, income approach and cost approach.

(g) *Inputs to the valuation techniques* are categorised into three levels i.e. level 1 based on quoted prices, level 2 based other observable inputs and level 3 based on unobservable inputs. The valuation technique selected must maximise the use of observable inputs and minimise the use of unobservable inputs.

4.6 FRD 103F Highest and best use (HBU) indicators

FRD 103F requires an entity in its annual fair value assessment to consider whether the HBU still remains applicable. Where the HBU has changed, the entity, in consultation with VGV, needs to assess if its existing HBU and fair value measurement basis is still appropriate. Appendix 1 provides an example of the fair value decision tree used by VGV.

An entity, as a minimum, must consider the external and internal HBU indicators in conjunction with the restriction on the use of the asset as outlined below.

4.6.1 External HBU indicators

(a) Changes in Acts, regulations, local laws or such instruments that may affect the use or development of the asset.

(b) Changes in a planning scheme, including zones, reservations, overlays that would affect or remove existing restrictions imposed on the assets’ use.

(c) Existence of government policies (e.g. Victoria Government Gazette) or public announcements with expectations that an asset is used in certain way to support service delivery.

(d) Government decisions declaring the asset’s redundancy or surplus.

(e) Evidence of social-environmental changes in public expectations of the assets’ use.

4.6.2 Internal HBU indicators

(a) When the use of an asset is at the entity’s discretion, plans or intentions that have been formally communicated for a different use of the asset from its existing use.

(b) Evidence suggesting the current use of an asset is no longer core to requirements to deliver an entity’s service obligation.

(c) Evidence suggesting the asset might be sold or demolished as it is nearing the end of its useful life.

4.6.3 Restriction on use of asset

In considering the internal and external indicators in determining the asset’s fair value, an entity should assess if the restriction on the use of the asset is a characteristic of the asset.

The restriction on the use of the asset:

(a) is a characteristic of the asset if the restriction is transferred with the asset when the asset is sold, e.g. crown land with permanent reserve. The market participants would likely factor the asset’s restriction when pricing of the asset; and

(b) is not a characteristic of the asset if the restriction is specific to the entity holding the asset and the restriction will not transfer with the asset when the asset is sold, e.g. crown land with temporary reserve. The restriction should not be considered when measuring fair value.

Determining whether a restriction is a characteristic of an asset or the entity holding the asset requires judgement on the specific facts and circumstances, including contractual arrangements on the use of the asset.

4.6.4 Implications of HBU indicators

When the HBU indicator individually or in combination:

(a) is not triggered, an entity can assume its current use is its HBU in measuring an asset’s fair value; or

(b) is triggered, an entity in consultation with VGV, needs to assess if its existing HBU and fair value measurement basis is still appropriate.

5 Valuation approaches

5.1 Selection of valuation techniques

In selecting the valuation technique, a valuer and management should consider:

(a) the technique that is appropriate in the circumstances and for which sufficient data is available to measure the fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs;

(b) that the objective of the valuation is to estimate the price at which an orderly transaction to sell the asset would take place between market participants, at the measurement date under current market conditions; and

(c) the use of the three common valuation techniques, which are the market, cost and income approach.

Appendices 2 and 3 provide examples that VGV, in conjunction with DTF, consider to be the likely fair value approaches for public sector assets.

5.2 Market approach

The market approach.

(a) Uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets or a group of assets, such as a business.

(b) Is generally used to assess the fair value of:

(i) non-specialised land, dwellings, vehicles and cultural assets where there is an active market;

(ii) non-specialised general or commercial buildings; and

(iii) specialised land; however, the assessed value based on the market approach may need to be adjusted for community service obligations (CSO) – refer to section 6 for guidance on CSO.

(c) It is referred to as the direct comparison approach in valuers’ terminology.

5.3 Income approach

The income approach.

(a) Converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. The fair value under this approach reflects the current market expectations about those future amounts.

(b) Is generally used only when the future economic benefit of the asset is primarily dependent on its ability to generate net cash inflows.

In instances when assets are used in a regulated-price market, consideration should be given to the significance of the regulated pricing on the asset’s future economic benefits. To the extent that the asset subject to regulated pricing is able to generate future economic benefit that is consistent with the current market expectations, the income approach will be considered as an appropriate valuation technique. Conversely, for assets that are subject to significant regulated pricing to the extent that the future cash flows do not represent the fair value of the asset, entities should consider another valuation technique (usually the cost approach) that best represents the asset’s fair value.

5.4 Cost or depreciated replacement cost approach (DRC)

The cost or DRC approach:

(a) represents the amount required to currently replace the service capacity of an asset (often referred to as DRC). This is the price based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. This assumes that fair value is the cost to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence as defined in AASB 13 Application Guidance B (which includes physical deterioration, functional (technological) obsolescence and economic (external) obsolescence.) Note: a valuer considers depreciation as the overall change in value of an asset due to the physical deterioration or obsolescence (which includes functional and economic factors).

Identify new cost of modern equivalent asset

Adjust for age/economic physical obsolescence/deterioration

Depreciated replacement cost/fair value

(b) Is generally used to assess fair value for:

(i) specialised buildings, plant and equipment with limited alternative use and/or substantial customisation; and

(ii) assets if there is no active market.

The accounting standards are quite explicit in that, when there is no open and liquid market or other indicators of market value (either through a market or income approach), entities should use a valuation technique that maximises the use of observable inputs. The cost approach should only be used when the other approaches are not available or are not representative of the fair value in the circumstances. This approach is commonly referred to as the DRC approach as the cost approach measures the value of the remaining service potential at current cost. Typically, the major assets controlled by public sector entities are the type that provide a community service and are not traded on an open and liquid market. Accordingly, their valuation basis would normally be depreciated current replacement cost. Examples would include regional water infrastructure, rail infrastructure roads and earthworks.

5.5 Fair value hierarchy

AASB 13 establishes a fair value hierarchy that contains three levels of inputs to the valuation techniques used to measure fair value. The hierarchy aims to increase the consistency and comparability in fair value measurements and related disclosures.

A fair value measurement is categorised in its entirety at the same level of the fair value hierarchy as the lowest-level input that is significant to the entire measurement. An input is significant if that input can result in a significantly different fair value measurement. AASB 13 requires consideration of factors specific to the asset.

Determining the significance of a particular input to a fair value measurement is a matter of judgement. A starting point is to have a basic understanding of all of the inputs that factor into the fair value measurement; the relative significance of each of the inputs; and whether those inputs are externally verifiable; or, are derived through internal estimates.

In assessing the significance of unobservable inputs to an asset’s fair value, the valuer should:

• consider the sensitivity of the asset’s overall value to changes in the data; and

• re-assess the likelihood of variability in the data over the life of the asset.

Given the level of judgement that may be involved, the valuer should always document the rationale when it is not straightforward to determine the classification of inputs in the fair value hierarchy.

5.5.1 Fair value levels of inputs

The three levels of inputs are as follows.

(a) Level 1 inputs are quoted market prices (unadjusted) in active markets for identical assets that an entity can access at the measurement date.

• This is the most reliable evidence of fair value and should not be adjusted to measure fair value except for the specified circumstances in paragraph 79 of AASB 13.

• Public sector assets generally would not apply Level 1 inputs in measuring fair value.

(b) Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset, either directly or indirectly.

(i) Level 2 inputs include:

• quoted prices for similar assets in an active or inactive market; and

• inputs other than quoted prices that is observable for the asset.

(ii) Adjustments to level 2 inputs vary depending on factors specific to the asset. The factors include:

• condition or location of the asset; and

• observable data for inactive markets adjusted for timing differences between the transaction and the measurement date, or differences between the asset being measured and a similar asset that was the subject of the transaction.

(c) Level 3 inputs are unobservable inputs for the asset.

When the adjustment to Level 2 uses significant unobservable inputs, the valuation for the asset may need to be categorised within Level 3. This may also affect the fair value disclosure of the asset. Following are examples of this circumstance.

• ‘Specialised land’ or ‘land under specialised buildings’ would be categorised within Level 3 of the fair value hierarchy. This results from the significant adjustment to Level 2 inputs (observable indirectly through corroboration with market data) for Community Service Obligation (CSO), which is derived based on significant unobservable inputs. This contrasts with ‘non-specialised land under investment properties’, when no significant adjustments are made to Level 2 inputs.

• Depreciation adjustments made to the direct market comparison approach will push the asset from Level 2 to Level 3 due to the level of judgement involved in estimating the asset’s useful life.

5.5.2 Disclosures

AASB 13 requires disclosure of sufficient information to help financial statement users to assess:

• valuation techniques and inputs used in the measurements of assets carried at fair value after initial recognition; and

• the effect on profit or loss, or other comprehensive income of recurring level 3 fair value measurements.

Management should also consider:

• the level of detail necessary;

• the degree of emphasis on each requirement;

• the degree of aggregation or disaggregation; and

• whether or not additional information is needed to evaluate the quantitative disclosures.

AASB 13 requires disclosures by class of assets. Grouping assets into classes is a judgemental exercise based on:

• the nature, characteristics and risk of the asset; and

• the level of the fair value hierarchy within, by which the fair value measurement is characterised.

In addition:

• more classes may be required for level 3 fair value measurements as those fair values are exposed to more uncertainty and subjectivity;

• classes will often be more disaggregated than balance sheet line items; and

• sufficient information should be provided to permit reconciliation to balance sheet line items.

5.5.3 Indicative fair value valuation levels

Public sector assets generally would apply Levels 2 and 3 inputs in measuring fair value because the assets are generally restricted in use, specialised and/or there is no active market that trades in these unique assets.

Appendix 3 and 4 provide examples that DTF consider to be the likely fair value levels for public sector assets based on the nature, characteristics and risks of the assets.

6 Guidance for valuers

6.1 Community service obligations (CSO)

6.1.1 CSO definition

CSO is an adjustment for the difference in value between unrestricted assets (e.g. freehold land) and assets held by the public sector, taking into account any legal, financial or physical restrictions imposed on the use or sale of the asset (e.g. restricted land due to a legal restraint).

Examples of assets that are subject to CSO are Crown land in a public use zone and iconic property restricted by legal, physical and financial constraints that would make it difficult to sell on the open market; or, where the constraints would affect the achievable value.

6.1.2 Application of CSO

FRD 103F and AASB 13 require land to be valued having regard to a HBU, taking into account any legal, financial or physical restrictions imposed on the use or sale of the asset. When there are restrictions on the use or disposal of the asset and there are restrictions on the alternative use, the land should be valued at the fair value for its current (existing) use, i.e. the value considering the HBU excluding the cost of achieving that value (e.g. creating a freehold title, rezoning, or overcoming the political or social constraints of an asset) considering the legal, financial and physical constraints.

The CSO adjustment is a reflection of the valuer’s assessment on the impact of restrictions associated with an asset to the extent that is also applicable to market participants. CSO is the difference between the hypothetical unencumbered fair value based on market evidence (i.e. HBU value without any restrictions) and the value ascribed to the asset based on its current use (existing value restricted by constraints). As the adjustments of CSO are considered significant unobservable inputs, specialised land would be classified as level 3 inputs.

6.1.3 CSO considerations

Valuers are expected to apply levels of value that are relative to the use and restriction of the land. The factors valuers use to adjust land values for CSO depends on the legal, financial and physical constraints applicable on the land.

The amount of adjustment applicable to each asset and portfolio depends on the risk factors associated with the property or portfolio and the likelihood that the entity would be able to sell the asset in the open market.

It should be noted that any CSO allowance reflects among other things the community’s attitudes and the government’s policy of the day.

6.1.4 Examples of CSO ranges

The table below provides examples of the ranges, in percentage, for the valuers to consider when determining the rate for the property they value. The adjustment factors are based on VGV’s extensive experience in assessing property valuations for government, on the results of court and tribunal decisions within Australia and on the limited sales evidence available. In all cases, the range of adjustment factors relate to the potential risks in achieving a rezoning of government held property assets, taking into account the economic, physical and political circumstances.

VGV provides the suggested adjustment factors and guidance to valuers, as required, to provide consistent assessment of similar assets across the State of Victoria.

*Table 1 – Examples of possible adjustments for CSO*

|  |  |
| --- | --- |
| **Type of asset** | **Appropriate CSO range (%)** |
| Land zoned residential, industrial, commercial etc. without government restrictions | 0 | 0 |
| Crown land – no planning or other restrictions | 10 | 20 |
| Hospitals, schools | 20 | 30 |
| Public housing in public use zone | 20 | 30 |
| Schools, TAFE colleges, universities | 20 | 30 |
| Arts centres/national galleries | 30 | 40 |
| State parks | 60 | 70 |
| Shrine of Remembrance, Government House | 60 | 70 |
| Water authorities (reservoirs, dams etc.)  |  | 90 |
| Cemeteries |  | 95 |

6.2 Valuation of land

Land should be valued at fair value and measured with regard to the HBU when and only when, there exists possible and feasible alternative uses in the existing natural, legal and financial environment and the alternative uses are feasible within the near future.

In assessing a feasible alternative use, general zoning restrictions should be distinguished from restrictions on current use that are placed on land by state and local government, which may be subject to change. The valuation considerations under AASB 13 must be based on the considerations of the market participant.

The types of zoning that would usually be relevant are general purpose zones, such as residential, commercial and industrial, while special zoning will reflect the current use such as ’public purpose reservation’ or floodway use. A public use may or may not impact on the potential HBU. The question to ask is whether the current zoning and use can be changed and how long would it take to amend.

In assessing public sector assets, land should be valued with regard to the HBU, including Crown land that is designated for development and/or disposal and land under general purpose building or plant, etc.

However, it should be noted that there can be natural, legal, political and financial restrictions on the use and disposal of land. If there are such restrictions on the use and disposal of land, and there is no feasible alternative use in the near future, the land should be valued at fair value for its existing use. For example, the valuation of restricted government assets such as parklands and heritage assets is based on the hypothetical HBU asset after due consideration is made for any legal, physical or financial restrictions imposed on the asset.

6.3 Valuation of buildings

In all cases, buildings and the land on which they are built must be considered together in determining whether there is an active and liquid market or feasible alternative uses exist.

For financial reporting purposes, separate classes of assets are reported; therefore a separate value must be attributed to land and buildings.

6.3.1 Non-specialised buildings

Non-specialised properties are valued by reference to direct market evidence and general valuation principles apply.

6.3.2 Specialised buildings

Specialised buildings are buildings designed for a specific limited purpose which may include schools, hospitals, courthouse and emergency services buildings, specialised buildings to house specialised infrastructure assets and some heritage and historic properties.

It should be noted that a specialised building may not be necessarily classified as specialised in all circumstances. In some instances, these special buildings have no or limited feasible alternative use because of a legal mandate to provide goods or services, or community obligations that the building permits. When there is no available market-based evidence, DRC would be regarded as the most appropriate method of valuation. In other instances (notwithstanding that a specialised building may be designed to provide community services), it may also be held for commercial objectives from the perspective of a market participant. In that case, the HBU may be for a commercial purpose, which can be fair valued using either a market value or income approach.

Therefore, professional judgement is required by the valuer to distinguish the difference between specialised and non-specialised buildings in order to determine the appropriate valuation method.

Similar to land, there may be circumstances when the specialised buildings may be identified as surplus to current needs. This could be due to services being moved to another location; they are no longer required for a strategic reason (e.g. a government decision to relocate a school); or, due to demographic changes (e.g. population movements).

In such cases, the entity must consider whether the HBU of the building has or can be changed, considering what is physically possible, legally permissible, and financially feasible. Those specialised buildings might have feasible alternative use if they can be converted into non-specialised buildings (i.e. commercial and general-purpose buildings and investment property for which there is a secondary market). In which case, the non-specialised buildings should be valued based on that higher feasible alternative use. Alternatively, if the HBU of the building in combination with the land can be achieved through selling the land as a vacant site, then the building and the land under the building must be valued as a group.

In cases of a surplus building subsequently being classified as held for sale in accordance with AASB 5 Non-Current Assets Held for Sale And Discontinued Operations, the entity must measure the building at the lower of its carrying amount and fair value less cost, to sell in accordance with the standard.

6.3.3 Heritage buildings

For heritage and iconic assets, the assessment of cost may need to consider the reproduction cost of the asset rather than replacement cost.

Valuers will be required to undertake the required research to determine the cost for the purposes of valuation and a quantity surveyor may be engaged to assist the valuer.

6.3.4 Componentisation

FRD 103F requires that when a building comprises components that can be separately identified and depreciated, the components should be separately identified and depreciated. This is applicable for assets that comprise of various components with materially different useful lives, and can be identified on a cost effective manner.

Componentisation relates to different useful (economic) life estimates that are determined by a process of analysis and observation.

The typical components are:

• structure/shell/building fabric;

• site engineering services and central plant;

• fit-out;

• trunk reticulated building systems; and

• combined fit-out and trunk reticulated building systems – this component is used for elements common to two of the components above where it is not practical to differentiate.

Entities and valuers should refer to FRD 103F for guidance on the depreciation of building components.

6.4 Valuation of investment property

AASB 13 requires the fair value for an investment property to be based on the property’s HBU. An investment property‘s fair value is typically based either on the market approach by reference to sales in the market of comparable properties or the income approach by reference to rentals obtained from the subject property or similar properties.

The cost approach is not appropriate for the fair value model under AASB 140 because the standard requires that the unit of account for an investment property is the property and the current leases. This effectively constrains the choice of valuation approaches. Fair value reflects rental income from current leases and other assumptions that market participants make about future rental income, based on current conditions.

The best evidence of fair value is usually provided by current prices in an active market for similar a property in a similar location and condition, and subject to similar lease terms and other conditions. Clearly, such conditions may not always be present and management should take into account and allow for differences from the comparable properties in location, nature and condition of the property; or, in contractual terms of leases and other contracts relating to that property. An example of this would be if the leased property contained restrictions on the uses to which the property may be put by present and future leases, which could significantly affect its fair value because it may restrict management’s ability to obtain the optimum market rentals.

When current prices in an active market are not available, valuers should consider evidence from alternative sources, such as:

• current prices in an active market for properties of a different nature, condition or location or that are subject to different lease or other contractual terms, adjusted to reflect the differences; and

• recent prices from transactions on lease active markets, adjusted to reflect changes in economic conditions since the date of those transactions.

Using the market approach to measure fair value of investment properties may be a level 2 measurement; although, if significant adjustments are made to the observable data inputs to the valuation, the measurement will be classified as level 3.

The fair value of an investment property may be measured using discounted cash flow projections based on reliable estimates of future rental income and expenditure, supported by the terms of existing leases and other contracts. Where practicable, external evidence should also be used, such as current market rents for properties of a similar nature, condition and location. Discount rates that reflect current market participants’ assessments of uncertainty regarding the amount and timing of cash flows should be used to discount the projected future cash flows.

Generally using the income approach to measure the fair value of investment property is likely to result in a level 2 measurement because the most significant input will be based on observable cash flows. However, it should be noted that in instances where it is based on projected cash flows that are not observable in the market, it would be a level 3 measurement.

It should be noted that the fair value model for investment properties needs to comply with the disclosure requirements of AASB 13, as well as the additional disclosures required by AASB 140.

6.5 Depreciated replacement cost

6.5.1 Fair value of asset based on depreciated replacement cost

As outlined AASB 13, the asset’s fair value can be assessed at the price that would be received to sell the asset (an exit price).

In the absence of a market, AASB 13 states that the entity (or valuer) should use valuation techniques that are appropriate in the circumstances and for which sufficient data is available, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

In this case, the best indicator of an asset’s fair value can be estimated using DRC. AASB 136 defines DRC as ’the cost of an asset less, where applicable, accumulated depreciation (calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset)’.

AASB 136 provides an exception for not-for-profit entities, so that only when the future economic benefits of an asset are primarily dependent on its ability to generate net cash inflows should the income approach be applied. In all other cases, the DRC approach would be more appropriate. This is because the exit price concept may be difficult to apply when there may be no active market for not-for-profit and public sector entities.

If the primary use of an asset is to fulfil a community service, then the DRC approach should be used unless there is a clear and obvious market for the asset. If part of the asset is income producing, which is secondary to providing community/public service use, the DRC approach should still be used, e.g. the primary use of a railway station is to provide a transport hub for the community – any income generated is secondary and can be used to offset operating cost.

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or transfer the liability would take place between market participants, at the measurement date and under current market conditions.

The cost approach or DRC reflects the amount that would currently be required to replace the service capacity of an asset. That is, from the perspective of a market participant seller, the price that would be received for the asset based on the cost to a buyer to acquire or construct a substitute asset of comparable utility, adjusted for depreciation and impairment.

The fair value of non-financial physical assets, measured using the replacement cost method, presents the highest value that a market participant would pay for an asset with similar utility. The cost approach is based on the principle of substitution. It uses costs to replace an asset as an indicator of the fair value of that asset. To determine the appropriate substitute asset or asset group as a measure of fair value, the utility of the replacement asset is compared to the utility of the asset being measured. Comparable utility implies similar economic satisfaction, but does not necessarily require that the substitute asset is an exact duplicate of the asset being measured. The cost of an exact duplicate is referred to as reproduction cost. The substitute asset is perceived as equivalent if it possesses similar utility and, therefore, serves as a measure of fair value for the asset being valued.

This approach is based on the premise that a market participant buyer would not pay more for an asset than the amount it could cost to replace the service capacity of that asset. DRC is based on modern equivalent assets (MEA) on an ‘optimised basis’, adjusted for over-design, as at the date of valuation.

6.5.1.1 Heritage assets

For heritage and iconic assets, cost may be the reproduction cost of the asset rather than the replacement cost because their service potential could only be replaced by reproducing them with the same materials. When heritage assets provide a functional service (e.g. accommodation or education), as well as possessing heritage significance, it should be kept in mind that the replacement cost of its capacity to provide the functional service will normally understate the gross current cost of the asset’s total service potential. Valuers need to research the appropriate cost for the purposes of DRC assessments. Alternatively, a quantity surveyor may be engaged to assist the valuer.

The service potential of assets, which do not depend on an ability to generate net cash inflows, may comprise some or all of the assets controlled by a not-for-profit entity. The assets are held primarily to provide goods and services in accordance with the entity’s objectives, and their future economic benefits are not limited to their ability to generate net cash inflows. As a result, the entity would only replace the assets’ capacity to provide goods and services.

6.5.2 Useful life

AASB 116 ‘Property Plant and Equipment’ defines depreciation as ‘the systematic allocation of the depreciable amount of an asset over its useful life’.

Useful life is defined as:

• the period over which an asset is expected to be available for use by an entity; or

• the number of production or similar units expected to be obtained from the asset by an entity.

The useful life of an asset is defined in terms of the asset’s expected utility to the entity. Valuers are required to consider and assess a useful life and remaining useful life, and as such need to be aware of this so they can allocate an age and ’remaining useful life’ to each asset valued for recording purposes.

When determining the useful life and remaining useful life of an asset, the valuer should consider to the following factors:

• discussions with the entity regarding their asset management and renewals program, i.e. the maintenance expected, assumed quality of the modern equivalent asset and the environment in which the asset is operated or constructed;

• existing age and condition of the asset;

• management’s expected usage of the asset;

• expected physical wear and tear;

• technical or commercial obsolescence;

• legal or similar limits on the use of the asset; and

• estimated future economic benefit generated from the asset.

6.5.3 Residual value

In accordance with AASB 116, the residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal – if the asset were already of the age and in the condition expected at the end of its useful life. In the Victorian public sector, FRD 103F deems the residual value of all non-financial physical assets, other than vehicles, to have a residual value of zero, unless there is evidence to the contrary.

It should be noted that, as the residual value of infrastructure assets reflects consideration receivable for an asset at the end of its useful life to the entity, it should not include cost savings from the re-use of in-situ materials.

6.5.4 Obsolescence

The concept of the cost approach in AASB 13 is based on replacing the ‘service capacity’ of an asset (AASB 13, App A defined terms). When determining the cost to replace the service capacity of an asset, reference should be made to a substitute of comparable utility (i.e. modern equivalent asset), adjusted for obsolescence (AASB 13, B9). This should include all costs that could be incurred by a typical market participant seeking to create an asset of comparable utility. Fair value should take into account the characteristics of the particular asset, including the condition and location of the asset.

In the absence of an AAS definition for obsolescence, the International Valuation Standard refers to following three types of obsolescence:

• physical deterioration;

• functional (technological) obsolescence; and

• economic (external) obsolescence.

*Physical obsolescence* is any loss of utility due to physical deterioration of the asset from age and normal usage. Some physical deterioration is curable by repair and maintenance, which can be estimated by the cost to cure it. Other causes of physical obsolescence cannot be remedied and are a factor of the portion of the useful life consumed.

*Functional obsolescence* refers to any loss of utility from inefficiencies in the asset compared to its replacement that results in a loss of value. There are two forms of functional obsolescence:

• excess capital costs when the asset has higher capital costs than the modern equivalent asset, as a result of changes in design, materials, technology or manufacturing techniques; and

• excess operating costs when the asset has higher operating costs than the modern equivalent asset, caused by improvements in design or excess capacity (see economic obsolescence below).

*Economic obsolescence* is a loss of utility caused by external factors relating to changes in supply and demand. An example of economic obsolescence is when the asset has excess capacity compared to reasonably foreseeable demand.

In not-for-profit entities, a test of ‘service potential’ can be applied when the service potential provides the means for an entity to achieve its objectives and provide benefits to those using the asset. If an asset is still in use (e.g. providing core services or other ancillary community use), no adjustment should be made for economic obsolescence. When an asset has been identified as surplus to the needs of the entity and is still subject to the restrictions on its current use (i.e. not available for sale or for a better use), this may indicate that the asset could be impaired. In this case, an entity shall determine the asset’s recoverable amount in accordance with AASB 136. In circumstances of the previous restrictions imposed on the surplus asset being removed, the entity must consider if there is a better or higher use of the asset, either through sale or other uses. For an asset that has been subsequently classified as held for sale in accordance with AASB 5, it must be measured at the lower of its carrying amount and fair value less cost to sell in accordance with the standard.

6.5.5 Modern equivalent asset (MEA)

International Valuation Guidance Note No 3.3.1 *Valuation of Public Sector Assets for Financial Reporting* and 8.3.1 *The Cost Approach for Financial Reporting (DRC)* define DRC as ’the current cost of replacing an asset with its modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation’.

The carrying amount of a depreciable asset must reflect the remaining economic benefits of the asset. Therefore, the replacement cost of the MEA is reduced to exclude the economic benefits already consumed or expired for the current asset.

The use of replacement cost as a basis of measurement first requires consideration of the existing asset for any excess capacity, over design (’gold plating’) or redundancy. Such consideration is commonly referred to the concept of the ’modern equivalent asset’. Permanent excess capacity and any redundant assets or components that are not severable should have no value assigned to them, unless the asset is still in use (refer to section 6.5.5).

The modern equivalent asset is defined as ’an asset which has a similar function and equivalent productive capacity to the asset being valued, but of a current design and constructed or made using current materials and techniques’.

Australian Valuation Guidance Note 1 (AVGN1) – Valuations for Use in Australian Financial Reports 1.2.6 provides IVSC definition, which defines MEA as ’an asset similar to an existing asset and having the equivalent productive capacity, which could be built using modern materials, techniques, and design. Replacement cost is the basis used to estimate the cost of constructing a modern equivalent asset’.

Redundant assets that are severable from the network should be valued at market selling price, less costs to sell, (exit price). Over designed ’gold plated’ assets have features that are not required for the services they provide. These features will not be included in the replacement cost of a modern equivalent asset.

The replacement cost of an asset must be determined for each component of the asset, notwithstanding that certain components may not actually need to be replaced (i.e. road earthworks).

6.5.6 DRC approach for specialised assets

To measure the fair value of specialised plant and infrastructure assets, the valuer must determine a transaction price (exit price), the best indicator of which is the DRC. This is arrived at first by determining the replacement cost of the full service potential of the existing asset, then adjusting this cost to take account of the expired service potential of the asset.

The first step in a cost approach is to identify the asset’s replacement cost. This will include investigation of the original cost (if relevant).

Replacement cost represents the indicated value of current labour and materials necessary to construct or acquire an asset or similar utility to the asset being measured.

Next, adjustments are made to the replacement cost to represent any losses in value due to physical deterioration, functional obsolescence or economic obsolescence of the asset, which results in the value of replacement cost being adjusted for depreciation and impairment.

Physical deterioration represents the loss in value due to the decreased usefulness of a fixed asset as the asset’s useful life expires. This can be caused by factors such as wear and tear, deterioration, physical stresses and exposure to various elements.

Functional obsolescence represents the loss in value due to decreased usefulness of a fixed asset that is inefficient or inadequate relative to the other more efficient or less costly replacement assets provided by new technological developments. If the asset has excessive operating costs relative to a new asset, this may indicate a form of functional obsolescence. If in developing a new replacement cost for an asset, that replacement cost is less than its reproduction cost, this may also be indicative of a form of functional obsolescence. The objective of the measurement is to identify the replacement cost of a modern equivalent asset.

However, no adjustment for economic obsolescence will be made for the value of a fixed asset if the asset is still in use (e.g. providing core services or other ancillary use).

Appendix 5 provides further guidance for specific asset classes.

6.5.7 Assets constructed to mitigate against extreme weather conditions

There are certain assets that are designed and constructed to provide ‘future-proofing’ against extreme weather events such as potential drought conditions such as large-scale desalination plants and water storage. Given the nature of these assets, it is unlikely that optimisation will be required because they are designed and constructed to meet inherently unpredictable, extreme and irregular weather conditions. Note: these assets are built for purpose to meet rare events.

7 Resources

AASB 13 *Fair value measurement*

AASB 116 *Property, plant and equipment*

AASB 136 *Impairment of assets*

AASB 140 *Investment property*

FRD 103F *Non-financial physical assets*

FRD 107A *Investment properties*

AASB Staff paper - Fair value, deprival value and depreciated replacement cost February 2001

NSW Government Treasury Accounting Policy TPP 14-01 *Valuation of physical non-current assets at fair value*

NZ Treasury *Valuation guidance for property, plant and equipment including specialised items in the Health and Education Sectors 2007*

8 Contact details

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Appendix 1 Fair value decision tree

Australian state and territory Valuers-General have agreed on the process involved in deciding the method to use for financial reporting in the government sector. A simplified high-level decision tree has been reproduced for guidance and should be viewed as a guide only.

**Valuer-General fair value decision tree for non-current physical assets in the public sector***Guidance to valuers in carrying out valuations to satisfy AASB 116*

**PROPERTY ASSETS**

1) Measure fair value at highest and best use of feasible alternatives based on market evidence.

Fair value = net market value (less costs to sell)

**SUMMARY**

Fair Value is determined by:

1) Market value – highest and best use in an active and liquid market.

2) Current market price of a similar asset.

3) Price of the most recent transaction for similar asset.

4) Depreciated replacement/ reproduction cost of the remaining future economic benefits.

Heritage: mandated by Government to be replicated requiring a valuation of the reproduction cost and the value of land supporting the heritage asset.

Where no liquid or active market exists Fair Value = Land Value + DRC, taking into account the resitricted nature of the site due to current use.

Is the asset surplus to the entity’s requirements?

2) Current market selling price is best evidence of fair value.

Market Value = price in an active and liquid market

Yes

No

Is there a quoted market price in an active and liquid market available for the asset?

Yes

No

Are there current market selling prices or recent transation prices available for the same assets or assets that are similar in use, type and condition? (Are there any comparable sales?)

3) Determine fair value using available comparison sales evidence.

Yes

No

No

4) Work out the depreciated replacement/reproduction cost of the asset’s remaining future economic benefits.

Value = restricted land value + DRC

Is the asset a specialised public sector asset that is primarily held to generate net cash flows?

**KEY**

DCF = Discounted cash flow

DRC = Depreicated replacement cost

FV = Fair value

NPV = Net present value

Yes

Work out the NPV of the cash flows using DCF

Appendix 2 Examples of public sector assets and the methods of valuation

|  |
| --- |
| **Crown land used for parks, recreation areas and open spaces**This land will generally be restricted for use by the community as passive recreation. While this type of land may occasionally come up for sale in the open market, the frequency of sales evidence does not necessarily make this an active and liquid market.The land is generally restricted in terms of its community service obligations and the current use would be regarded its HBU. On this basis, given there is no active and liquid market, the valuer needs to consider sales evidence from comparable sales (as much as possible) but adjust for the restrictions in the use of that type of land. |
| **State government offices**If there is sufficient market evidence and an active and liquid market, the valuer will determine the fair value based on the market approach. If the offices are of a specialised nature, then a depreciation replacement cost approach will apply. |
| **State Library of Victoria/museum/Shrine of Remembrance/Arts Centre/National Gallery/Government House/State Parliament**These assets are highly specialised and have no feasible alternative uses. As a result, they will be valued using the DRC approach. If the asset is listed in the heritage register or is an iconic heritage asset, it should be valued on a reproduction cost basis. |
| **State Hockey Centre/State Netball Centre/Tennis Centre/State Aquatic Centre**These are specialised assets with no active and liquid market sales evidence. As a result, the land will be valued taking into account the restrictive use, and the building will be valued using the DRC approach. |
| **Information centres/halls/scout halls/guide halls/community centres**These are specialised assets with no active and liquid market sales evidence. As a result, the land will be valued based on the underlying zoning values in the area subject to the restrictive use, and the building will be valued using the DRC approach. |
| **Aged care complexes**While sale of these specialised assets do occur in the open market and there can be an inferred ’active and liquid’ market; at times, consideration needs to be given to where the centre is located, how many there are in the area, sales evidence of similar types of property and any special restrictions that might apply to the centre.In general, aged care complexes are measured using the DRC approach because the assets are built specifically to meet the obligations of the entity and may not be marketable without significant discounting or renovation. |
| **Dwellings**It should be noted that some public sector agencies own residential houses, units and apartments in a tradeable normal zone. In general, dwellings that are used as such and could be readily sold in the residential market would be valued on a direct comparison market value approach, based on sales evidence. There will be situations, however, where dwellings are just part of a much bigger complex and may be surplus to requirements.In some cases the dwellings will add little or no value if the land underneath is destined for other uses in the near future. Only the requesting authority will know these facts and will need to be consulted. |
| **Conservation reserves/forest areas/state plantations** The valuation of reserves, national parks, forests and plantations should be valued based on the assumption of the HBU considering comparison with available sales in an active and liquid market, However, adjustments need to be made for zoning and the CSO to reflect the physical and legal constraints on selling the land or using the sites for alternative uses. |

Appendix 3 Typical valuation approaches by asset classes

|  |  |  |
| --- | --- | --- |
| **Asset type** | **Approach to valuation** | **Level** |
| Freehold land | Because freehold land is traded on an open and liquid market, the valuation basis will be market value. Each parcel of land is, however, unique and the valuation will be determined by reference to the sale prices of similar or reference sales  | 2 |
| Restricted land | This type of land is not able to be traded in an open market and its value is not linked to its income-operating capacity. The valuation basis will be a cost approach and determined by reference to the sale prices of parcels of freehold land similar characteristics. | 3 |
| Residential buildings | Because residential buildings are traded in an open and liquid market, the valuation basis will be market value. Each asset is, however, unique and the valuation will be determined by reference to the sale prices of similar or reference sales. | 2 or 3 |
| Commercial buildings | The values of these are usually determined using either a market value or income approach by reference to sales or similar buildings and analysis of the gross and net assets, leasing rates, vacancy rates, outgoings and other factors. | 2 or 3 |
| Specialised buildings | The nature of the public sector is that entities often have buildings that service a specific purpose and, as a consequence, may have specialised features built into them or be in a specific location. As a consequence, they are normally considered specialised buildings and are normally valued at depreciated current replacement cost.The building may be componentised into different parts and valued and depreciated separately. The cost will be determined by reference to the actual construction costs or other similar or reference buildings, standard rates obtained from construction guides and, in some cases, costs developed from first principles using prices for materials and taking into account allowances for design and construction. | 3 |
| Infrastructure assets operated by a for-profit entity | The nature of these assets is that their overall value is based on the income-generating capability of the business as a whole, As a consequence, an income approach will be used, which takes into account the cash inflows and outflows, with allowance made for risks, discount factors and a range of other information. These assets are often subject to regulatory pricing and therefore, if pricing is out of the control of the entity, there may be significant uncertainty regarding future income streams. | 2 or 3 |
| Infrastructure operated to provide a service to the community at no or nominal fee. This may include government business entities. | These typically comprise the bulk of assets operated by the public sector and include assets such as roads, bridges, parks, footpaths, rail, water and sewerage infrastructure. These assets would be valued at depreciated current replacement cost by reference to actual construction of similar assets, unit rates of construction guides or costs developed from first principles using prices for materials and taking into account allowances for design and construction. | 3 |

Appendix 4 Indicative fair value valuation levels

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Asset class** | **Examples of asset types** | **Expected fair value level** | **Likely valuation approach** | **Significant inputs (Level 3 only)** |
| Buildings – Non-specialised  | * For general/commercial buildings that are just built
 | Level 2 | Market | N/A |
| Buildings – Specialised(a)  | * Specialised buildings with limited alternative uses and/or substantial customisation

(e.g. prisons, hospitals, and schools) | Level 3 | Cost  | * Cost per square metre
* Useful life
 |
| Cultural assets | * Artworks, for which there is an active market for the item
 | Level 2 | Market  | N/A |
| Cultural assets | * Museum/library collections, for which there is no active market for the item
 | Level 3 | Cost | * Cost per unit
* Useful life
 |
| Dwellings(a) | * Social/public housing, employee housing
 | Level 2, where there is an active market. | Market  | N/A |
|  |  | Level 3, where there is no active market | Cost | * Cost per square metre
* Useful life
 |
| Heritage assets | * Shrine of Remembrance
* Governor’s House
 | Level 3 | Cost | * Cost per square metre
* Useful life
 |
| Plant and equipment(a) | * Specialised items with limited alternative uses and/or substantial customisation
 | Level 3 | Cost | * Cost per square metre
* Useful life
 |
| Infrastructure(a)(b)  | * Water infrastructures (metro)
 | Level 3 | Income | * Estimated cash flow per year
* Discount rate
 |
|  | * Water infrastructure (regional)
* Rail infrastructure(i)
* Others(i)
 | Level 3 | Cost | * Cost per unit
* Useful life
 |
| Land – Non-specialised  | Where there is an active market for:* Vacant land
* Land not subject to restrictions on use or sale
 | Level 2 | Market  | N/A |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Asset class** | **Examples of asset types** | **Expected fair value level** | **Likely valuation approach** | **Significant inputs (Level 3 only)** |
| Land – Specialised | * Land subject to restriction on use and/or sale
* Land in areas where there is no active market
 | Level 3 | Market | CSO adjustments |
| Road, infrastructure and earthworks(a)  | Any type | Level 3 | Cost | * Cost per metre
* Useful life
 |
| Vehicles | * If there is an active resale market available;
 | Level 2 | Market  | N/A |
|  | * If there is no active resale market available
 | Level 3 | Cost | * Cost per unit
* Useful life
 |

*Notes:*

*(a) Newly built or acquired assets could be categorised as Level 2 assets as depreciation would not be a significant unobservable input (based on the 10 per cent materiality threshold).*

*(b) Infrastructure systems include railways, rail bridges, rail tunnels, harbours, pipelines. Dams and major components of water supply networks e.g. pump.*

Appendix 5 Supplementary guidance for specific asset classes

The public sector controls a wide range of assets. Examples include but are not limited to the following asset classes.

*Table 1 Typical asset classes*

|  |  |
| --- | --- |
| **General category** | **Asset classes** |
| Land | Land – non specialised (freehold)Land – specialised (parks and gardens, cemeteries, land under water) |
| Buildings | Buildings – non specialised (commercial buildings, social/public housing)Buildings – specialised (Governor’s house, Shrine of Remembrance, prisons, hospitals, schools) |
| Miscellaneous | Cultural assets (art works, museum/library collections)Plant and equipment |
| Road infrastructure | Sealed and unsealed roadsBridges, culvertsKerb and channelTraffic signals and traffic management devices |
| Water infrastructure | Water mainsWater meters and servicesWater equipment and civil assetsDams, weirs and canals |
| Sewerage infrastructure | Sewerage pipesSewerage manholesSewerage equipment and civil assets |
| Miscellaneous infrastructure | Major civil assetsMarine assetsFoot paths and cycle ways |

The following guidance is provided for a selection of these different asset types. The following should be seen as guidance only. Ultimately it is the responsibility of the department or entity to adopt an approach which is appropriate given its particular circumstance and requirements.

**Non-specialised land**

Freehold land can be openly traded, which would require a freehold title. It may also exhibit indicators of some form of impairment, e.g. floods or contamination. This type of land would be valued at market value by a valuer.

**Specialised land**

Specialised land is land that has been designated Crown land, reserve or has specific restrictions placed on it (legal, financial or physical), resulting in its inability to be traded in the market. The fair value of land is generally assessed using a market based direct comparison approach, whereby the specific block of land is compared to comparable sales of similar allotments, with adjustments for points of difference to establish the fair value of that block of land. The value is then adjusted, if appropriate, for a CSO allowance reflecting the legal, financial or physical constraints and the associated risk of removing the restrictions.

**Specialised buildings**

Buildings that are considered to be specialised should be valued using the DRC or cost approach. In some rare cases, the income approach can be used.

The income approach should only be used if its value is primarily dependent on its income generating capability. The use of discounted lease streams to provide access to sections of the community that could not afford to pay the lease at full market price would indicate the asset is not dependent on its cash-generating capability.

**Non-specialised buildings**

Typically, the market value will be determined for the entire site (including all structures, improvements and the land on which the building is located). Once the overall market value has been determined (using the direct market comparison or income approach), the valuer needs to determine the value of the land component. This is typically done using the vacant land rate. The difference between the overall market value and the land component is the building part.

**Buildings and other structures (valued using the cost approach)**

These typically comprise buildings and structures that are constructed with special properties or designs, built in specific locations with no active and liquid market. The various assets may comprise an overall facility that delivers a particular service to the community. As such, they need to be valued on the cost approach. Examples include hospitals, prisons, court houses, work depots, etc.

**Componentisation**

Each asset will need to be componentised to allow for condition assessment and determination of depreciation expense. Each component should:

• be significant in cost (however for asset management purposes, some departments and entities may choose to treat some parts with lower costs as a separate component); and

• have a different useful life or depreciation pattern.

Consideration needs to be given to the level of detail required given the size and nature of the associated facility asset. The conclusions reached from this analysis should be incorporated in the respective department’s or entity’s non-current assets policy or valuation and depreciation methodology.

**Determining the gross current replacement cost**

The cost will typically be determined by either or a combination of:

• recent construction costs by the entity or a similar entity;

• details provided from an industry construction guide;

• benchmark against similar entities; and

• valuers in-house cost databases.

The source of data and process used to arrive at the final cost needs to be well documented. It also needs to be assessed against the level of valuation input as specified in AASB 13 as different levels have a significant impact on the level of disclosure required in the financial statements.

**Pattern of consumption and depreciation**

Due consideration needs to be given to the:

• factors that drive the economic consumption of the asset and each component;

• likely pattern of consumption for each component; and

• likely asset management treatments and subsequent impact on the useful life and residual value for each component.

The drivers of consumption are usually holistic (such as functionality, capacity, utilisation, obsolescence, equitable access and safety) and component-specific (such as physical condition and history).

Typically, as buildings age the impact of the holistic factors becomes increasing more important and physical condition is less important.

Once assessed, these and the assessed pattern of consumption need to be documented and used within an appropriate valuation depreciation methodology to determine the level of consumed future economic benefit (accumulated depreciation) and depreciation expense.

It is also important to document the evidence to support the key assumption used to support the valuation.

**Road infrastructure**

• Road infrastructure typically comprise a range of different asset types which, due to their different nature, characteristics and asset management regimes, should be classified as different asset classes. Typically, these include:

- sealed roads;

- unsealed roads;

- bridges;

- culverts;

- kerb and channel (gutters);

- traffic signals;

- traffic management devices;

- road furniture and signs;

- street lighting;

- footpaths and cycle ways; and

- stormwater and drainage.

**Segmentation**

The bulk of these types of assets are commonly referred to as lateral assets because they stretch for some distance. As such, these assets need to be segmented.

Each segment should be homogeneous, in that they should comprise the same characteristics (such as width and material) and have the same condition across the entire segment. Once the overall portfolio is segmented into these different sub-populations, the valuation can then be performed efficiently using a range of assumptions.

In an urban environment, it is usual to break the segments into intersections. However, in a rural environment, the distance between intersections may be long, with the road experiencing significant change in the underlying characteristics and condition.

In this situation, it is advisable to set a maximum segment length and smaller segments in places where that part of the road network is expected to have a different consumption pattern from the other parts.

**Other infrastructure**

The process for all other infrastructure is the same as for roads. It includes identification of the appropriate:

• segments;

• components;

• costs;

• factors the drive the consumption;

• asset lifecycle and treatments and subsequent impact on useful life and residual value; and

• valuation and depreciation methodology.

Consideration needs to be given to the level of detail required because of the size and nature of the associated facility asset. The conclusions reached from this analysis should be incorporated in the respective department’s or entity’s non-current assets policy or valuation and depreciation methodology.