

Assets - Valuation of Physical Non-Current Assets at Fair Value

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Summary The Valuations of Assets policy has been tailored to NSW Health needs with reference being made to the Department's 3 yearly revaluation policy, the need to engage external valuations, the recognition of heritage assets at "written down replacement" of a modern equivalent asset, the exclusion of Plant & Equipment from revaluation requirements, the expectation that there are no investment properties. The updated policy should not require any change in accounting treatment with NSW Health and the prime benefit of its issue is to consolidate various instructions issued and extend the guidance available.

Author Branch Finance and Business Management

Branch contact Tim Cheeseman 9391 9175

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This Policy Directive may be varied, withdrawn or replaced at any time. Compliance with this directive is **mandatory** for NSW Health and is a condition of subsidy for public health organisations.

**Accounting Policy:
Valuation of Physical Non-Current Assets at Fair Value**

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Preface

This Accounting Policy provides guidance for valuing physical non-current assets at fair value for general purpose financial reporting, taking into account the unique circumstances of the public sector. The aim is to provide relevant and reliable information for decision making and ensure a consistent approach to asset valuation across NSW Health.

Many assets with NSW Health have few or no alternative uses in the existing socio-political environment and many assets, including infrastructure assets, are specialised. The Policy & Guidelines Paper therefore clarifies the meaning of 'fair value' for assets with few or no alternative uses.

The policy also provides practical guidance on valuing:

- Land and buildings, including specialised and general buildings and investment property;
- Specialised plant and infrastructure assets;
- Specialised assets that form part of a cash-generating unit; and
- Heritage assets.

This Policy is applicable to all NSW Health entities for financial years ending on or after 30 June 2007. The Policy is consistent with the Australian Equivalents to International Financial Reporting Standards (AEIFRS).

Executive Summary

Physical non-current assets comprise a significant proportion of NSW Health assets. These assets are used to meet Government objectives and desired outcomes through the delivery of goods and services. The purpose of this Policy & Guidelines Paper is to provide practical guidance for valuing physical non-current assets for general purpose financial reporting. This will provide relevant and reliable information for decision-making and ensure a consistent approach to asset valuation across NSW Health.

Subsequent to initial recognition, Australian Accounting Standards AASB 116 *Property, Plant and Equipment* and AASB 140 *Investment Property* require assets to be valued at fair value or cost. In addition, property, plant and equipment are subject to an impairment test in AASB 136 *Impairment of Assets*. This paper provides guidance not provided in AASB 116, AASB 140 and AASB 136 to measure the fair value of assets taking into account the unique circumstances in the public sector. Many assets within NSW Health have few or no alternative uses in the existing socio-political environment and many assets, including infrastructure assets, are extremely specialised.

This Policy has been updated for amendments to the Australian equivalents to International Financial Reporting Standards (AEIFRS) requirements applicable to financial years ending on or after 30 June 2007. In practice, however, no change is expected within NSW Health. There will be no difference for NSW Health entities, as this Policy has been amended, based on references to other similar requirements in other current Accounting Standards, or by incorporating the withdrawn Guidance into this Policy, where indicated.

This Policy provides the following:

- Fair value is measured having regard to the highest and best use for an asset. However, where there are socio-political restrictions such that the asset has no feasible alternative use in the near future, the asset is to be valued at fair value for its existing use.
- Where current market prices cannot be observed, an asset's fair value in AASB 116 is measured at depreciated replacement cost.
- The income approach option in AASB 116 should not be applied for specialised property, plant and equipment. This is because, for specialised public sector assets, where there is no feasible alternative use, depreciated replacement cost is the most relevant valuation method.
- Replacement cost is measured by reference to the lowest cost of replacing the economic benefits with a technologically modern equivalent optimised asset, having regard to differences in the quality and quantity of outputs and operating costs, and adjusting for over-design, overcapacity and redundant components.
- For a not-for-profit entity, where an asset does not belong to or constitute a cash-generating unit, it cannot be impaired under AASB 136, unless selling costs are material.

Using the above, the policy provides separate practical guidance on how to value:

- Land and buildings, including specialised and general buildings and investment property;
- Specialised plant and infrastructure assets;
- Heritage/cultural assets.

Further, the policy provides practical guidance on the following issues:

- The difference between fair value and deprival value;
- Issues associated with a pre-tax versus a post-tax weighted average cost of capital;
- For-profit/not-for-profit classification;

1. Introduction

1.1 Purpose of Policy

The purpose of this Policy is to provide practical guidance for valuing physical non-current assets for general purpose financial reporting.

Physical non-current assets comprise a significant proportion of NSW Health assets. These assets are used to meet Government objectives and desired outcomes through the delivery of goods and services. The objective of valuing these assets is to report on the value of economic benefits embodied in the asset. This will provide relevant and reliable information for decision-making about resource allocation, performance measurement and accountability and ensure a consistent approach to asset valuation across NSW Health.

1.2 Fair value adopted

The purpose of financial reporting is to provide relevant and reliable information for decision-making purposes. Based on this purpose, fair value is the most relevant measurement attribute for physical non-current assets, and that sufficiently reliable estimates of the fair value of assets can be determined.

After initial recognition, Australian Accounting Standard AASB 116 *Property, Plant and Equipment* requires each class of non-current assets to be measured using either the cost model or the revaluation model (i.e. on a fair value basis) (AASB 116, para 29). Further, AASB 140 *Investment Property* requires all investment property to be measured on either the cost model or the fair value model. Consistent with past practice, all physical non-current assets, including investment property, are to be valued on the fair value basis.

1.3 Application

This Policy applies to all Health Services.

The Policy applies to all physical non-current assets, except:

- Inventories (see AASB 102 *Inventories*);
- Assets arising from construction contracts (see AASB 111 *Construction Contracts*);
- Biological assets (see AASB 141 *Agriculture*); and
- Mineral rights and reserves and assets subject to AASB 6 *Exploration for and Evaluation of Mineral Resources*.

This Policy applies to financial years ending on or after 30 June 2007. This Policy is consistent with the relevant Australian equivalents to International Financial Reporting Standards.

In practice, however, no change is expected within NSW Health entities, as this Policy has been amended, based on references to other similar requirements in other current Accounting Standards, or by incorporating the withdrawn Guidance into this Policy, where indicated.

In addition, further guidance has been included in the Policy distinguishing 'investment property' (that is subject to AASB 140) from other property.

2. Overview of Valuation Policy

2.1 General property, plant and equipment valuation principles

Physical non-current assets are to be valued at fair value in accordance with Australian Accounting Standards AASB 116 *Property, Plant and Equipment* and AASB 140 *Investment Property*. Fair value is defined as “the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction” (AASB 116, para 6, AASB 140, para 5).

The valuation of property, plant and equipment (excluding investment property) is determined in a two-step process. First, “fair value” is determined in accordance with AASB 116. Second, the AASB 116 “fair value” is subject to a separate “impairment” test as part of AASB 136 *Impairment of Assets*.

Investment property is separately discussed in section 3.3. The concept and definition of fair value in AASB 116 and AASB 140 are identical. Therefore, while not strictly applicable, the AASB 116 fair value decision tree can be equally applied to investment property subject to AASB 140. However, unlike property, plant and equipment subject to AASB 116, investment property:

- Is not subject to AASB 136 and impairment testing.
- Is accounted for under the fair value model, with changes in fair value recognised in the income statement rather than the asset revaluation reserve (revaluation model).

2.1.1 Step one - Valuation principles in AASB 116

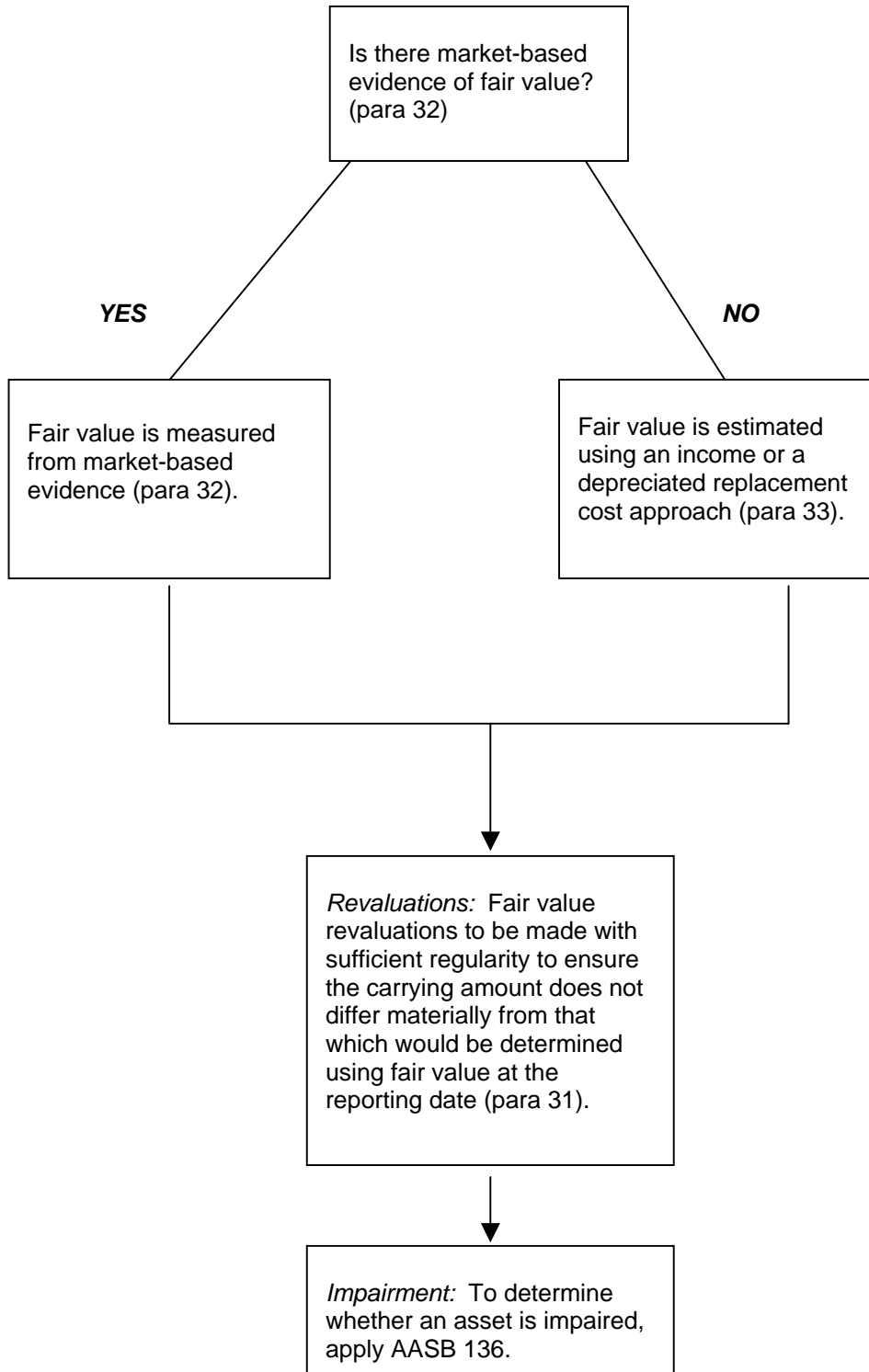
AASB 116 contains the following three principles to apply the above definition of fair value:

1. Fair value is usually determined from market-based evidence (AASB 116, para 32).
2. If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment, an entity may need to estimate fair value using an income or a depreciated replacement cost approach (AASB 116, para 33).
3. Revaluations must be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date (AASB 116, para 31).

A full extract of the above paragraphs of AASB 116 is included at Appendix A.

The following decision tree reflects the above principles.

STEP ONE - FAIR VALUE DECISION TREE IN AASB 116



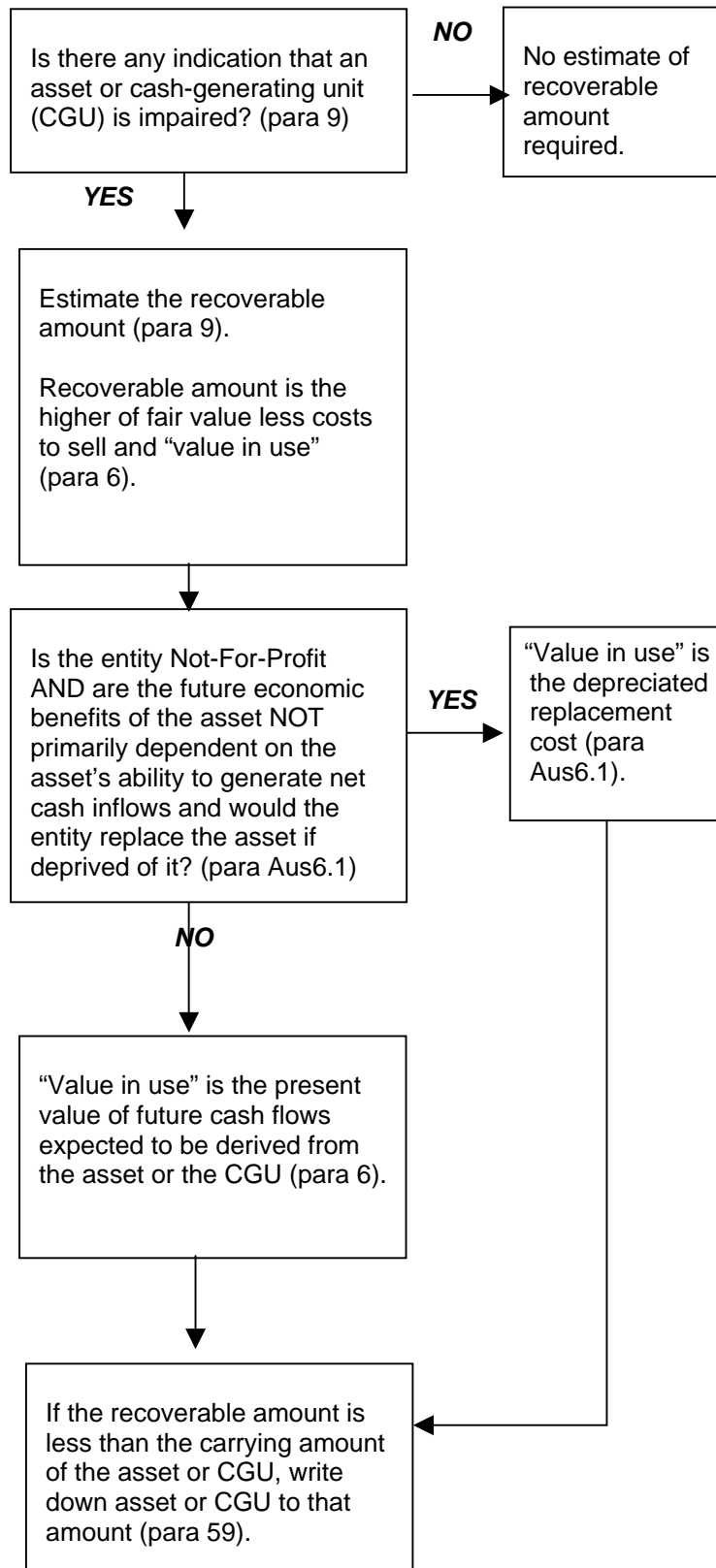
2.1.2 Step two - Impairment principles in AASB 136

AASB 136 contains the following three principles to determine impairment:

1. An entity must assess at each reporting date whether there is any indication that an asset or cash-generating unit is impaired. If any such indication exists, the entity must estimate the recoverable amount of the asset or unit (AASB 136, para 9):
 - Recoverable amount is defined as the higher of an asset's or cash-generating unit's fair value less costs to sell *and* its value in use (AASB 136, 6 and para 18).
 - Value in use is the present value of the future cash flows expected to be derived from the asset or cash-generating unit (AASB 136, para 6 and paras 66-67), subject to below.
2. In respect of a *not-for-profit entity*, value in use is depreciated replacement cost when the future economic benefits are not primarily dependent on the asset's ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits (AASB 136, para Aus6.1).
3. If, and only if, the recoverable amount of an asset or cash-generating unit is less than its carrying amount, the carrying amount must be reduced to its recoverable amount. That reduction is an impairment loss (AASB 136, para 59) and is treated as a revaluation decrease in accordance with AASB 116 (AASB 136, para 60).

The following decision-tree reflects the above principles.

STEP TWO - IMPAIRMENT DECISION TREE IN AASB 136



2.2 Clarification needed to apply the property, plant and equipment and fair value principles

This Policy provides additional guidance needed to implement the principles of AASB 116 and AASB 136 in Australia and the public sector. In the absence of such guidance, diverse practices may occur that will undermine the relevance and reliability of general purpose finance reports.

Additional guidance is required to address the following public sector issues:

- The concept of “highest and best use” must be applied and clarified. The majority of assets in the public sector including Health have either no, or limited, feasible alternative uses in the existing socio-political environment. This is because these assets are held as community, cultural or heritage assets and/or the government entity is mandated to continue to provide the services permitted by the assets.
- The current market prices of the majority of public sector assets cannot be observed because of either the specialised nature of the assets or significant imperfections in the markets in which the assets are traded.
- In the absence of market-based evidence, entities may estimate fair value using either the depreciated replacement cost or income approach. The Standard, however, provides little guidance on how to apply these approaches.
- The economic benefits of the majority of assets in public sector are not primarily dependent on their ability to generate net cash inflows.

As a result, guidance is needed for the following types of assets:

- Land such as botanic gardens, national parks and land under specialised assets;
- Community properties including schools, hospitals, etc;
- Specialised infrastructure assets and buildings;
- Heritage and cultural assets, including library, museum and some art collections;
- Specialised assets forming part of a cash-generating unit.

This paper therefore provides guidance additional to that in AASB 116 and AASB 136 on the following:

- Applying AASB 116 principles to the above public sector issues (see Section 2.3).
- Applying AASB 136 principles to cash-generating units (see Section 2.4 and Section 5).
- Clarifying the AASB 116 and AASB 136 decision trees (see Section 2.5).
- Applying the Policy to the major categories of physical non-current assets (Sections 3 to 6 and Appendix B).

2.3 Step one - Guidance to apply AASB 116 valuation principles

The following additional guidance is provided to apply the three valuation principles in AASB 116 to the unique circumstances of the public sector.

2.3.1 Fair value of assets is to be measured at highest and best use

AASB 116 merely states that fair value “is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction” (AASB 116, para 6). This Policy clarifies that the fair value of an asset:

- Is the most advantageous price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer.

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- Presumes the entity is a going concern, without any intention to liquidate or materially change the scale of operations.
- Presumes that there is an adequate period of marketing.
- Excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale.

Further, this Policy clarifies that fair value is determined by reference to its 'highest and best use' taking into account the existing physical, legal, financial and socio-political environment in which the entity operates and which results in the highest value.

The concept of the highest and best use is also consistent with the approach adopted by economists and valuers. In applying the willing buyer and seller principle, valuers generally measure fair value or "market value based on its highest and best use, which will not necessarily be the existing use". The argument is that "the prudent and well informed vendor would not willingly part with his land for a price less than that appropriate to its highest and best use; and the prudent buyer would not expect to be able to purchase it for less. Each party would take into account not only the present purpose to which the land is applied, but also any more beneficial purpose to which, in the course of events at no remote period, it may be applied" (quote of Isaacs J in the High Court decision of *Spencer V the Commonwealth of Australia* (1907) 5 CLR 148 quoted in R.O. Rost and H.G. Collins *Land Valuation and Compensation in Australia*).

Although this quote applies to land, it is equally applicable to any asset. Therefore, the term 'highest and best use' is clarified (and qualified) by "any more beneficial purpose to which, in the course of events at no remote period, it may be applied".

Given the above, guidance is needed to apply 'highest and best use' consistent to the unique circumstances in the public sector.

In the public sector, there can be natural, legal, financial and socio-political restrictions on the use and disposal of assets. In fact, most assets in the general government sector are held as community, cultural or heritage assets. Further, most entities are mandated by government/ministerial directives or legal/administrative requirements to continue to provide the services that the assets assist them in providing. Therefore, the natural, legal, financial and socio-political environments are relevant because they impact on the opportunities available to the entity. These restrictions may mean that certain opportunities or alternative uses are not available and therefore should not be taken into account.

From the above, the following three general policy guidelines can be drawn in applying the principle that fair value is to be measured having regard to the 'highest and best use' of the asset:

- 'Highest and best use' means a feasible alternative use. It therefore must take account of (or is qualified by) the existing natural (or physical), legal, financial and socio-political environment in which the entity operates (as well as the general zoning and statutory restrictions in respect of land).
- 'Highest and best use' means a feasible alternative use that is not remote. A practical guide to this is that an alternative use should only be considered to be feasible where it can be demonstrated that it can be achieved in the relatively near future (say the next five years) rather than at some remote future time.
- 'Highest and best use' must take account of the costs of achieving the feasible highest and best use alternative. These costs include holding costs, the costs required to provide utilities, the costs for any rezoning of the land and the costs of restoration or removal of existing improvements and/or repair work to restore the land to useable condition for that alternative use.

Based on the above, the following policies apply in valuing assets having regard to 'highest and best use':

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- Fair value of assets should be measured having regard to 'highest and best use' (net of costs to achieve that use) when and only when there exist feasible alternative uses in the existing natural, legal, financial and socio-political environment and the alternative uses are feasible within the near future. Such assets include much land and general use buildings.
- Conversely, where there are natural, legal, financial or socio-political restrictions on use and disposal of an asset, such that there is no feasible alternative use in the relatively near future, such an asset should be valued at fair value for its existing use. This is because fair value determined by reference to its highest and best use means "existing use" where there is no feasible alternative use.

Assets with no feasible alternative use include botanic gardens, national parks, most community assets such as schools and hospitals, some heritage properties, library and museum collections and most specialised assets (e.g. water and sewerage systems).

Valuing assets at "Fair (or Market) Value for Existing Value" (or "Existing Use") contemplates the continued use of an asset in contributing to the objectives and outcomes of the entity. This is not the value to the specific existing owner, but the value to a class of owners that would continue the existing use.

The above clarification acknowledges that the concept of 'highest and best use' is not a black and white distinction; but allows possibilities within a spectrum. There are cases where there are few or restricted feasible alternative uses. For example, land under heritage buildings and the heritage buildings may have few or limited restricted potential for development for feasible alternative uses.

Further guidance is given in Section 3 in applying the above to land and buildings.

2.3.2 Fair value is determined by the best available market evidence

"The fair value of land and buildings is usually determined from market-based evidence..." (AASB 116, para 32). This can be clarified as follows:

Where a quoted market price in an active and liquid market is available for an asset, that price represents the best evidence of the asset's fair value. When a quoted market price for the asset in an active and liquid market is not available, the fair value is estimated by reference to the best available market evidence of the price for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. This evidence includes current market prices for assets that are similar in use, type and condition ('similar assets') and the price of the most recent transaction for the same or a similar asset (provided there has not been a significant change in economic circumstances between the transaction date and the reporting date). Current market prices for the same or similar assets can usually be observed for land, non-specialised buildings, used motor vehicles, and some forms of plant and equipment. For land and buildings, these prices can also be derived from observable market evidence (e.g. observable current market rentals) using discounted cash flow analysis (AASB 116, withdrawn Australian Guidance, para G3).

2.3.3 Fair value where market prices cannot be observed

AASB 116, para 33 provides:

"If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach."

In some circumstances the fair value of the asset is not able to be determined from market-based evidence as the market buying price and market selling price of an asset differ materially because the asset usually is bought separately in the new asset market, but if sold

separately, could only be sold for its residual value. (AASB 116, withdrawn Australian Guidance, para G4)

In the public sector, the specialised nature of most physical non-current assets and/or significant imperfections in the markets in which they are traded may preclude the current market selling price from being observed. Public sector specialised assets include most infrastructure assets, land under infrastructure, roads and certain heritage and cultural assets.

Given the above, guidance is needed to apply the concept of depreciated replacement cost and the income approach to the specialised assets in the public sector (see below in sections 2.3.4 and 2.3.5).

2.3.4 Guidance on depreciated replacement cost

Depreciated replacement cost is a market buying price. As noted at section 2.3.3, guidance is needed to apply the concept of depreciated replacement cost, because AASB 116 does not provide any direction. However, AASB 136 states that:

“Depreciated replacement cost is the current replacement 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, para Aus6.2).

Replacement cost is not necessarily the cost of replicating the asset. Instead, replacement cost is defined as the “lowest cost at which the gross future economic benefits of that asset could currently be obtained in the normal course of business” (AASB 136, para Aus32.2).

What this means in general terms is that the replacement cost is determined by reference to the lowest cost of replacing the gross service potential embodied in the existing asset with a technologically modern equivalent asset, allowing for any differences in the quantity and quality of output and operating costs, and adjusting for overdesign, overcapacity and redundant components. For depreciable assets the carrying amount only reflects the remaining service potential. Therefore, the gross replacement cost is reduced by the economic benefits consumed or expired.

Further guidance is given in Section 4 in applying the above to infrastructure assets.

2.3.5 Why an income approach should not be used to value specialised assets, where there is no market-based evidence of fair value

In the absence of market evidence, AASB 116 provides that either depreciated replacement cost or an income approach may be used to estimate fair value (AASB 116, para 33).

Some commentators note that the Standard allows the option of using an income approach. These commentators therefore suggest that ‘value in use’ in AASB 136 could be used as an application of the income approach and therefore as a surrogate for fair value in AASB 116. This is based on the view that the requirements of AASB 116 and AASB 136 can be met simultaneously by using the income approach.

The Standards, however, do not provide any direction on what is meant by an “income approach” or when to apply it. The following therefore provides guidance on this matter. This Policy concludes that depreciated replacement cost rather than an income approach should be used under AASB 116 as the primary valuation method for valuing specialised assets for the following main reasons:

- *Nature of public sector assets* - The majority of public sector assets are specialised infrastructure assets, with no feasible alternative use (refer section 2.3.1). The specialised nature of these assets may preclude the current market selling price from being observed. Further, such entities must continue to provide the government mandated services and replace the existing service potential embodied in those assets. Given this, depreciated replacement cost is the most relevant valuation method for specialised assets.

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- *Contrary to the two-step approach in AASB 116 and AASB 136* – Currently the Australian Accounting Standards Board (AASB) has adopted a two-step process for valuing physical assets. First, fair value is measured under AASB 116 and second, the fair value is tested for impairment under AASB 136. Therefore, the use of the AASB 136 “value in use” measure for the income approach in AASB 116 is contrary to the current two-step approach of the AASB. Further, the use of the two step approach is consistent with draft guidance provided by the IASB/AASB, which advocates the use of multiple valuation techniques, as appropriate (see following dot point).
- *Consistent with international developments* - Internationally, the IASB/AASB have issued Discussion Papers based on an equivalent FASB Standard reviewing alternative methods to measure fair value. In discussing the income approach, these Discussion Papers emphasise market evidence in active markets. As discussed, however, for specialised assets there is unlikely to be market evidence. This results in the need to measure fair value at depreciated replacement cost (i.e. market buying price), as a more relevant surrogate for fair value, and leads to a conclusion not to use an income approach.
- *Income approach is more relevant in some circumstances and less relevant in other circumstances* - The income approach is relevant and used where there is market-based evidence and is most frequently used for non-specialised commercial properties where there is a liquid market. Conversely, the income approach is less relevant in valuing specialised assets. In these circumstances, the use of significant entity inputs derived from an entity’s own internal inputs and assumptions is required. However, this is in essence the concept of “value in use” used in AASB 136. This is done as the second step in the valuation process, by means of the impairment test in AASB 136.
- *Depreciated replacement cost information provides valuable decision-making information* – It provides information for users and the shareholder regarding the cost to replace the existing asset base. It also provides valuable information for entities where prices are set by an independent regulator. The entity requires knowledge of replacement cost so it can determine whether the entity will be able to replace its assets and therefore remain sustainable in the long term. This information is also required to advise the price regulator, otherwise, prices may be set too low to enable it to replace its assets and this may erode the economic capacity of the entity.
- *Adopting replacement cost enhances transparency and accountability* – If a write down is required under the impairment test pursuant to AASB 136, this will highlight the reasons for a downward revaluation – such as:
 - The impact of any regulatory or government policy decision which impacts on an agency’s capacity to derive an appropriate return from the asset in question; or
 - Building capacity based on long-term demand forecasts which did not eventuate.

Although there are alternative views on this issue, there is no solution that suits all purposes - accounting, performance monitoring and price regulation. Given this, and since this issue is currently being examined by both the IASB and AASB, the pragmatic solution of using multiple valuation techniques, using the two step approach is to be retained.

In summary, pending future developments by the Accounting Standard-setters, this Policy requires that, in the absence of market evidence, specialised assets must be valued using the depreciated replacement cost approach rather than using the income approach in AASB 116. However, the depreciated replacement cost is then subject to separate impairment testing in AASB 136, based on value in use.

This issue is further discussed at section 3.2.2 (specialised building) and section 4 (specialised plant and infrastructure).

2.3.6 Frequency of revaluation

Where non-current assets are measured at fair value, AASB 116 states:

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“Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date...The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation” (AASB 116, paras 31 and 34).

In effect, AASB 116 requires that an entity assesses at each reporting date whether there is any indication that an asset’s carrying amount differs materially from fair value. If any indication exists, the asset (and class to which it belongs) must be revalued (AASB 116, para 36).

This is consistent with the requirement in AASB 136 to assess whether there is any indication that an asset may be impaired. Therefore, when assessing whether there is any indication that the carrying amount differs materially from fair value in AASB 116, reference should be made to the minimum indicators in AASB 136. This includes external and internal sources of information, where relevant (refer AASB 136, para 12 and 111 and section 5.2 of the Policy). This includes indicators of *both* adverse and favourable effects.

These indicators are not exhaustive. For example, there may be other relevant factors or indicators that a revalued asset’s carrying amount may differ materially from its fair value, that are not included in AASB 136¹; e.g. other external sources of information – during the period, a price index relevant to the asset has undergone a material change.

Subject to the above, NSW Health’s policy requires that all classes of property, plant and equipment must be revalued at least every three years.

The valuations are, as far as practicable, to be revalued with effect from 1 July of that year thereby providing depreciation for a full twelve months which will be more valuable in terms of comparison with other year’s results.

The revaluations are to be completed by no later than 31 March in the year of review.

2.4 Step two - Guidance to apply AASB 136 impairment principles

The second step in valuing property, plant and equipment is to test for impairment. AASB 136 provides extensive guidance on the impairment principles. The following additional guidance is provided to apply the three principles in AASB 136 (paras 9, Aus6.1 and paras 59-60, see section 2.1.2 above) to determine impairment to the unique circumstances of the public sector.

2.4.1 Meaning of “fair value less costs to sell” in the recoverable amount test

AASB 136 requires an entity to assess at each reporting date whether there is any indication that an asset or cash-generating unit may be impaired. If any such indication exists, the entity must estimate the recoverable amount (AASB 136, para 9). Recoverable amount is defined as the higher of fair value less costs to sell and value in use (AASB 136, para 6).

The recoverable amount test is based on the premise that the value of an asset or cash-generating unit should *not exceed* the higher of its market-based valuation (fair value less costs to sell) and the entity specific valuation based on expected future cash flows (“value in use”) (AASB 136, para 6).

“Fair value” in AASB 136 is defined identically to AASB 116. However, its application in AASB 136 is more limited than AASB 116. The commentary on “fair value less costs to sell” in AASB 136 (paras 25-29) refers to market-based valuations only, as evidenced by binding sale agreements, current bid prices or recent transactions for similar assets. Unlike AASB 116, AASB 136 does not envisage or refer to situations where there is no market-based evidence. Therefore AASB 136 has a narrower

¹ This factor was referred to in the withdrawn Australian Guidance to AASB 116 (para G7).

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concept of fair value than AASB 116, as it effectively excludes fair value, in the absence of market evidence. That is, “fair value less selling costs” in AASB 136 is restricted to the net market selling price (refer IFRS 5, Basis for Conclusions, paras BC82-BC83).

In the public sector, however, the specialised nature of most physical non-current assets means that due to the lack of market-based evidence, a market selling price is unlikely to be available. As a result, for specialised assets, in the absence of a market selling price, the recoverable amount is the value in use. AASB 136 confirms this as it states that where there is no basis for making a reliable estimate of the amount obtainable from an arm’s length sale, the entity may use the asset’s value in use as its recoverable amount (AASB 136, para 20).

This means that specialised assets that form part of a cash-generating unit must be written down where the value in use of the unit, based on the expected future cash flows (per AASB 136), is lower than the total of the fair value of the assets (AASB 136, paras 104-108), which for specialised assets will be based on depreciated replacement cost (per AASB 116 and section 2.3.5 of the Policy).

2.4.2 Recoverable amount for a cash-generating unit

AASB 136 requires the recoverable amount to be estimated for the individual asset, or if not possible, the cash-generating unit (AASB 136, para 66). The *cash-generating unit* is defined as:

“...the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets” (AASB 136, para 6)

The recoverable amount for an individual asset cannot be determined if:

- “(a) the asset’s value in use cannot be estimated to be close to its fair value less costs to sell (e.g. when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and
 - (b) the asset does not generate cash inflows that are largely independent of those from other assets.”
- (AASB 136, para 67)

Stated another way, the recoverable amount for an individual asset can only be determined if it constitutes a cash-generating unit in itself. This is also supported by AASB 136, para 22.

Therefore, this Policy clarifies the AASB 136 decision tree by using the term “cash-generating unit” to also include reference to an individual asset that constitutes a cash-generating unit.

2.4.3 Recoverable amount test – Application to not-for-profit entities

The recoverable amount test is complicated in the public sector for not-for-profit entities, where assets do not form part of a cash-generating unit, as they are not held primarily for profit generation.

The AASB has addressed this issue by re-defining the concept of “value in use” for these assets of not-for-profit entities, as follows:

“...in respect of not-for-profit entities, value in use is depreciated replacement cost of an asset when the future economic benefits of the asset are not primarily dependent on the asset’s ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its future economic benefits” (AASB 136, para Aus6.1)

A “not-for-profit entity” is defined as “an entity whose principal objective is not the generation of profit” (AASB 136, para Aus6.2). Therefore a “for-profit entity” is an entity whose principal objective is the generation of profit. Classification as a for-profit or not-for-profit entity is further discussed in section 5.4.

Although not explicit in the Standard, the practical effect of the modified definition of “value in use” is to modify the concept of a cash-generating unit for not-for-profit entities. Accordingly, this Policy clarifies that:

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“For a not-for-profit entity, an asset does not form part of a cash-generating unit when the future economic benefits of the asset are not primarily dependent on the asset’s ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits” (AASB 136, para Aus6.1).

Alternatively, this has the same effect as modifying the definition of a cash-generating unit as follows:

“...the smallest identifiable group of assets **comprising those assets that are primarily dependent on the assets’ ability to** generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets” (AASB 136, para 6).

In effect, this means that a “cash-generating unit” is a unit whose primary or principal objective is profit generation. This is similar to the definition for a for-profit entity. This has a number of implications that are clarified in this Policy, as follows:

- The definition for “value in use” depends on whether an asset forms part of a cash-generating unit. By definition, all assets of a for-profit entity belong to one or more cash-generating unit/s. This is further discussed in section 5.5.
- A not-for-profit entity may have cash-generating unit/s. However, an operation of a not-for-profit entity that has a number of objectives, but where generating profit is not the primary objective, is excluded from the definition of a cash-generating unit. The distinction between a for-profit and not-for-profit entity discussed at section 5.4 is also relevant to a not-for-profit entity and the distinction between a cash-generating and non-cash-generating unit.
- Where an asset of a not-for-profit entity does not belong to a cash-generating unit, it cannot be impaired under AASB 136, unless selling costs are material. This is the case, whether or not the ‘value in use’ is depreciated replacement cost (AASB 136, para Aus6.1). This is because the recoverable amount cannot be lower than fair value in AASB 116, unless selling costs are material, as the following two possible scenarios demonstrate i.e.:
 - *For an asset that is not primarily dependent on the generation of net cash inflows and if the entity would replace the asset, if deprived of it, the ‘value in use’ is depreciated replacement cost (AASB 136, para Aus6.1) – Fair value under AASB 116 will be determined using market-based evidence (e.g. market selling price), or in its absence, based on depreciated replacement cost. Fair value under AASB 116 will either be the same as fair value or ‘value in use’ under AASB 136.*
 - *For an asset that is not primarily dependent on the generation of net cash inflows and if the entity would not replace the asset, if deprived of it, the ‘value in use’ is based on discounted cash flows (AASB 136, para 6) – Fair value under AASB 116 will be determined using market selling price (refer section 4.4.2 and Appendix B, section 3.3 of the Policy). Fair value under AASB 116 will be the same as fair value under AASB 136.*

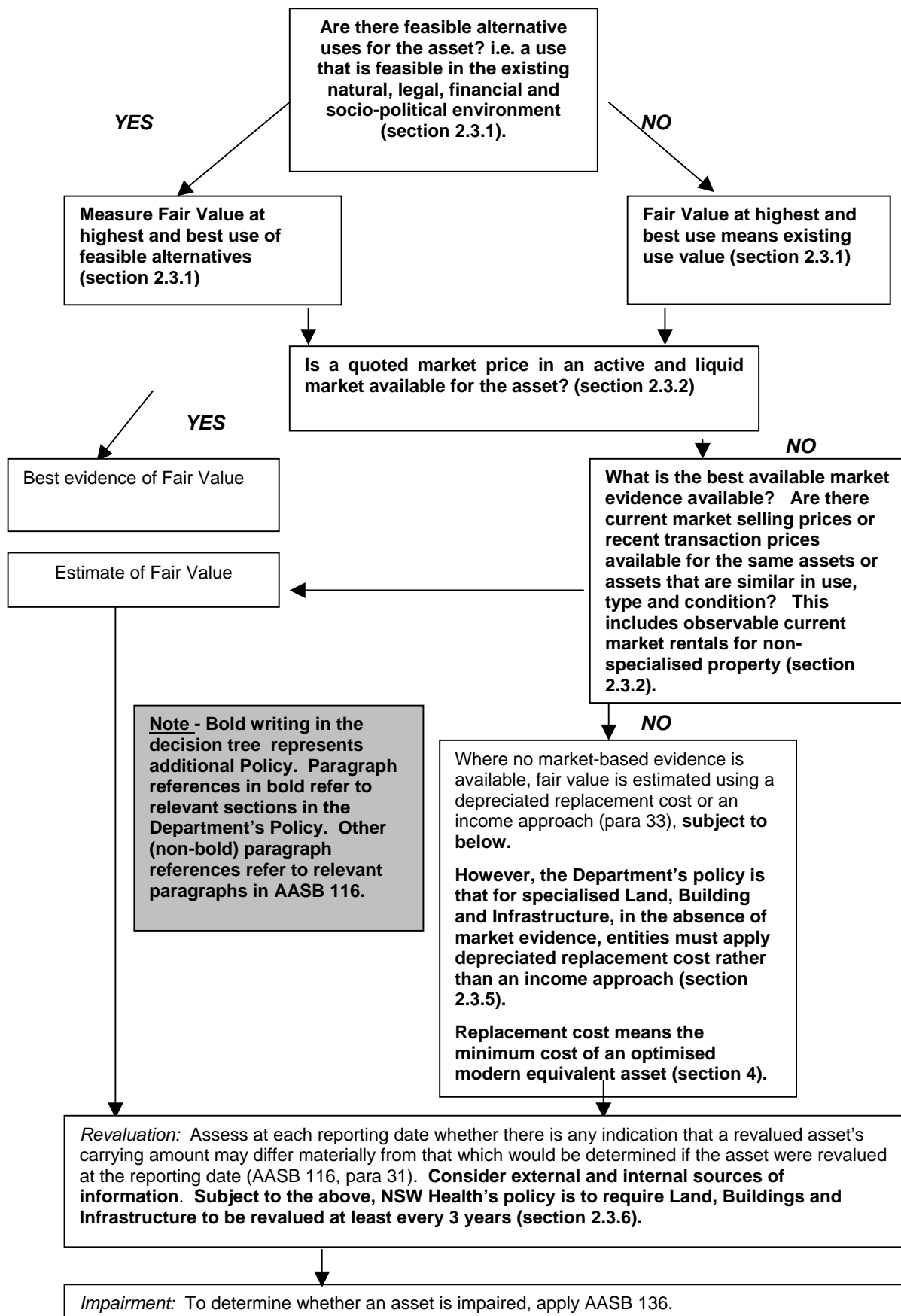
In most cases selling costs will not be material and, in effect, for a not-for-profit entity, this exempts assets that are not primarily dependent on the generation of net cash inflows from AASB 136 and impairment testing. This is because there is no material dollar impact.

Additional guidance about the level of the cash-generating unit is provided at section 5.3.

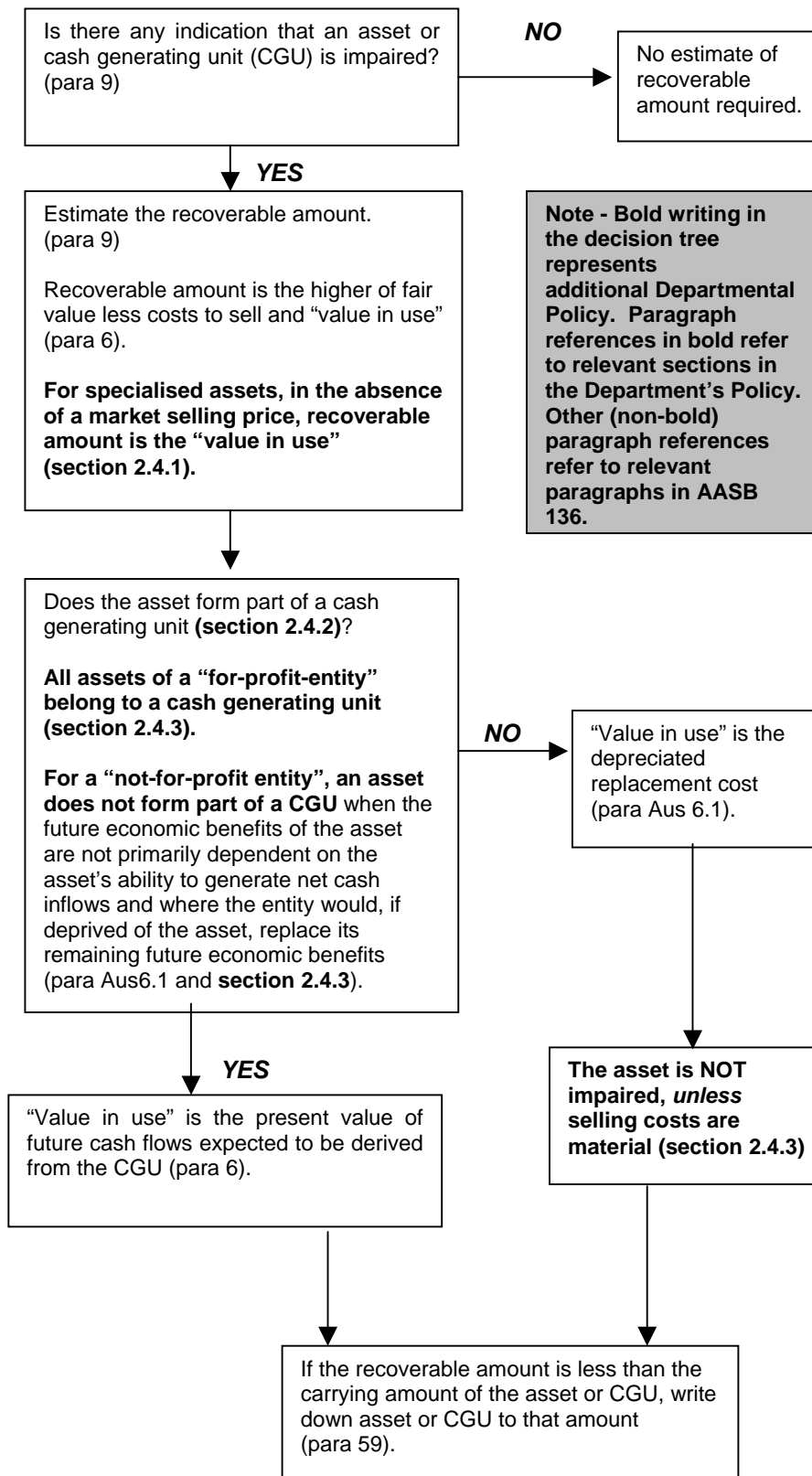
2.5 Clarified decision trees

The guidance in sections 2.3 and 2.4 leads to the inclusion of additional or modified steps to apply the principles in AASB 116 and AASB 136, as highlighted in the following decision trees. These additional or modified steps do not alter the decision trees derived from the respective Standards. Instead they provide clarification and additional guidance relevant to the circumstances in the public sector.

FAIR VALUE DECISION TREE WHICH CLARIFIES AASB 116



IMPAIRMENT DECISION TREE CLARIFYING AASB 136



3. Valuation of land and buildings (including investment property)

This section discusses the valuation of land and buildings (including investment property) under AASB 116 and AASB 140. Impairment under AASB 136 is separately discussed in section 5.

3.1 Valuation of land

Land is to be valued at fair value in accordance with AASB 116 having regard to the highest and best use that is feasible (section 2.3.1).

Land should be valued at fair value and measured having regard to the 'highest and best use' when and only when there exist feasible alternative uses in the existing natural, legal, financial and socio-political environment and the alternative uses are feasible within the near future. Further, it is measured after taking account of the costs of achieving the highest and best use.

In assessing feasible alternative use, general zoning restrictions should be distinguished from restrictions placed on land by Government that are in the nature of restrictions on current use. An example is an agricultural research station on the fringe of an expanding urban development. It is not to be assumed that the only use to which this land could be put in the future would be for this specific purpose. Where there is special zoning it may reflect the mechanism by which the government, as owner, recognises its current use. These restrictions, even if reflected in special zoning, should not provide the basis on which the feasible alternative use valuation is determined. The types of zoning that would usually be relevant are the general types of zoning (residential, commercial and industrial).

In the public sector, much land can be valued having regard to highest and best use. This includes Crown land that is designated for development and disposal, and land under general purpose buildings or generalised plant.

In the public sector, however, there can be natural, legal, financial or socio-political restrictions on the use and disposal of land. Much land in the public sector is held as community, cultural or heritage assets or is land under assets held for such purposes. Further, most entities are mandated by government/ministerial directives or legal/administrative requirements to continue to provide the services that the land assists them in providing.

Where there are natural, legal, financial or socio-political restrictions on use and disposal of land such that there is no feasible alternative use in the relatively near future, such land should be valued at fair (market) value for its existing use. That is, opportunities that are not available to the entity are not taken into account (section 2.3.1). Land assets in the public sector with no feasible alternative use include parks and botanic gardens, national parks and reserves that are held for public benefit and vacant Crown land.

Further, mandates for service delivery may impose restrictions on the use of land under specialised buildings or infrastructure assets held and used for mandated purposes. Such mandates may eliminate any possible highest and best use value related to an alternative use or arising from any redevelopment potential of the land. For example, examination of NSW railway corridors indicates that few sections in the metropolitan area have potential for alternative use.

Similarly, feasible uses for land under Parliament House, Government House and historic and similar heritage buildings are restricted to the extent of the restricted feasible alternative uses of the buildings.

For other land under assets, the land may have feasible alternative uses because it may be feasible to relocate the assets used in providing the service. A fire station located in the centre of a country town may be moved to the outskirts. In other cases, the asset on the land may no longer be required in that location because of changes in demographics over time or consolidation of services for strategic and efficiency reasons. Assets such as schools and hospitals can become surplus in particular circumstances and therefore the land can become available for feasible alternative uses. Generally, this would be supported by a government decision that the asset is surplus. Therefore, the highest and best use of the land and improvements are assessed together. In these circumstances,

an entity must also consider whether the item meets the definition of an “asset held for sale”, which is discussed in section 7.10. For land under most schools, hospitals and fire stations, there is no alternative use, because the entity is mandated to continue to provide the services and the services are needed at that location.

Regarding reliable measurement, current market prices (whether measured at highest and best use or existing use) usually can be observed for land (AASB 116, para 32). They can also be derived from observable market evidence, for example, observable current market rentals for leased land (see also section 3.2 below).

Detailed guidelines for the valuation of specific types of assets including Crown lands, national parks and reserves, parks and botanic gardens and land under general and specialised buildings, and land under specialised plant, infrastructure and heritage assets are set out in Appendix B.

3.2 Valuation of buildings

Buildings are to be valued at fair value in accordance with AASB 116. In all cases, buildings and the land on which they are built must be considered together in determining whether feasible alternative uses exist.

AASB 116 discusses the types of market-based evidence for property, plant and equipment. The Standard implicitly acknowledges that there are specialised and non-specialised assets (AASB 116, para 33).

3.2.1 Non-specialised buildings

Non-specialised buildings include commercial and general purpose buildings for which there is a secondary market. Non-specialised property is to be valued at fair value having regard to highest and best use. The building and the land under the building are valued consistently.

Fair value based on current market prices can usually be observed for land and non-specialised buildings (AASB 116.32). In the absence of observable market prices, current market prices can also be derived from observable market evidence (e.g. observable current market rentals) using discounted cash flow analysis (section 2.3.2). This is an application of the income approach allowed under AASB 116, para 33. As this uses market-based evidence, it is permitted by this Policy (refer section 2.3.5).

3.2.2 Specialised buildings

Conversely, specialised buildings are buildings designed for a specific limited purpose. Such buildings include hospitals, schools, court houses, emergency services buildings (police, fire, ambulance and emergency services stations), specialised buildings to house specialised infrastructure or plant and some heritage properties.

In most cases, such specialised buildings and the land under them have no feasible alternative use, because the entity is mandated to continue to provide the goods or services that the building permits. Further, where a building is specialised, there is generally no observable market evidence of its market selling price. As discussed previously in section 3.1, there are exceptions to this where the services can be moved to another location or are no longer required, either for strategic reasons or because of demographic changes.

Where there is no available market-based evidence, specialised buildings are to be valued at the replacement cost of the asset’s remaining economic benefits. This is consistent with the view adopted by this Policy for the valuation of specialised assets, as discussed in Section 2.3.5.

The above distinction between specialised and non-specialised buildings exists on a spectrum and is not black and white. Professional judgment is therefore required. To illustrate, the valuation of specialised plant and infrastructure must be adjusted for permanent excess capacity. For some specialised buildings, however, excess capacity may have feasible alternative uses. For example,

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excess capacity in a hospital may be able to be leased out to another entity for medical-related services, but it would need to be demonstrated that a feasible alternative use exists. In these demonstrated cases, the excess may not be permanent excess capacity.

The valuation of specialised plant and infrastructure assets is further discussed at Section 4. Impairment testing of specialised assets that form part of a cash-generating unit is discussed at Section 5. Heritage buildings are discussed at Section 6.

3.3 Valuation of investment property

3.3.1 Fair value model adopted

Consistent with the valuation of property, plant and equipment, this Policy requires that, after initial recognition, investment property must be measured at fair value (refer section 1.2 of the Policy).

Unlike AASB 116 *Property, Plant and Equipment*, AASB 140 adopts a fair value model rather than a revaluation model. This means that for investment property, any changes in fair value are recognised in the income statement rather than the asset revaluation reserve (AASB 140, para 35). Further, depreciation is not recognised as AASB 116 does not apply (AASB 116, para 5) and investment property measured at fair value is not subject to the AASB 136 impairment test (AASB 136, para 2(f)).

3.3.2 Distinguishing investment property from other property

Investment property is “property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- (a) Use in the production or supply of goods or services or for administrative purposes; or
- (b) Sale in the ordinary course of business” (AASB 140, para 5).

Investment property also includes property held for a currently undetermined future use (AASB 140, para 8).

It excludes “owner-occupied property” and property held for a determined future use as either owner-occupied property or investment property (AASB 140, paras 5, 9(c) and 9(d)).

In the case of a not-for-profit entity, investment property also excludes property held to meet service delivery objectives rather than to earn rental or for capital appreciation. Investment property therefore excludes property held for strategic purposes and property held to provide a social service, such as those which generate cash inflows where the rental revenue is incidental to the purpose for holding the property (AASB 140, para Aus9.1). However, a not-for-profit entity is not precluded from having investment property merely because of its not-for-profit status.

An investment property generates cash flows largely independently of the entity’s other assets. This distinguishes it from owner-occupied property (AASB 140, para 7).

Investment property is recognised and measured under AASB 140. Conversely, owner-occupied property and property held by a not-for-profit entity to meet service delivery objectives are recognised and measured as property, plant and equipment under AASB 116. Determining the correct classification requires the use of judgement, having regard to the primary reason for holding the property.

A lessor classifies a rental property (under an operating lease) as either investment property or as property, plant and equipment, depending on the particular circumstances of the case.

This policy clarifies that the earning of rent, even commercial rent, does not necessitate a property being classified as investment property if the property is primarily held for another purpose and the rent is merely incidental, such as when:

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- A not-for-profit entity holds a property primarily to meet service delivery, strategic or social service objectives (AASB 140, para Aus9.1); or
- A for-profit entity holds a property for its own future occupancy (AASB 140, para 9).

An agency's enabling legislation will often help determine the agency's reason for holding property.

A NSW Health agency's primary reason for holding any particular rental property (as lessor) will usually be determinable by reference to the agency's overall objectives and its for-profit or not-for-profit status. The Department therefore considers that, unless the lessor agency can demonstrate the contrary:

- Any property subject to a long-term lease (exceeding 50 years) is likely to be investment property;
- Any other leased property of a for-profit entity is also likely to be investment property; but
- Any other leased property of a not-for-profit entity is unlikely to be investment property.

3.3.3 Additional AASB 140 guidance on fair value

"Fair value" in AASB 140 is defined consistently with AASB 116. Therefore, much of the discussion regarding land and buildings in Section 3.1 and 3.2 is also relevant to investment property. However, AASB 140 provides specific additional guidance regarding fair value measurement of investment properties, in the following key areas:

- The fair value of investment property must reflect market conditions at the reporting date (AASB 140, para 38). This implies that, for investment property, fair value must be determined at each reporting date, where market conditions have changed.
- Fair value specifically excludes an estimated price inflated or deflated by special terms or circumstances (AASB 140, para 36).
- The willing seller is motivated to sell the investment property at market terms for the best price obtainable (AASB 140, para 43). The willing seller is neither an over-eager nor a forced seller.
- The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts (AASB 140, para 45).
- In the absence of current prices in an active market for similar property (as above), an entity must consider information from a variety of sources, including:
 - Current prices in an active market for properties of different nature, condition or location, adjusted to reflect those differences.
 - Recent prices of similar properties in less active markets, with adjustments to reflect any changes in economic conditions.
 - Discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and by external evidence such as current market rentals (AASB 140, para 46).
- The various sources of evidence listed in the previous dot points may provide different estimates of fair value. An entity must consider the reasons for those differences to arrive at the most reliable estimate of fair value within a range of reasonable fair value estimates (AASB 140, para 47).

The above dot points are similar to the discussion in sections 2.3.1 and 2.3.2. Fair value under AASB 140 is also consistent with the AASB 116 decision tree. However, the main difference in the valuation of investment property compared to property, plant and equipment, is that investment property tends to be non-specialised. As a result, market evidence is normally available for investment property (including market rentals).

As discussed in section 3.2.1 on non-specialised buildings, the use of current market rentals is an application of an income approach. As this uses market-based evidence, it is permitted by this Policy (refer section 2.3.5).

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In the absence of current prices in an active market, the Standard requires the entity to consider information from a variety of sources (e.g. discounted cash flow projections) (AASB 140, para 46). The Standard includes a rebuttable presumption that fair value of an investment property can be determined. Fair value will be unavailable only in exceptional circumstances (AASB 140, para 53).

3.3.4 Property leased to other entities in the group

AASB 140 clarifies that where an entity owns property that is leased to other entities within the economic group, from the entity's perspective, it is an investment property if it meets the definition (AASB 140, para 15). On consolidation, however, the property is owner-occupied and therefore would not qualify as an investment property but would be valued as property, plant and equipment under AASB 116.

3.3.5 Property interests held by a lessee under an operating lease

In accordance with AASB 140, this Policy mandates that a property interest held by a lessee under an operating lease must be classified and accounted for as investment property, if it otherwise meets the definition of an investment property (AASB 140, para 6). This Policy mandates that the lessee must use the fair value model for this type of property, consistent with section 3.3.1 above (AASB 140, para 6). Prior to the adoption of AEIFRS, such operating lease payments were accounted for as an expense over the lease term based on the pattern of benefits.

4. Valuation of specialised plant and infrastructure

4.1 Introduction

Plant and infrastructure are to be valued at fair value in accordance with AASB 116 and the additional guidance given in this Policy (refer below). The second step of impairment testing is discussed in section 5.

In the public sector, however, there can be natural, legal, financial or socio-political restrictions on the use and disposal of assets. In fact, most assets in the general government sector (the non-commercial sector of the public sector) are held as community, cultural or heritage assets. Further, the majority of public sector assets are held to continue to provide the services that government/ministerial directives or legal/administrative requirements mandate the entity to provide to the community at cost or less than cost.

Finally, in the public sector, the specialised nature of most physical non-current assets and/or significant imperfections in the markets in which they are traded may preclude the current market selling price from being observed. In the public sector, specialised assets include most infrastructure assets.

For such specialised assets, fair value is measured at depreciated replacement cost, in accordance with AASB 116. Depreciated replacement cost is a market buying price. Because of the absence of market evidence, the income approach option is not to be used, as outlined in section 2.3.5 (but refer section 5 for impairment testing).

Given the above circumstances in the public sector, guidance is needed to determine depreciated replacement cost.

4.2 Valuation of infrastructure

The fair value of infrastructure assets is measured at depreciated replacement cost (which is not necessarily the cost of replicating the asset) (AASB 116, para 33).

Depreciated replacement cost is the current replacement cost of an asset less accumulated depreciation to reflect the already consumed future economic benefits of the asset (AASB 136, para Aus6.2). Current replacement cost is "...measured by reference to the lowest cost at which the gross

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future economic benefits of that asset could currently be obtained in the normal course of business” (AASB 136, para Aus32.2).

The Guidance Notes to the Statement of Accounting Practice SAP 1 *Current Cost Accounting* (SAP 1) clarify the above definitions of replacement cost as follows:

“For more complex depreciable assets – the (gross) current cost of the total service potential of the existing asset may be established...by reference to the cost per unit of service potential of the most appropriate modern facility (replacement cost)...” (SAP 1, Guidance Notes, para 47)

The replacement cost of the existing asset must be adjusted for any differences between the practical capacity and/or useful life of the modern equivalent facility and that of the existing asset (SAP 1, Guidance Notes, para 49).

In other words, replacement cost is the minimum that it would cost, in the normal course of business, to replace the existing asset with a technologically modern equivalent new asset with the same economic benefits, allowing for any differences in the quantity and quality of output and in operating costs.

The SAP 1 Guidance Notes (para 52) further states:

“In determining current cost with reference to the most appropriate modern facility...the modern facility should be of commercially available technology and should not require a redesign or re-engineering of an entity's existing plant ...”

In this paper, this is termed optimised replacement cost.

The application of SAP 1 imposes three steps in determining optimised replacement cost:

1. The replacement cost of an asset is to be determined, not by reference to the lowest replacement cost of an identical asset, but by reference to the lowest cost of replacing the economic benefits embodied in an existing asset with a modern equivalent asset.
2. Second, the minimum replacement cost is to be adjusted for overdesign, overcapacity and redundant components (termed optimisation).
3. Optimisation is limited to the extent that this can occur in the normal course of business using commercially available technology (termed “incremental optimisation”).

These three steps are discussed following.

4.3 The lowest cost of a modern equivalent asset

Reference to a modern equivalent asset is made to obtain a surrogate for the current cost of the asset held. It does not imply that the reference asset will be acquired as a replacement some time in the future (SAP 1 Guidance Notes, para 47).

The modern equivalent asset may have a different capacity, quality, configuration or useful life from the existing asset to be valued. In such cases the replacement cost of the modern equivalent asset is to be pro-rated to the economic benefits of the existing asset which should not exceed the anticipated needs as realistically determined by the entity, termed ‘expected capacity in use’.

‘Expected capacity in use’ is the required level of economic benefits or output consistent with both the anticipated future growth in demand and the objective of minimising the whole-of-life cost of assets within an entity’s business planning horizons. It assumes no improvement to the components of the economic benefits of the existing asset; i.e. capacity, quality of service and useful life.

Further, current cost in SAP 1 refers to the lowest cost at which the “gross service potential” (or economic benefits) could currently be obtained (SAP 1, Guidance Notes, para 47-48). The carrying amount of a depreciable asset, however, needs to reflect the remaining economic benefits of the asset. Gross current cost, therefore, must be reduced to exclude the economic benefits already consumed or expired.

4.4 Adjustment for overdesign, overcapacity and redundant assets

Where assets are overdesigned, have excess capacity, or are redundant, this should be identified by the entity and an adjustment made so that the resulting valuation reflects the cost of replacing the existing economic benefits based on an efficient set of modern equivalent assets to achieve the required level of service output within the entity’s planning horizon. Spares for a particular asset form part of the cost of that asset and are depreciated over the useful life of the related asset.

4.4.1 Overcapacity

Overcapacity or redundant assets may be defined as assets that have a greater service capacity than is necessary to meet the service delivery outputs within an entity’s business planning horizon (capacity in use).

Entities would need to distinguish between temporary excess capacity and permanent excess capacity. Temporary excess capacity refers to the situation where a current excess capacity is required to cater for anticipated future growth in demand.

Permanent excess capacity refers to the situation where an entity has over invested in infrastructure assets in the past due to incorrect estimates of future demand for its services or other changed circumstances. Permanent excess capacity should be excluded from the asset value.

4.4.2 Redundant components

Redundant assets (e.g. of an integrated network) that are severable should be regarded as surplus assets and valued at their market selling value. Non-severable components which are redundant or represent overcapacity should be excluded from the valuation. As these components cannot be disposed of, no valuation should be assigned to them.

4.4.3 Overdesigned assets

Overdesigned assets are assets with features that are unnecessary for the goods or services the assets provide. They are often referred to as “gold-plated” assets. Measuring the economic benefits embodied based on modern equivalent assets automatically excludes attributing any value to the overdesigned features.

4.4.4 Spares for plant and equipment

Spares for a particular asset that would become redundant if that asset were retired or discontinued form part of the cost of that asset. As these spares can only be used in connection with a particular asset, they do not have useful lives of their own and therefore are depreciated over the useful life of the related asset.

Depreciable spares, however, are distinguished from separate parts of an asset or separate standby assets that have their own useful lives. A standby asset may be kept as back up to an operating asset in the normal course of business to minimise disruption to the operations when the prime assets are temporarily out of service. They are an integral part of the operating asset and should be valued in the same way, but they may have different useful lives and should be separately depreciated.

Depreciable spares can also be distinguished from spares held for sale or use in after-sales, materials, consumable stores and other supplies, which would generally be consumed in a production process or in the rendering of services, which are dealt with in AASB 102 *Inventories*.

4.4.5 Service and quality standards

The modern equivalent reference asset used normally has a higher service and quality standard than the design standards of the existing asset. Therefore, a pro-rata reduction will generally be necessary to reduce the gross replacement cost of the modern equivalent asset to reflect the lower service standards of the existing asset. This reduction is an estimate of the expenditure required to raise the current standards of the existing asset to the higher standard of a modern equivalent asset.

4.5 “Incremental optimisation”

Incremental optimisation refers to the optimal method of replacement of assets in the normal course of business. This will be different from the manner in which the existing assets were acquired or constructed, and different from ‘greenfields optimisation’.

SAP 1 *Current Cost Accounting* states that, in determining current cost, it is to be assumed that a redesign or re-engineering of the existing plant is not to occur (SAP 1, Guidance Notes, para 52). This “incremental optimisation” allows progressive or incremental optimisation to the extent that it occurs in the normal course of business, including large scale replacements that may normally occur in the planning horizons of entities.

The incremental optimisation approach recognises that there is always some degree of suboptimality and allowance for growth in future demand, and it reflects the historical development of the existing business, the time lag in asset planning and construction, the very long lives of the assets, and the replacement of their components in the normal course of business. As asset systems expand and change, a degree of suboptimality at any point of time is inevitable and is part of the total cost of output.

Incremental optimisation therefore places a constraint on the extent of optimisation. It does not allow a valuation based on optimal replacement of an entity’s entire asset network. This latter approach is termed “greenfields optimisation”. Greenfields optimisation involves determining the replacement cost of assets based on what is the most cost-effective (or optimal) set of assets to achieve the required level of economic benefits (in terms of capacity, service quality and useful life). Greenfields optimisation assumes the design of an entirely new optimal network of assets for the entity.

In practice, a greenfields replacement cannot occur in the normal course of business (except in rare circumstances). A greenfields replacement would rarely be feasible, given the constraints imposed by the existing network and customer access to services. For example, in the electricity distribution industry, these constraints include the given positions of points of supply and customers. Similarly, in the road and rail industries, the existing transport network means that greenfields optimisation is not feasible for the majority of the network.

5. Impairment testing of cash-generating units

5.1 Introduction

After fair value measurement under AASB 116, the second step is impairment testing under AASB 136. However, AASB 136 *does not* apply to *investment property* under AASB 140.

AASB 136 requires an entity to assess at each reporting date whether there is any indication that an asset or cash-generating unit may be impaired. If such an indication exists, the entity must estimate the recoverable amount (AASB 136, para 9). Recoverable amount is defined as the higher of fair value less costs to sell and value in use (AASB 136, para 6). An impairment loss is recognised where the carrying amount of the asset or cash-generating unit exceeds the recoverable amount (AASB 136, para 59).

The recoverable amount test is based on the premise that an asset or cash-generating unit should not exceed the higher of its market-based valuation (fair value less costs to sell) and the entity specific valuation based on expected future cash flows (value in use). While fair value in AASB 136 is defined consistently with AASB 116, its application is more limited than AASB 116. As discussed in section

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2.4.1 of the Policy, “fair value less costs to sell” in AASB 136 is restricted to the net market selling price. This means that for specialised assets, in the absence of a market selling price, the recoverable amount in AASB 136 will be the “value in use”. Therefore, this means that specialised assets that form part of a cash-generating unit must be written down where the value in use of the unit, based on the expected future cash flows (per AASB 136), is lower than the total of the fair value of the assets, which for specialised assets will be based on depreciated replacement cost (per AASB 116 and section 2.3.5 of the Policy).

Further, according to AASB 136 the recoverable amount must be estimated for the individual asset or, if not possible, the cash-generating unit. The cash-generating unit is defined in AASB 136 as:

“...the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets” (AASB 136, para 6).

This Policy clarifies (section 2.4.2) that any reference to a cash-generating unit also includes reference to an individual asset that constitutes a cash-generating unit in itself.

As not all assets in the public sector are held primarily for profit generation, the AASB has modified the definition of value in use for not-for-profit entities, as follows:

“...in respect of not-for-profit entities, value in use is depreciated replacement cost of an asset when the future economic benefits of the asset are not primarily dependent on the asset’s ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its future economic benefits” (AASB 136, para Aus6.1).

Because not explicit in the Standard, section 2.4.3 of this Policy concludes that the practical effect of the above paragraph is to exclude these assets from the definition of a cash-generating unit.

Stated another way, this modifies the definition of a cash-generating unit to:

“...the smallest identifiable group of assets **comprising those assets that are primarily dependent on the assets’ ability to** generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets” (AASB 136, para 6).

In summary, section 2.4.3 clarifies that where an asset does not constitute or does not form part of a cash-generating unit, it cannot be impaired under AASB 136, unless selling costs are material. In most cases selling costs will not be material. This means that where an asset does not constitute or form part of a cash-generating unit, it is effectively exempted from AASB 136 and impairment testing. This is because there is no material dollar impact.

Additional guidance, however, is needed to identify when assets form part of a cash-generating unit, that is, when assets are primarily dependent on generating net cash inflows. Therefore, the following guidance drawn from AASB 136 is provided to assist practical implementation of this clarified definition:

- Identifying impaired assets;
- What constitutes a cash-generating operation;
- Classifying for-profit/not-for-profit entities;
- Whether an entity can have both cash-generating units and other assets;
- Determining the net cash inflows of a cash-generating unit;
- Discounting future cash flows;
- Other guidance.

5.2 Identifying impaired assets

AASB 136 requires an entity to assess at each reporting date whether there is any indication that an asset (or cash-generating unit) may be impaired (or that an impairment has reversed) (AASB 136, paras 9 and 110). It lists a minimum of external and internal indicators that must be considered (AASB 136, para 12).

External indicators of impairment include (AASB 136, para 12(a)-(d)):

- An asset's market value has declined significantly more than expected;
- Adverse events in the technological, market, economic or legal environment;
- Market interest rate increases that are likely to affect an asset's value in use;
- Net assets of the entity exceed its market capitalisation.

Internal indicators of impairment include (AASB 136, para 12(e)-(g)):

- Obsolescence or physical damage of an asset;
- Adverse changes in the expected use of an asset, including plans for restructuring;
- Less than expected economic performance of an asset.

If (but only if) any such indication exists, an entity must estimate the recoverable amount of the asset (AASB 136, para 9).

5.3 Guidance on what constitutes a cash-generating unit

AASB 136 provides guidance on identifying the cash-generating unit to which an asset belongs in assessing impairment (AASB 136, paras 66-73). AASB 136 notes that, to identify an asset's cash-generating unit involves judgement (AASB 136, para 68). In making that judgement:

“...an entity considers various factors including how management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decisions about continuing or disposing of the entity's assets and operations” (AASB 136, para 69).

Therefore the Standard specifies *different levels of aggregation at which impairment is assessed* (i.e. different to the 'class of non-current assets' which was used in the previous AASB 1010). AASB 136 provides various other examples to illustrate the principles in the above-mentioned paragraphs (refer AASB 136, paras 67-68 and Illustrative Example 1).

For example, a cash-generating unit also includes a group of assets for which an active market exists even if some of the output is used internally (AASB 136, para 70).

Further, AASB 136, para 68 gives an example of a bus service, where the entity does not have the option under its contract to curtail any individual route or routes. Based on this, the cash-generating unit for each route is the entity as a whole. Other illustrative examples of the above (that are not part of the Standard) are provided after the Appendix to the Standard.

Analogously, many public sector infrastructure assets, such as those of a water and sewerage authority or an electricity distributor, are of a highly specialised nature. In these instances, due to the highly interdependent nature of the assets, the cash-generating unit may be the entire business. For a water and sewerage authority, it may or may not be possible to split the business between water distribution, sewerage treatment and drainage, but, even if possible, it may be difficult to identify any smaller identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

5.4 For-profit/not-for-profit entity classification

AASB 136 defines a not-for-profit entity as “an entity whose principal objective is not the generation of profit” (AASB 136, para Aus6.2). Health Services satisfy this classification. By implication, a for-profit entity is an entity whose principal objective is the generation of profit.

Section 2.4.3 of this Policy clarifies that all assets of a for-profit entity form part of one or more cash-generating units.

In the public sector, many entities are gradually moving towards becoming fully commercial, that is, to a position where their primary objective is the generation of profits. There are many such entities in a ‘transitional phase’ and as such, these transitional entities are considered *not-for-profit* entities. In this phase, there are number of factors, including the socio-political environment and/or legislative requirements that may prevent the generation of profit from being their principal objective.

Because of this, *not-for-profit* entities will have property, plant and equipment that do not comprise a cash-generating unit because the future economic benefits comprising those assets are not primarily dependent on the assets’ ability to generate net cash inflows from continuing use.

Classification as a *not-for-profit* or *for-profit* entity that requires consideration of a number of factors, such as:

- Statements by owners about the objectives of the entity, such as statements contained in legislation, regulations, entity constitutions and shareholder resolutions;
- Governance framework applied to the entity; i.e. the corporate structure adopted and the formal relationship with owners;
- Purpose, nature and extent of funding from owners, focusing on the extent to which ongoing budget support is provided to an entity;
- Targeted financial performance of the entity, as agreed between owners and the board/management, focusing on the extent to which the entity funds its expenses, maintains its asset base and provide returns to owners; and
- Classification of the entity under Government Finance Statistics (GFS).

The fact that an entity is classified as “not-for-profit” under AEIFRS does not imply that it is not required to operate efficiently, or in a commercial manner, as set out by its governance framework. Such a classification does not override legal requirements; e.g. a requirement to pay dividends to owners. Similarly, the fact that an entity is classified as “for-profit” does not mean it is released from wider obligations to society imposed by owners or other external parties.

Classification as a *for-profit* or *not-for-profit* entity is based on a substance over form approach and involves the exercise of professional skill and judgement. No single factor can conclusively determine the status of an entity. The above factors, when considered together, will assist in the application of professional judgment to the task of identifying an entity’s principal objective.

5.5 Whether an entity can have cash-generating units and other assets

Practitioners in the public sector are accustomed to the distinction between a not-for-profit entity and a profit-generating entity (in AASB 1010). Now, valuing assets under AASB 136 will be based on whether they belong to a cash-generating unit based on this Policy’s clarified definition. Therefore, the question arises as to whether an entity can have both cash-generating units and other assets.

5.5.1 For-profit entity

Prior to the adoption of AEIFRS, AASB 1010 made it clear that specialised assets of a profit-seeking entity used to provide goods or services at no charge or at less than the full cost recovery (i.e. “community service obligations”) must be included in the group of assets that is dependent on the provision of those goods or services to enable it to generate net cash inflows (AASB 1010 para 5.3).

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From this, under AASB 1010, a profit-generating entity could not have assets that were not part of a cash-generating unit.

This conclusion is explicitly supported by ED 109's 'Request for Comment' (the precursor to AASB 136). ED 109 asked for comment on the proposal that "the concept of cash-generating units removes the need to explicitly provide guidance on calculating the recoverable amount of assets subject to community service obligations". Implicit in this is the view that community service obligation assets are part of a cash-generating unit and therefore are not independent cash flows.

Under AASB 136, the above treatment is also implicit. Further, it is consistent with the treatment of corporate assets in AASB 136. Corporate assets such as building headquarters do not generate separate cash inflows. AASB 136 makes it clear that such assets belong to a cash-generating unit (AASB 136, para 101) and that, where there are any indicators of impairment, the recoverable amount is determined for the cash-generating unit to which the corporate assets belong.

5.5.2 Not-for-profit entity

AASB 136 defines a *not-for-profit* entity as an entity whose principal objective is not the generation of profit (AASB 136, para Aus6.2). Further, it explicitly states that, where the assets of a not-for-profit entity are *not* primarily dependent on the generation of net cash flows, value in use shall be determined as the depreciated replacement cost of the asset.

In effect, as discussed in section 2.4.3, these types of assets are excluded from the definition of a cash-generating unit and from impairment testing, unless selling costs are material. Notwithstanding this, a *not-for-profit* entity can have cash-generating units. This means that a *not-for-profit* entity may include non-cash-generating assets as well as a cash-generating unit/s.

A "unit" of a *not-for-profit* entity that has a number of objectives, but where generating profit is not the primary objective, is excluded from the definition of a cash-generating unit. The distinction between a for-profit and not-for-profit entity discussed in section 5.4 is also relevant to the distinction between a cash-generating and non-cash-generating unit of a *not-for-profit* entity.

5.6 Determining the net cash inflows of a cash-generating unit

5.6.1 Elements of value in use

AASB 136 requires that the following elements must be reflected in the calculation of a cash-generating unit's value in use (AASB 136, para 30):

- Estimate of future cash flows the entity expects to derive from the cash-generating unit;
- Expectations about possible variations in future cash flows*;
- The current market risk-free rate of interest;
- The risks specific to the asset (or price for bearing the uncertainty inherent in the asset)*; and
- Other factors that market participants would reflect in pricing the future cash flows*.

The asterisked elements above can be reflected either as adjustments to future cash flows or as adjustments to the discount rate (AASB 136, para 32). Appendix A to AASB 136 (which is part of the Standard) provides additional guidance on the use of present value techniques in measuring value in use.

5.6.2 Basis of estimates for value in use cash-flows

AASB 136 provides extensive guidance regarding the basis for the estimates of future cash flows (AASB 136, para 33-38), including what these estimates should include and exclude (AASB 136, paras 39-53). This guidance is briefly summarised below:

Estimates of future cash flows must be based on:

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- Management's best estimates of the range of economic conditions that will exist over the remaining useful life of the asset (giving greater weight to external evidence) (AASB 136, para 33(a));
- Most recent budgets approved by management (for a maximum period of five years unless longer is justified) (AASB 136, para 33(b)); and
- Most recent budgets extrapolated using a steady or declining growth rate (unless an increasing rate can be justified but not to exceed the long-term average growth rate for the products et al) (AASB 136, para 33(c)).

Future cash flows must be estimates for an asset based on its *continued use* (AASB 136, paras 39-43) and in its *current condition* (AASB 136, para 44-49).

- This includes:
 - Cash flows for the day-to-day servicing of the asset as well as directly attributable future overheads (AASB 136, para 41);
 - Cash flows from a committed restructuring (AASB 136, para 47);
 - Future cash flows to maintain the level of economic benefits expected to arise from an asset in its current condition (AASB 136, para 49);
 - Net cash flows, if any, to be received for the disposal of the asset at the end of its useful life (AASB 136, para 39(c) and 52-53).
- Estimates of future cash flows must exclude:
 - Cash inflows from assets that generate cash inflows largely independent of the cash inflows from the asset under review (e.g. receivables) (AASB 136, para 43(a));
 - Cash outflows that relate to obligations that have been recognised as liabilities (e.g. provisions or payables) (AASB 136, para 43(b));
 - Certain cash flows or related cash flow savings from a future restructuring that an entity is not yet committed to or improving or enhancing an asset's performance (AASB 136, para 44); and
 - Cash flows from financing or tax (AASB 136, para 50).

When a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the future cash flows associated with the unit. Similarly, when a single asset consists of components with different estimated useful lives, the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset when estimating the future cash flows generated by the asset (AASB 136, para 49).

Where management expectations are relied on, it is appropriate that these estimates be supported by a due diligence review by external consultants.

5.7 Discounting future cash flows

AASB 136 requires the future cash flows of a cash-generating unit to be discounted using a pre-tax rate that reflects current market assessments of the time value of money and risks specific to the asset for which the future cash flow estimates have not been adjusted (AASB 136, para 55).

AASB 136 paragraphs 56 to 57 and Appendix A to the Standard provide additional guidance.

Consistent with that guidance, this Policy requires the discount rate to be based on the weighted average cost of capital (WACC) of the operation determined under the Capital Asset Pricing Model (CAPM).

5.8 Other guidance

AASB 136 includes extensive guidance in other areas on determining and accounting for the impairment loss for cash-generating units and goodwill. For example:

- *How the concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated* (AASB 136, para 15). If previous calculations show an asset's recoverable amount is significantly greater than the carrying amount, it need not be re-estimated if no events have occurred that would eliminate that difference.
- *How to allocate goodwill to cash-generating units* (AASB 136, paras 80-87). This involves both a 'bottom up' and 'top down' test.
- *How to allocate corporate assets to cash-generating units* (AASB 136, paras 100-103).
- *How to calculate the recoverable amount of a cash-generating unit where the owner has a restoration liability* (by eliminating the restoration liability from both the carrying amount of the asset and the cash flows) (AASB 136, paras 39-43 and 78).
- *How to allocate the impairment loss* (AASB 136, para 104-108). For a cash-generating unit any impairment loss must be allocated to reduce the carrying amount of the assets of the unit in the following order:
 - first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit; and
 - then, to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the unit.

However, in allocating an impairment loss, an entity must not reduce the carrying amount of an asset below the highest of its fair value less costs to sell; value in use (if determinable); and zero.

- *When an impairment loss is to be reversed* (AASB 136, para 109-125). An entity must assess whether there is any indication that an impairment loss previously recognised no longer exists or has decreased, considering external and internal sources of information.
- *How to recognise an impairment loss* (AASB 136, paras 59-60). An impairment loss is recognised in the income statement, where the carrying amount of the asset or cash-generating unit exceeds the recoverable amount (AASB 136, para 59). However, impairment of an asset recognised at a revalued amount is treated as a revaluation decrement (AASB 136, para 60).

6. Heritage/cultural assets

6.1 Introduction

Heritage/cultural assets are assets held by entities because of their unique cultural, historical, geographical, scientific and/or environmental attributes. They assist the relevant entities in meeting their objectives in regard to exhibition, education, research and preservation, all of which are directed at providing a cultural service to the community.

Some heritage assets are solely of a historical or cultural interest (for example, monuments and statues) while others also provide a functional service (for example, heritage buildings used as commercial offices).

Heritage assets are to be valued at fair value in accordance with AASB 116 and the additional guidance in this Policy. Where such assets are held by not-for-profit entities, by their nature it is unlikely that they are held primarily for profit generation, unless they are part of a larger cash-generating unit. Therefore, most heritage assets are effectively exempt from AASB 136 and impairment testing. This is because there is no material dollar impact.

Where heritage assets are held by for-profit entities they will form part of a cash-generating unit subject to impairment testing (refer Section 5 of the Policy).

Fair value must be determined having regard to the "highest and best use" for which market participants would be prepared to pay (section 2.3.1). However, a characteristic of many cultural/heritage assets is that they have few or no alternative uses because there are natural, legal, financial

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or socio-political restrictions on their use and disposal, as discussed in section 2.3.1. Therefore, for many heritage/cultural assets, fair value means “existing use” value.

Fair value is determined by reference to the best available market evidence. Where available, this should be based on the current market selling price for the same or a similar type of asset (for example, for works of art). Many types of heritage assets are of a *specialised* nature (or unique) for which no market selling price can be observed or for which no relevant market exists. The treatment of specialised assets is discussed in section 2.3 and section 2.4 of this Policy and in AASB 116, para 33.

For example, a majority of the items within a natural history collection may not have an available market value. These include collections from arachnology, botany, crustacea, entomology, geology, herpetology, ichthyology, invertebrate zoology, mammalogy and ornithology.

In these circumstances, the asset’s fair value is measured at its depreciated replacement cost, in accordance with AASB 116. Because of the absence of market evidence, the income approach is not to be used, as outlined in section 2.3.5.

There will be instances where heritage/cultural assets are not capable of reliable measurement and will not be recognised. This occurs where there is no market selling price and where a replacement cost is not available, or cannot be reliably measured, due to the unique nature of the asset.

Reliable measurement may be difficult for certain groups of items including:

- Unique items that have iconic status (e.g. a landing board used at Gallipoli, an original Eureka flag etc);
- Historic library and museum collections; and
- Items that are sacred to particular communities.

A decision not to recognise certain heritage assets in the financial statements because of the inability to obtain a reliable value normally would need to be supported by an external opinion given by an expert in that particular area.

Where heritage assets are not recognised in the financial statements, relevant information on those items should be disclosed in the notes to the financial statements, as outlined in Section 7.7.

6.2 Library/museum collections and works of art

Library/museum collections and works of art generally have no feasible alternative use and should be valued based on “existing use”.

Artworks, furniture, jewellery, book collections (historic and current), philately and coin collections can usually be valued reliably based on market selling value because of the existence of sufficiently deep markets and the availability of expert valuers. Other collections, including archival, technology, and fashion and design collections may have very thin markets and valid sampling techniques may be difficult to establish.

Given the specialised unique nature of these other types of heritage/cultural assets, the best available market evidence of fair value may be the replacement cost, consistent with Section 2.3.5. This Policy provides that the replacement cost will be based on the lower of the current replacement cost and the current reproduction cost of the asset.

For specimens, the only available indicator of fair value may be the reproduction cost. The cost of mounting an expedition or field trip to collect similar replacement specimens, together with the costs associated with their documentation and preparation, represent their reproduction cost.

In determining the replacement cost of a heritage/cultural asset, it is important to consider the function/purpose of the asset. It may be possible to replace the function of an asset, not with an

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identical asset, but with another type of asset. Therefore the absence of an active secondary market for a particular type of asset does not necessarily mean that the asset cannot be measured reliably.

For instance, an asset may represent a certain school of art or the clothes of a particular historical person. It may be possible to replace the function that a unique item performs by the acquisition of another painting of that school or some other possessions of the historical character.

However, if the painting was held because it was by a particular artist, or because the clothes had been worn by a famous fashion model, or the film had been collected because it was the work of a particular producer, the replacement items used as a reference for valuation must relate to those specific persons.

Further, for specimens, it may be that the function is more readily replaced where the specimens are intended for display rather than scientific purposes. If the function is to provide a scientific specimen representative of the location and time at which the specimen was collected, it may not be possible to replace the function of the assets. Alterations to habitat and extinction of species can make it impossible to replace many specimens.

It is important, therefore, for the collection managers to decide on the form or manner in which an asset would be replaced (where possible), having regard to its function, and to advise the valuer accordingly.

Exhibits comprising general items of technology (without any specific intrinsic characteristics) that are used to illustrate a technical process or product could be valued at either their replacement or reproduction cost, depending on the manner in which replacement would be undertaken.

In some cases, however, the function of library and museum collections may not be capable of reliable measurement because its function cannot be replaced (eg State archives/records) or it may not be feasible to obtain a replacement or reproduction cost given the nature of the asset (e.g. certain scientific specimen collections).

The valuation of library/museum collections and works of art may also involve the use of sampling techniques by professional statisticians. This is further discussed in Appendix G.

6.3 Heritage properties

Heritage buildings are to be valued at fair value, having regard to the highest and best use of the asset. As there are few or no alternative uses for such properties, they are generally valued based on "existing use".

There are exceptions to this - where a heritage building may be available for a feasible alternative use.

For example, it may be feasible that a fire station situated in a heritage building could be relocated and the heritage building used for commercial purposes. Where this is a feasible alternative within the existing socio-political environment, then the building must be valued based on highest and best use, which, for example, may be as a commercial building.

The fair value of heritage buildings is determined by reference to the best available market evidence. Where the building has a feasible alternative use, it may be possible to obtain a market selling price for the building as say a commercial building or the current market price may be derived from current market rentals, as discussed in sections 2.3.2 and 3.2 of this Policy.

Where the building has few or no feasible alternative uses, this may be more difficult. In particular, where the building is unique (or specialised), generally there is no observable current market selling price. For example, there are no current market selling prices available to value Parliament House or the Mitchell Library building. The best available market evidence for unique (or specialised) heritage buildings is the replacement cost of the remaining economic benefits, consistent with section 2.3.5. The remaining economic benefits reflect the current condition of the building.

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In determining the replacement cost for heritage buildings, heritage buildings often have both functional as well as heritage characteristics. But, where such buildings are held because of their heritage significance, and the heritage uniqueness cannot be replaced with a modern building (replacement cost), current cost means the cost of replicating the existing asset. This is because the replication cost reflects the valuation of the heritage value or quality embodied in the asset.

Replication (reproduction cost) would assume reconstruction with modern materials, but sympathetic with the original heritage design and structure, to the extent that this is feasible. If a heritage building was a prestige construction with an imposing entry, high ceilings, elaborate sandstone carvings, open verandas and large carved cedar doors, the cost of replication would reflect that design and structure.

For example, it may not be feasible to replicate cedar doors built from 1,000 year-old cedar trees sourced from the Dorrigo Mountains. Instead, replication would assume sympathetic replication with similar materials. The cedar doors could be reconstructed using other available cedar. Similarly, modern construction might include concrete with sandstone façade in place of metre thick sandstone blocks.

Although the functional benefits of the building could be replicated with a contemporary building, the above sympathetic replication does not imply that the building is overvalued. Instead, the valuation accurately reflects the heritage value at current replacement/replication cost.

There may be other cases where it is difficult to reliably measure the heritage features of a building that has both functional and heritage features. In these cases, additional information on the heritage features and the annual maintenance/preservation costs should be included in the notes to the financial statements (see Section 7.7).

In other cases, it may be determined that a building has no or little heritage value. In these cases, the replacement cost would assume the existing building would be replaced by a modern building and valued at the replacement cost of the economic (functional) benefits only.

Land under heritage buildings and investment properties is to be valued in accordance with Section 3.

7. Other valuation issues

7.1 Separate restatement of gross amount and accumulated depreciation

AASB 116 para 35 states that when an item of property, plant and equipment is revalued, any accumulated depreciation must be treated in either of the following ways:

- “(a) Restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. This method is often used when an asset is revalued by means of applying an index to its depreciated replacement cost; or
- (b) Eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. This method is often used for buildings.”

This Policy mandates the method in para (a) above, where an entity revalues depreciable assets by reference to current prices for assets newer than those being revalued, and adjusts those amounts to reflect the present condition of the asset. Para (a) requires the separate restatement of the gross amounts and accumulated depreciation. This is consistent with the option provided in the previous AASB 1041. Therefore, gross restatement is typically required for specialised assets where valuation using replacement cost is required under AASB 116 and in accordance with this Policy. For non-specialised assets where market-based evidence is available the method in para (b) should be adopted.

The treatment in para (a) is mandated because, in the circumstances noted, the gross amount of current values of new assets and the accumulated depreciation are both considered to be relevant information, as most public sector infrastructure assets are specialised assets, with no feasible

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alternative uses. To continue to provide the services that the government mandates, such entities must replace the existing service potential embodied in the assets. This is further discussed in section 2.3.5 of the Policy.

Further, the gross restatement method in para (a) above is mandated irrespective of whether a revaluation has been conducted in that particular year and irrespective of whether the class or cash-generating unit has been written down to recoverable amount.

Finally, where there has been a write down to recoverable amount, this Policy requires that entities must separately disclose for each class of property, plant and equipment, the:

- Gross replacement cost;
- Accumulated depreciation;
- Depreciated replacement cost;
- Accumulated impairment losses; and
- Recoverable amount.

Where an asset is written down to recoverable amount, the accumulated depreciation disclosed above must still be based on the gross replacement cost, for *disclosure* purposes i.e. the gross restatement method.

Notwithstanding this, where there has been a recoverable amount write-down, the depreciation expense *recognised* in the Operating Statement in future periods must be based on the recoverable amount (i.e. rather than the gross replacement cost), in accordance with AASB 136, para 63.

Other disclosures regarding impairment losses are specified in AASB 136 paras 126 to 133.

7.2 Asset revaluation reserve on disposal

AASB 116 provides that an Asset Revaluation Reserve may be transferred directly to Accumulated Funds either when the asset is derecognised or progressively as the asset is used (AASB 116, para 41). This Policy requires that this transfer is only made when the asset is derecognised. The timing for this transfer is appropriate because the revaluation increment has been realised on derecognition.

7.3 Asset revaluation reserve – unit of measure

AASB 116 does not prescribe the unit of measure for recognising assets, that is, what constitutes an item of property, plant and equipment (AASB 116, para 9). This is relevant to *for-profit entities*, because revaluation increments and decrements must be offset on an individual asset basis (AASB 116, para 39). Prior to the adoption of AIFRS, under AASB 1041, revaluation increments and decrements were offset on a class basis for all entities. Under AASB 116, the requirement to offset on a class basis is only retained for *not-for-profit entities*.

According to AASB 116, for *for-profit entities*, an “asset”, not a “part of an asset”, is the basis for accounting for the movement in the asset revaluation reserve. This means that asset revaluation increments and decrements relating to parts of a complex infrastructure asset (e.g. electricity power station) may be offset. Notwithstanding this, the Standard requires that where major parts of an asset have useful lives materially different from the asset and therefore require replacement during the life of the asset, each part is depreciated over its shorter useful life (AASB 116, para 44 and para 45).

For valuation purposes, professional judgement is required in determining the unit of measure for an entity’s specific circumstances. For-profit entities should consider the following issues:

- How the business is managed. This may be evidenced by:
 - How management assesses and monitors performance.

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- Whether the business is managed on an individual, functional, geographical or total entity basis. Supporting documents include strategies in respect of service delivery, capital expenditure, asset management and risk management.
 - Whether the business is managed on the basis of a cash-generating unit.
 - The regulatory approach adopted by national and state jurisdictional regulators in respect of the entity's economic and operational activities.
-
- What is an operating asset:
 - Whether an item has utility by itself or only when operating in conjunction with other items of property, plant and equipment – that is, whether the components work together as an integrated whole to provide a service or bundle of related services to the end customer and deliver future economic benefit.
 - What items of property, plant and equipment would be aggregated to constitute an asset for the purposes of disposal as evidenced by observable market transactions.

For example, a water corporation's rationale for the unit of measure at the complex asset level may be based on the integrated functionality of individual components. That is, reservoirs, treatment/filtration plants and pumping stations of a water corporation may contribute towards a complete delivered water service to customers. The case for one complex asset may also be evidenced by an integrated water delivery system where water may be sourced from multiple reservoirs should there be supply or water quality issues in one particular part of the system. A water entity may have three assets – the above mentioned water delivery asset, as well as sewerage and drainage assets.

An electricity Distribution Network Service Provider may only have one complex infrastructure asset based on an analysis of the above principles, including that all components within the network must work together in order to reliably supply electricity to the end customer.

7.4 Restoration/remediation costs

Fair value should take into account the current condition of an asset, including the impact of any contamination or environmental damage. The best evidence of fair value is given by "current prices...for similar property in the same location and *condition...*" (AASB 140, para 45) (italics added). Therefore fair value reflects the un-remediated condition.

Where there is a legal or constructive obligation recognised for remediation or restoration costs under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*, entities must *recognise the related asset at fair value plus the remediation costs* (AASB 116, para 16(c)).

Nevertheless, the current condition of the asset, in its un-remediated state, is measured by:

- Obtaining the un-remediated fair value;
- Adding the remediation costs net of depreciation; and
- Deducting the related remediation liability (to avoid double counting).

The net valuation is the same under both situations (i.e. where there is and is not a remediation liability), only the mechanics and (gross) recognised amounts differ. That is, where there is an obligation for remediation, the current condition of the asset is reflected net of the related remediation liability; while where there is no related liability, the condition of the asset is reflected in the fair value of the asset.

The two scenarios where a remediation liability is and is not recognised are further discussed below.

7.4.1 Remediation costs where there is a legal or constructive obligation

AASB 116 states that the cost of an item of property, plant and equipment includes the initial estimate for dismantling, removing and restoring an asset, arising from both (AASB 116, para 16(c)):

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- An obligation incurred as a consequence of installing the item; or
- An obligation incurred as a consequence of using the item during a particular period.

In other words, if a restoration provision is recognised in accordance with AASB 137, it should be accompanied by the capitalisation (and depreciation) of the restoration cost (AASB 116, para 16(c)). IAS 16 Basis for Conclusions para BC 16 notes that the above applies whether assets are measured at cost or revalued amount. Such costs must be included where restoration/remediation costs are recognised under AASB 137. Previous Accounting Standards did not address this issue.

AASB 137 notes that provisions include legal or constructive obligations (AASB 137, para 17). It is only those obligations arising from past events that exist independently of an entity's future actions that are recognised as provisions (AASB 137, para 19-22, Appendix C, Examples 2A, 2B and 3). This may arise as a consequence of installation or as a consequence of using an item (AASB 137, para 19, Appendix C, Example 3). Conversely, an intention to operate differently in future is not a present obligation as there is no obligating event (where the entity can avoid the expenditure by changing its method of operations) e.g. intention to fit smoke filters in a factory (AASB 137, para 19 and Appendix C, Example 6). Similarly, provisions cannot be recognised for major periodic maintenance or overhauls as there is no present obligation (AASB 137, Appendix C, Examples 11A and 11B).

The Standard gives the following examples of provisions for restoration/remediation costs (AASB 137, para 19):

- Penalties or clean-up costs for unlawful environmental damage;
- Decommissioning costs of an oil installation or nuclear power station to the extent the entity is obliged to rectify damage already caused.

The amounts may not be easily determined due to the long time frames commonly involved. Another analogous example of a provision for restoration, although not explicitly mentioned in the Standard, is a make-good provision of leasehold premises.

Where a liability for restoration/remediation costs is recognised, it is also important to understand the basis of the valuation of the land obtained, to avoid double counting. Consistent with UIG Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* (para IE7), recognition of a liability for remediation costs affects the amount recognised for the related asset, as follows:

- Value in use - AASB 136 and UIG 1 make it clear that cash outflows relating to obligations recognised as liabilities must be excluded from the value in use calculation (AASB 136, para 43). This is necessary to avoid double counting.
- Depreciated replacement cost – Where a remediation liability is recognised under AASB 137, an appropriate amount will need to be added to the valuation of the related asset to reflect the depreciated replacement cost of that part of the asset.
- Market selling price – Market selling price should reflect the current condition of the asset. Therefore, where reference is made to prices for similar assets, these must be adjusted for any differences in condition, including potential remediation costs. Where a remediation liability is recognised under AASB 137, to ensure that it is not counted twice, the asset must be recognised at market selling price (fair value) based on the current condition *plus* the allowance for the remediation costs.

Accounting for changes in restoration or remediation costs is further outlined in UIG Interpretation 1. UIG 1 includes an illustrative example using the revaluation model, including journal entries (UIG1, Illustrative Examples, paras IE6-IE12).

7.4.2 Remediation costs where there is no legal or constructive obligation

There may be circumstances where an entity holds an asset that is environmentally damaged or contaminated, but where there is no legal or constructive obligation to remediate or restore the asset. For example, a constructive obligation does not arise unless the conduct of the entity, through its past

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practices, policies or statements, has created a valid expectation on the part of those affected that it will discharge its responsibilities and remediate the site (AASB 137, para 10).

Where there is no legal or constructive obligation, the treatment of remediation and restoration costs depends in part on whether existing use or highest and best use valuation is adopted.

Existing use valuation

Where there are no feasible alternative uses, the fair value of an asset should reflect the current condition of an asset in its existing use. Therefore, where there has been environmental damage to an entity's asset, this should be reflected in its fair value.

Further, by definition, an existing use valuation does not take into account any costs necessary to dismantle, remove and restore a site for an *alternative use*.

For example, lands under railway corridors are likely to have no feasible alternative use. The existing use value may best be expressed as undeveloped industrial or residential land discounted to allow for constraints of development e.g. shape and size etc (refer Appendix B, section 3.2 of the Policy).

Further, where the railway corridor land is contaminated, the value of the undeveloped industrial land must also be reduced to reflect the impact of the contamination on its value.

The costs of removing the railway track or tunnel/cuttings are not relevant as there is no feasible alternative use for the land.

Highest and best use (feasible alternative use) valuation

Where an asset has a feasible alternative use, fair value is measured as the 'highest and best use', after taking into account the costs of achieving the feasible highest and best use alternative.

Therefore, fair value is net of the costs to achieve that use. These costs include costs for any rezoning of the land and the costs of restoration or removal of existing improvements and/or reparation work to restore the land to useable condition for that alternative use.

7.5 Major inspection costs

AASB 116, para 14, provides:

"A condition of continuing to operate an item of property, plant and equipment (e.g. an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed."

This means that, on initial acquisition or construction, major inspection costs not separately identified must be re-allocated as a portion of the recognised value, rather than being added to cost or fair value of an item of property, plant and equipment.

Further, unlike restoration or remediation costs, inspection costs do not give rise to a liability. This is because there is no obligation to undertake the inspection (refer also AASB 137, para 19 and Appendix C, Examples 11-11B). It is only those obligations arising from past events that exist independently of an entity's future actions that are recognised as provisions.

As a result, when accounting for revalued assets with material inspection costs, it is important to understand the basis of the valuation obtained, as follows:

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- Value in use – The cash outflow relating to major inspection costs should be included as part of the value in use calculation. This is consistent with AASB 136, para 49 which states that when a single asset consists of components with different useful lives (e.g. the inspection component), the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset and therefore is included in estimates of the future cash flows.
- Depreciated replacement cost - If an asset is valued on a depreciated replacement cost basis, the valuation obtained may not separately identify the inspection cost component. If it does not, an appropriate amount will need to be re-allocated (rather than added) to the valuation to reflect the depreciated replacement cost of that part of the asset.
- Market selling price – A valuation based on market selling price is unlikely to separately identify the inspection cost component. Therefore, an appropriate amount will need to be re-allocated (rather than added) to the valuation to reflect the inspection cost component.

7.6 Conduct of valuations

AASB 116 does not prescribe whether valuations should be conducted by internal or external valuers, but notes that the fair value of land and buildings is “normally” undertaken by professionally qualified valuers (AASB 116, para 32). AASB 140 also encourages, but does not require, the fair value of investment property to be determined by a professionally qualified independent valuer, with recent relevant experience (AASB 140, para 32).

In NSW Health the valuations are to be performed by external valuers.

The involvement of external valuers will help ensure the independence of the process. Also, any decision not to recognise assets because of the inability to obtain a reliable value normally would need to be supported by an external opinion given by an expert in that particular area.

It is important that valuers are instructed that their valuation must be made in accordance with this Policy. It is the primary responsibility of the Health Service to determine the basis for the valuation and adequately instruct the valuer. In particular, Health Services need to provide instructions to valuers in the following areas:

- Whether assets are to be valued at highest and best use or existing use (based on feasible alternative use criteria).
- Existence of any contamination/damage to property including (but not limited to) areas where there is a legal or constructive obligation.
- Timing of any major inspection costs.
- Different categories of assets to be valued e.g. assets held for sale, investment property, easements etc.

Consistent with the instructions, the valuer’s report should include the following explicit statements:

- The valuation is made in accordance with AASB 116, AASB 136, AASB 140 (where relevant) and this Policy;
- The method(s) used in determining fair values for each class of assets; and
- The reason for the method(s) used (for example that assets have been valued at existing use because of the absence of feasible alternative uses).

However, it is a Health Service’s responsibility to review any independent valuations to ensure they are appropriate prior to their use.

7.7 Disclosures for assets not recognised

Health Services are required to make disclosures additional to those required by Australian Accounting Standards where assets are held that are not recognised in the financial statements

because they cannot be measured reliably. In these cases, the following disclosures should be made in the notes to the financial statements:

- The reasons for the inability to obtain a reliable value;
- The quantum, nature and functions of the assets; and
- An estimate of the annual costs of maintenance or preservation, where applicable.

7.8 Depreciation

7.8.1 Depreciation under AASB 116

Under AASB 116, parts of assets are not separate assets for valuation purposes (refer AASB 116, para 43 and section 7.3 of the Policy), but the Standard requires that each part with a cost that is significant in relation to the total cost of the item must be separately depreciated (para 43-45). Stated another way, where major parts of an asset have useful lives materially different from the asset and therefore require replacement during the life of the asset, each part is depreciated over its shorter useful life. The fact that an asset is valued at fair value and periodically revalued does not obviate this necessity because depreciation is an allocation process over an asset's useful life (not over the period between revaluations). Also, the residual value, useful life and depreciation method must be reviewed annually.

AASB 116 requires the "depreciable amount" to be depreciated because all physical assets have a limited "useful life". "Useful life" is the shortest of an asset's expected physical, technological or economic life to the entity. "Depreciable amount" means the historical or revalued gross cost less the net amount to be recovered on disposal at the end of its useful life.

Some assets may have an extremely long useful life (and the life may be indeterminate or even indefinite). For example, original artworks and collections are typically carefully preserved and restored for display or heritage reasons. Similarly, it is the intention to preserve other heritage assets, including heritage buildings, indefinitely. This would include iconic heritage assets such as the Opera House and the Harbour Bridge.

In these cases, the amount of depreciation may be immaterial and/ or may not be able to be reliably measured, because either or both the useful life or the net amount to be recovered at the end of the useful life (and therefore the depreciable amount) cannot be reliably measured. In these cases, depreciation is not recognised, but the decision not to recognise depreciation must be reviewed annually as required by AASB 116.

This line of argument does not extend to any other assets, including specialised assets such as infrastructure. This is because such assets are complex systems comprising separate parts that have differing useful lives that can be estimated, these parts are replaced, and Australian Accounting Standards (including the Australian Accounting Interpretations) both require the parts to be depreciated and prohibit renewals accounting.

7.8.2 Investment property

Investment property measured at fair value in accordance with AASB 140 is not depreciated as changes in fair value are fully recognised in the income statement each financial year.

7.9 Non-specialised assets

Non-specialised assets discussed in this section are physical non-current assets not otherwise discussed in this Policy. Examples include motor vehicles, office equipment and computers.

As noted above, physical non-current assets are to be valued at fair value in accordance with Accounting Standards and the additional guidance in this Policy. Fair value is measured at quoted market price or the best available evidence, including current market prices for assets that are similar in use, type and condition (similar assets) and the prices of the most recent transactions. Where

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current market prices cannot be observed, fair value is measured at the replacement cost of the asset's remaining service potential (section 2.3.5 of this Policy).

For non-specialised assets with short useful lives, these guidelines allow recognition at depreciated historical cost as an acceptable *surrogate* for fair value. This is because any difference between fair value and depreciation is unlikely to be material. In other words, it equates with fair value in all material respects. Further, the benefit of ascertaining a more accurate fair value does not justify the additional cost of obtaining it. Finally, use of a surrogate is allowed to avoid the necessity of obtaining market evidence to justify that the difference is immaterial. The valuation policy would state that the assets are valued at fair value.

7.10 Assets held for sale

7.10.1 Measurement and disclosure requirements

AASB 5 *Non-current Assets Held for Sale and Discontinued Operations* creates *held for sale* assets as a separate class of assets and specifies different measurement and disclosure requirements, as follows:

- The assets or disposal group are measured at the lower of carrying amount and fair value *less costs to sell* (AASB 5, para 15);
- An impairment loss is recognised in profit or loss for any initial or subsequent write down from the carrying amount measured immediately before reclassification or re-measurement (AASB 5, para 18 and 20, IFRS 5, Basis for Conclusions, BC48);
- The assets are not depreciated (AASB 5, para 25);
- The assets and liabilities must be re-classified to current assets and liabilities (AASB 5, para 3);
- The assets and liabilities must be shown separately from other assets and liabilities in the balance sheet (but no offsetting) (AASB 5, para 38);
- The major classes of assets and liabilities must be separately disclosed either on the face of the balance sheet or in the notes (AASB 5, para 38).

To meet the definition of *held for sale*, a number of strict criteria must be satisfied, e.g. the asset must be available for immediate sale and the sale must be highly probable (refer AASB 5, paras 6-12).

In most circumstances, re-classification and re-measurement as an asset *held for sale* will have no material effect on any previous measurement as property, plant and equipment. This is because under this Policy, entities are already required to recognise these assets based on fair value. Therefore, the only difference will arise where selling costs are material. In Treasury's view, in most cases, selling costs will not be material.

7.10.2 Exclusions

The *held for sale* measurement requirements do not apply to those assets already carried at fair value with changes in fair value recognised in profit or loss under another standard (e.g. investment property measured at fair value) (AASB 5, para 5(d)).

AASB 5 also does not apply to administrative restructures (equity transfers) between government departments subject to AAS 29 *Financial Reporting by Government Departments* (AASB 5, para Aus2.1). Further, NSW Treasury's view is that other equity transfers, not subject to AAS 29 (e.g. between a department and statutory body or between two statutory bodies), do not satisfy the *held for sale* definition. Accounting for equity transfers is further addressed in Treasury Policy TPP 06-7 *Contributions by Owners made to Wholly-Owned Public Sector Entities*.

7.11 Valuation of easements

Easements must be accounted for in accordance with AASB 138 *Intangible Assets* rather than AASB 116, because easements are an “interest” in land or property that is intangible rather than tangible in nature.

Easements may be related to the existence of specialised system assets on or under the surface of land owned by parties external to the entity. Common examples in the public sector include transmission line and pipeline easements. Easements generally create a right of way or right to use land only. As such, they meet the definition of an intangible asset under AASB 138. That is, they are “...an identifiable non-monetary asset without physical substance” (AASB 138, para 8). Easements are similar in nature to the “contract based intangible assets” referred to in the Illustrative Examples provided to AASB 3 *Business Combinations* (see Example D). These examples include “use rights” such as “route authorities” and other drilling, water, air, mineral and timber cutting rights.

Under AASB 138, easements are likely to be valued on an historical cost basis (para 74), because it is unlikely that an active market in easements exists to allow for fair value measurement (AASB 138, para 78). Prior to the adoption of AEIFRS, easements were accounted for in accordance with AASB 1041, in the same manner as all other property, plant and equipment (i.e. at fair value). As an intangible asset, easements will also be subject to impairment testing in AASB 136 (AASB 138, para 111 and AASB 136, paras 106-107).

7.12 Other references

Reference should be made to other Treasury publications that deal with financial reporting matters:
<http://www.treasury.nsw.gov.au/account/finrpt.htm>

Appendix A

General valuation principles

1. AASB 116 Property, Plant and Equipment

Property, plant and equipment are to be valued at fair value in accordance with Australian Accounting Standard AASB 116. The requirements of AASB 116 are basically contained in paragraphs 31 to 33.

“After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date” (AASB 116, para 31).

“The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal” (AASB 116, para 32).

“If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach” (AASB 116, para 33).

2. AASB 140 Investment Property

Investment property is to be valued at fair value in accordance with Australian Accounting Standard AASB 140. The requirements of AASB 140 are basically contained in paragraphs 36 to 52 of the standard, reproduced below:

“The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm’s length transaction (see paragraph 5). Fair value specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale” (AASB 140, para 36).

“An entity determines fair value without any deduction for transaction costs it may incur on sale or other disposal” (AASB 140, para 37).

“The fair value of investment property shall reflect market conditions at the reporting date” (AASB 140, para 38).

“Fair value is time-specific as of a given date. Because market conditions may change, the amount reported as fair value may be incorrect or inappropriate if estimated as of another time. The definition of fair value also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might be made in an arm’s length transaction between knowledgeable, willing parties if exchange and completion are not simultaneous” (AASB 140, para 39).

“The fair value of investment property reflects, among other things, rental income from current leases and reasonable and supportable assumptions that represent what knowledgeable, willing parties would assume about rental income from future leases in the light of current conditions. It also reflects, on a similar basis, any cash outflows (including rental payments and other outflows) that could be expected in respect of the property. Some of those outflows are reflected in the liability whereas others relate to outflows that are not recognised in the

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financial statements until a later date (e.g. periodic payments such as contingent rents)” (AASB 140, para 40).

“Paragraph 25 specifies the basis for initial recognition of the cost of an interest in a leased property. Paragraph 33 requires the interest in the leased property to be re-measured, if necessary, to fair value. In a lease negotiated at market rates, the fair value of an interest in a leased property at acquisition, net of all expected lease payments (including those relating to recognised liabilities), should be zero. This fair value does not change regardless of whether, for accounting purposes, a leased asset and liability are recognised at fair value or at the present value of minimum lease payments, in accordance with paragraph 20 of AASB 117. Thus, remeasuring a leased asset from cost in accordance with paragraph 25 to the fair value in accordance with paragraph 33 should not give rise to any initial gain or loss, unless fair value is measured at different times. This could occur when an election to apply the fair value model is made after initial recognition” (AASB 140, para 41).

“The definition of fair value refers to “knowledgeable, willing parties”. In this context, “knowledgeable” means that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the reporting date. A willing buyer is motivated, but not compelled, to buy. This buyer is neither over-eager nor determined to buy at any price. The assumed buyer would not pay a higher price than a market comprising knowledgeable, willing buyers and sellers would require” (AASB 140, para 42).

“A willing seller is neither an over-eager nor a forced seller, prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in current market conditions. The willing seller is motivated to sell the investment property at market terms for the best price obtainable. The factual circumstances of the actual investment property owner are not a part of this consideration because the willing seller is a hypothetical owner (e.g. a willing seller would not take into account the particular tax circumstances of the actual investment property owner)” (AASB 140, para 43).

“The definition of fair value refers to an arm’s length transaction. An arm’s length transaction is one between parties that do not have a particular or special relationship that makes prices of transactions uncharacteristic of market conditions. The transaction is presumed to be between unrelated parties, each acting independently” (AASB 140, para 44).

“The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts. An entity takes care to identify any differences in the nature, location or condition of the property, or in the contractual terms of the leases and other contracts relating to the property” (AASB 140, para 45).

“In the absence of current prices in an active market of the kind described in paragraph 45, an entity considers information from a variety of sources, including:

- (a) Current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;
- (b) Recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and
- (c) Discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows” (AASB 140, para 46).

“In some cases, the various sources listed in the previous paragraph may suggest different conclusions about the fair value of an investment property. An entity considers the reasons

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for those differences, in order to arrive at the most reliable estimate of fair value within a range of reasonable fair value estimates” (AASB 140, para 47).

“In exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property following the completion of construction or development, or after a change in use) that the variability in the range of reasonable fair value estimates will be so great, and the probabilities of the various outcomes so difficult to assess, that the usefulness of a single estimate of fair value is negated. This may indicate that the fair value of the property will not be reliably determinable on a continuing basis (see paragraph 53)” (AASB 140, para 48).

“Fair value differs from value in use, as defined in AASB 136 *Impairment of Assets*. Fair value reflects the knowledge and estimates of knowledgeable, willing buyers and sellers. In contrast, value in use reflects the entity’s estimates, including the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to knowledgeable, willing buyers and sellers:

- (a) Additional value derived from the creation of a portfolio of properties in different locations;
- (b) Synergies between investment property and other assets;
- (c) Legal rights or legal restrictions that are specific only to the current owner; and
- (d) Tax benefits or tax burdens that are specific to the current owner” (AASB 140, para 49).

“In determining the fair value of investment property, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:

- (a) Equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment;
- (b) If an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognise that furniture as a separate asset;
- (c) The fair value of investment property excludes prepaid or accrued operating lease income, because the entity recognises it as a separate liability or asset; and
- (d) The fair value of investment property held under a lease reflects expected cash flows (including contingent rent that is expected to become payable). Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised liability, to arrive at the fair value of the investment property for accounting purposes” (AASB 140, para 50).

“The fair value of investment property does not reflect future capital expenditure that will improve or enhance the property and does not reflect the related future benefits from this future expenditure” (AASB 140, para 51).

“In some cases, an entity expects that the present value of its payments relating to an investment property (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts. An entity applies AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether to recognise a liability and, if so, how to measure it” (AASB 140, para 52).

Appendix B

Valuation of land

1. Practical considerations in land valuation

The key principle in all real estate valuations is to determine the monetary price at which an asset would sell in open market trading among willing but not anxious parties who were all aware of the nature and potential of the property at the date of valuation. The essential elements are the knowledge of the relevant features of the assets and the understanding of the comparable property markets.

An important aspect in property valuations is the identification of all elements that would be taken into account by buyers and sellers in setting the price. Some of the basic elements include the land's description, area and/or dimensions, the legal or other interest of the entity, planning and other constraints on development, the availability of services, the potential for alternative use and the physical impediments existing in the land.

It is recognised that often there will be no active market in the types of assets being valued because of the unique nature of those assets. It is, however, the task of the valuer to establish appropriate value levels from market evidence of similar land types (based on existing use or feasible alternative use – refer section 2.3.1 of the Policy) and to document the processes and assumptions used to arrive at such levels. Given that the aim is to obtain realistic assessments of entities' land holdings, particularly those for which market values are not usually available, it is important to be able to show the rationale of those assessments. It is also necessary for the valuation reports to clearly state the methodology used to determine the values and to indicate that either all properties have been inspected and valued or a sampling process has been used to arrive at the figures.

The valuation of an asset for financial reporting purposes is not necessarily the same as the original acquisition cost to the entity. That cost might have represented the value to the vendor including development rights that no longer exist or improvements that have been removed. The valuation therefore should be based on the asset in its current use and condition or feasible alternative use.

A major issue in land valuation in the public sector is the size of the holdings of some entities. In some cases, it may be a question of providing a selection of benchmarks which are representative of the stock of land assets and making sufficient valuations to validly sample the whole portfolio. In other cases, such as the National Parks and Wildlife Service which has close to five million hectares of land in New South Wales, the difficulty is that the entities concerned may have land located throughout the State in a large number and variety of holdings. In these circumstances, the opportunities for sampling are somewhat restricted and will only be available after a rigorous process of categorising holdings according to similar characteristics.

2. Valuation methods for specific land assets

2.1 Crown land

For the purposes of this Policy, Crown land is defined as all land held by government entities that remains unalienated from the Crown and for which there is no title. It should be treated as any other asset controlled by government entities and recognised in the financial statements of those entities that have control over its economic benefits. There are a number of categories of Crown land, including Vacant Crown Land, Crown Land held for Development, and Crown Land subject to Perpetual Leases.

Vacant Crown land, such as large isolated rural parcels, should be valued in the same way as national parks and water catchment areas. Care must be taken to consider the possibility of claims being made and sustained under Native Title legislation.

Crown Land that is designated for development and disposal is to be valued at fair value having regard to the highest and best use of the land.

Crown Land that is subject to perpetual leases (including leases where there is a statutory right to buy the freehold) is to be valued at the present value of net cash flows received under the leases. The same principles apply here as would in any valuation where the interest was less than freehold. The value to be determined must reflect the extent of the interest of the entity in the asset. Where appropriate, a note should be included in the financial statements indicating the nature and extent of restrictions placed on the use and disposal of the land.

2.2 National parks and reserves

The aggregate of land owned or controlled as national parks and reserves in New South Wales exceeds 5 million hectares and represents a significant cross-section of all types of land in the State. Generally, these lands are held in substantial parcels, often relatively unimproved or wilderness areas with no prospects of alternative use because of the natural, legal or administrative restrictions on the use of the lands.

National parks comprising large holdings outside cities or urban centres are to be valued relative to adjoining similar lands with account taken of the state of land improvement (particularly clearing) and statutory or planning controls on subdivision or use. Consequently, a national park in the Western Division of the State could have a land value similar to surrounding grazing properties.

A wilderness area near a coastal urban centre, however, would be valued using evidence of markets for unimproved rural retreats, taking account of the relevance of building and other development rights.

The valuation of parks and reserves in urban areas can also be established in terms of the market values of comparable lands as long as care is taken to identify and account for any restrictions and circumstances peculiar to the land being valued. In many cases, a national park reserve will have similar rights of use as a local park, i.e., public recreation, limited by the protection of the environment. A bushland reserve would therefore have a valuation based on the market for land that cannot be developed and further restricted by any statutory duties imposed on the National Parks and Wildlife Service.

The values of parkland in urban areas are not normally related to the values of adjacent developed land. Generally, there are sufficient instances of sales of land for recreation, open space or similar purposes to establish a framework and allow valid comparisons.

For example, the land in a Western Division park can be valued at a rate per unit (per hectare, or per sheep area) relative to adjoining comparable rural properties but excluding any element of development potential, such as irrigation potential, not available to the entity. The same principle applies for a national park on the Coast. Any potential, say for tourist development, has to be excluded despite the fact that the acquisition of the land would have cost the entity an amount that compensated the former owner for any potential that then existed. This is because the asset is now in the control of the entity subject to its current restrictions. Urban sites are treated the same, and any valuation must take account of the existing development potential and not impute any that cannot be realised.

3. Valuation of land under specialised plant, buildings and infrastructure assets

3.1 Land under special purpose buildings

The following examples show the valuation approaches that are to be applied to assess the values of land under hospitals and schools. The two examples illustrate circumstances where there are feasible alternative uses because of the government's and community's recognition of demographic changes. Therefore, the land will be valued at highest and best use, i.e. the greater of existing and feasible alternative use. If there were no feasible alternative uses, because the service is

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needed/mandated to continue to be provided at that location, the land would be valued at existing use value in accordance with these guidelines. The same approaches can be adopted for court houses, prisons and other similar facilities.

The site of a surplus inner suburban hospital. As an example, assume a parcel of land of about 2.5 hectares with frontage to a main road and access to side or rear streets. Old hospital buildings are erected on the site. All the usual utility services are available to the site and the property. While zoned for a hospital, the land is surrounded by residential development with some potential for commercial/retail uses on the main road.

Value at "Existing Use" (land only)

Value of 2.5 hectares @ \$1,300,000 per hectare based on analysis of sales of private hospital sites. \$3,250,000

Value of "Feasible Alternative" say -

48 Town House sites	48 @ \$65,000	
2,000 square metres of commercial land	<u>2,000 @ \$275/sq m</u>	3,670,000
<u>Less</u> cost of site remediation	225,000	
approvals, rezoning	140,000	
services, Council contributions	<u>205,000</u>	
		<u>570,000</u>
Net Value		<u>\$3,100,000</u>

The existing use value of the site is greater and the amount of \$3,250,000 is adopted as the fair value in accordance with this Policy.

Professor Debora Picone AM
Director-General