



What to do when government restrictions prevent site access by external valuers

The challenge

The restrictions recently implemented to prevent the spread of the coronavirus may affect asset valuation work scheduled for the year ending 30 June 2020. This is particularly a risk for remote communities that are in lockdown.

This fact sheet outlines both challenges and opportunities for entities and their auditors where physical inspections by expert valuers are restricted from fair valuing physical assets using current replacement cost.

AASB 116 *Property, Plant and Equipment* requires entities to undertake revaluations with sufficient regularity to ensure that the carrying amount does not differ materially from fair value. The standard indicates a maximum period between revaluations of five years. It has been our long-standing opinion that indexations are insufficient on their own once the entity has used them for a period exceeding five years (and sometimes for shorter periods as well). The indices used are regional averages for broad asset classes, rather than asset specific, and fail to address other factors that impact fair value such as changes in asset condition that depreciation expense has not adequately measured.

In the next section we supply a potential alternative to site visits by external valuers that, if properly implemented, could provide sufficient support for valuations. We are also open to considering any other solutions. Please continue to discuss asset valuation options with your engagement leader.

Fact sheet

What could constitute a suitable alternative

Step 1: Update gross replacement costs

We prefer that entities maintain internal budget models to develop unit rates for asset types that they construct or acquire regularly, rather than relying on external valuers. This leverages off local knowledge and expertise; creates efficiencies through integration of business processes; reduces the cost of engaging external valuers; gives greater transparency, retention of corporate knowledge and ease of audit (compared to external valuations protected by intellectual property); and gives greater consistency between years (compared to when entities change valuation firms). Where internal budget models are maintained, the inputs (for example, unit cost of gravel) are updated annually to give a more precise valuation (and capital expenditure budgets) than a flat index.

If it is not workable to use internal models, indexation is often enough for gross replacement cost regardless of the number of years involved. However, before relying on an index in any year, management should follow the guidance provided in Appendix 1. This guidance does not usually require physical inspection of assets.

Step 2: Recalculate accumulated depreciation (obsolescence)

Incurable physical obsolescence

The International Valuation Standards advise that incurable physical obsolescence (that is, normal wear and tear that is unrelated to deferred maintenance) is measured as the proportion of the expected total life consumed. On this basis, and assuming zero residual value, the formula for incurable physical obsolescence is as follows:



Some entities may not have used this formula last year. While we currently accept other approaches, a valuer must implement them as part of a 'comprehensive' or 'specific appraisal' valuation. This year, entities can change to the straight-line formula detailed above and perform the calculation internally (where usual valuation methods are not available). That is, entities do not necessarily need to engage external valuers to measure incurable physical obsolescence. We regard the change in such approach as described above as being a change in estimate rather than a prior period error.

Regardless of whether coronavirus is a factor, it is usually not necessary to engage external valuers to review useful lives. Where available, an entity's engineers/asset managers (or other suitably knowledgeable staff) who monitor the assets regularly can assess their current condition. Ideally this will involve taking photos to help assess the rate of deterioration over time and for consulting with experts in other locations, as necessary.

AASB 116 requires entities to review useful lives every year. Therefore, entities should conduct a consistent approach each year and should not experience greater fluctuations in useful lives in years that a specific appraisal valuation is performed. However, this is sometimes not the case in practice, where we see that the annual reviews that management perform often lack rigour. If an independent valuer has not sighted all assets within the last five years, it is necessary for internal staff to perform a quality assessment this year. Appendix 2 provides guidance for reviewing useful lives.

Other forms of obsolescence

In addition to making an adjustment for incurable physical obsolescence, further adjustments are needed if other forms of obsolescence exist. These other forms of obsolescence are rarely material. We do not expect coronavirus to have a material impact for these other forms of obsolescence in 2019–20.

Appendix 3 summarises the forms of obsolescence, including incurable physical obsolescence discussed above, and how to measure them.



Appendix 1: Factors to consider before using an index

Review for changes in unit rate categories

For each major asset type, document whether there have been any significant changes in unit rate categories since acquisition or the last detailed revaluation. This will typically be the case where you have introduced new asset types (for example, due to expansion or the provision of new services) or changed your asset management practices (for example, instead of replacing a component every 20 years, splitting it into two sub-parts that are replaced at different times and require separate unit rates). Entities do not usually require physical inspection to identify new unit rate categories.

Review for changes in the modern substitute asset

For each major asset/component type, document whether there has been a notable change in the modern substitute asset since the last detailed revaluation. An example would be if lower cost materials are now available to construct replacements, or if construction methods have improved to reduce costs. Entities will have this knowledge internally for components that they construct regularly, such as water pipes and road seals. For major asset types that are less frequently constructed, entities may need to obtain written advice from a peer or external valuer. Entities do not usually require physical inspection to find changes in the modern substitute asset. Significant changes in the modern substitute are usually infrequent. If the modern substitute has changed significantly, indexation is insufficient.

Develop/update unit rates

In the isolated cases where new unit rate categories have arisen or the modern substitute asset has changed, determine whether your engineering and finance staff have sufficient information to cost the modern substitute and make adjustments for the differences in service levels between the modern substitute and the existing asset. Where sufficient information or expertise is unavailable internally, we recommend obtaining advice from an external valuer. Entities do not usually require physical inspection of assets to derive the unit rates for gross replacement cost. For example, asset specifications, photos, costing of recent projects for the modern asset, and experience with these or similar assets is usually enough.

For the remaining unit rate categories, update internal unit pricing models or apply a suitable index.

Address estimation uncertainty

For gross replacement cost, address estimation uncertainty by documenting an assessment of the reasonableness of unit rates with reference to a range developed from two or more relevant alternative sources, such as:

- actual costs for recent projects
- schedules of rates supplied by developers on handover of assets
- schedules of rates provided by tenderers for capital works
- information provided by quantity surveyors
- unit rates published by external experts such as the Roads and Transport Alliance for roads, Cordell, or Rawlinsons (consider the age and validity of the published data to your circumstances)
- benchmark data from nearby or otherwise comparable entities.

If unit rates are not within the range identified from these sources, it is likely that a new approach for deriving unit rates is required, particularly if the valuation is based on a long-term indexation.

Rolling revaluation of asset classes

Can a specific appraisal (revaluation) of asset classes be deferred?

For entities that undertake a program or cycle of revaluing a selection of classes of physical assets each year (rather than all asset classes in the one year), management should assess whether the cycle of revaluations can be altered.

If the most material asset classes (for example, roads) are still within cycle and it is only a low value asset class (for example, footpaths) that is due for revaluation in this financial year, and there are no practical alternate valuation methods available, management should assess the materiality of such asset classes. It is important that entities document this assessment and their conclusions. Where management concludes that a revaluation is not required for certain asset classes based on materiality, this should be discussed with the external auditor and should also be submitted to those charged with governance for endorsement.

Appendix 2: Guidance for reviewing useful lives

Review standard useful lives

Entities normally have a standard useful life for each component type that they use as the default life when a component is acquired.

Entities should document an assessment of the reasonableness of these default lives each year with reference to a range developed from two or more relevant alternative sources such as:

- the number of years it will take to replace the component type for the entire network based on rolling average annual funding (assuming that funding is sufficient to safely operate the network over the long term)
- minimum, maximum and average useful lives for disposed assets
- design lives advised by suppliers
- estimates used by other entities in the industry.

If the default life changes, entities should apply the new life in the calculation of accumulated depreciation for the current year.

Review for assets with lives that differ from standard useful lives

Each year, entities should review for individual assets whose useful lives are deviating from the standard life and adjust, as necessary.

As a minimum, we recommend that management finds outliers relative to default lives each year by documenting a review for:

- components that have passed, or are within a few years of passing, their standard useful lives
- components that the entity intends to replace per the asset management plan, but have different lives in the asset register
- components whose useful lives per the asset register end during the period covered by the asset management plan for which the entity does not intend to replace during that period.

Entities with a greater commitment to asset management can also consider:

- implementing a condition assessment program where staff document the condition of all assets using a standard form on a rolling basis of up to five years. Entities can use this information to adjust useful lives for components whose condition is better or worse than average for their age
- reviewing for assets requiring early retirement despite being in good condition because of obsolescence or legal limits (lease agreements or licence conditions).



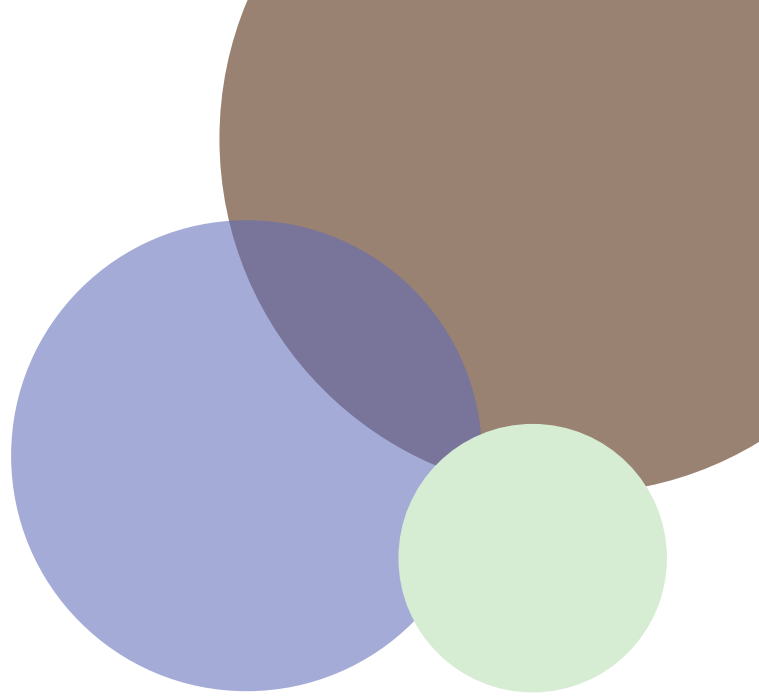
Appendix 3: Obsolescence

Forms of obsolescence

The below table summarises the forms of obsolescence and how to measure them. Accumulated depreciation normally only relates to incurable physical obsolescence, which applies to all assets unless they are new or have an indefinite life. Refer to Step 2 and Appendix 2 for further guidance on incurable physical obsolescence. The other forms of obsolescence are rarely material. We do not expect coronavirus to have a material impact for these other forms of obsolescence in 2019–20.

If the impacts of the virus stretch long after 30 June 2020, risks of a material impact become greater. For example, curable physical obsolescence can become material if maintenance backlogs grow significantly. Or, external obsolescence becomes a factor if the virus affects the way that government services are delivered in the long term such that existing assets become redundant or less useful. This is unlikely to affect the more material classes like roads, water and sewerage, but could possibly affect specialised buildings if working from home and service delivery direct to the home becomes more common long term.

Form of obsolescence (description)	Sub-category	Adjusted against	Example	Measurement basis
Physical deterioration (A loss in service capacity caused by the physical deterioration of the asset resulting from its age and usage. The deterioration is categorised as incurable unless a market participant could fix it through cost-effective repairs and maintenance.)	Incurable	Accumulated depreciation	Normal wear and tear	The proportion of expected total useful life consumed (i.e. a straight-line depreciation formula)
	Curable	Accumulated depreciation	Leaking roof that does not require fixing by replacing the whole roof.	The cost required to fix the obsolescence (usually deferred maintenance costs)
Functional obsolescence (When improvements in design, technology or materials result in the existing asset having a higher construction cost and/or operating cost in comparison to the modern substitute asset.)	Excess capital cost	Gross replacement cost	Concrete/steel bridge is cheaper than a wooden bridge	Captured by basing gross replacement cost on the modern substitute asset
	Excess operating cost	Accumulated depreciation	Energy efficiencies in modern buildings.	Present value of the excess operating costs over the asset's remaining useful life
Economic or external obsolescence (temporary or longer term) (A loss in service capacity caused by economic or other external factors outside of the owner's control. Economic factors relate to decreases in demand or adverse changes in supply.)	Declining demand	Accumulated depreciation	School buildings that are permanently over-sized due to loss of mining industry in the region.	Percentage difference in replacement cost between the asset's current and required size applies to carrying value (after all other adjustments)
	Other factors	Accumulated depreciation	Services provided by an asset that are inconsistent with revised government priorities	Usually as for incurable physical deterioration or declining demand as above



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