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### Re Staff Paper on 'Fair Value Measurement for Public Sector Entities

I have read with interest your Staff Paper on "Fair Value Measurement for Public Sector Entities" dated 16 April 2019. Having had some 30 years' experience in valuing all types of public sector assets, I have grave concerns over some of the changes to the assessment of how these assets are proposed to be valued in accordance with Fair Value.

I can concur that valuing assets for public sector entities assets that do not directly fall under guidance of market type properties i.e. residential, commercial or industrial properties generally traded in the marketplace, do present a few challenges when assessing their value in accordance with Fair Value AASB 116 and 13.

The valuation of these types of assets should not be undertaken by anyone other than qualified experienced and competent valuers who understand the concepts of valuation and the application of the highest and best use, it is evident that there are some valuation organisations who clearly have no understanding of this concept, and how it should be applied in applying Fair Value to the organisation's assets.

Competent qualified CPV valuers understand the concepts of required and would be familiar with the concept of Highest and Best Use. This was clearly outlined in the early Australian case of *Spencer Vs Commonwealth 1907*.

*"To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever in the amount which one would otherwise be willing to fix as the value of the property"*

This test, which envisages that the prudent hypothetical parties are aware of all the circumstances of the land which affect its use or potential use, requires an examination of the highest and best use of the land.

The highest and best use of a parcel of land is the most advantageous use to which the land may be put having regard to relevant planning instruments and the circumstance of the land. Where a claimant contends that the highest and best use is a potential or future use, the claimant must establish that:

- it is likely that the relevant development approvals would be obtained;
- the use must be probable within a reasonable period of time (**and not simply possible**); and
- there is a demand for the use and economic conditions make it probable that the use would take place.

It is this concept and more so the implementation of the highest and best use for non-market use land that presents the biggest challenge to the valuer in applying an appropriate value in order to comply with the basic concepts of the highest and best use in the application of Fair Value (*a price that would be received to sell the asset regardless of if it is an observable or estimated valuation methodology*).

The example of the purchase of land for a cemetery land for \$10 Million that is then re zoned for its specific use. In reality (which we are trying to ascertain) the value of the land would in fact diminish in value over time as it was consumed by burial plots. Furthermore, the likelihood of the land being re zoned and cleared of burial is far removed from reality as to be idealistic.

With reference to 18 on page 21 of your Staff Paper:

*“Therefore, holders of View 2 argue that the cemetery land’s fair value should be measured using the cost approach (i.e. at its current replacement cost), consistent with AASB 13.B916 and paragraphs BC78 - BC79 of the IASB’s Basis for Conclusions on IFRS 13. They argue that the cemetery land’s current replacement cost should be determined as the price of the comparable land that would need to be purchased to replace the cemetery land (which, in this example, is the market price of the adjoining residential land, i.e. \$10 million). Their other reasons for this view are:*

(a) the IASB’s Basis for Conclusions on IFRS 13 states that, to measure the fair value of a specialised asset, the market participant buyer is assumed to need that asset in its own operations and, in effect, “steps into the shoes of the entity that holds the specialised asset” (para. BC78). Similarly, the IASB’s Basis for Conclusions on IFRS 13 states that: “... an entity’s cost to replace an asset would equal the amount that a market participant buyer of that asset (that would use it similarly) would pay to acquire it ...” (para. BC141, emphasis added);

In relation part (a) *an entity’s cost to replace an asset would equal the amount that a market participant buyer of that asset (that would use it similarly) would pay to acquire*

It should be noted that methodology applied to the cost approach state that:

*(1) This comparative approach considers the possibility that, as an alternative to the purchase of a given property, one could acquire a modern equivalent asset that would provide equal utility. In a real estate context, this would involve the cost of acquiring equivalent land and constructing an equivalent new structure. Unless undue time, inconvenience, and risk are involved, the price that a buyer would pay for the asset being valued would not be more than the cost of the modern equivalent. Often the asset being valued will be less attractive than the cost of the modern equivalent because of age or obsolescence. A depreciation adjustment is required to the replacement cost to reflect this.*

*(1)Source: Australian and New Zealand Valuation and Property Standards - Sixth Edition (2008)*

The holders of View 2 are in fact trying to apply a Deprival Value concept to the assets in order that the calculations for Fair Value can be determined by modelling the asset.

One of the principle arguments against this approach is that it will give rise to values that differ significantly from market values. Comparison between the values of assets owned by different entities may be significantly different where deprival value is used because it reflects more the position of the reporting entity.

By applying the cost approach without regard for its reduction in utility, this will in fact overstate the entities true asset value and negate the concept of Fair Value, it would however make it easy to calculate by applying a modelling approach such as the example outlined on page 23-foot note (b&c). It should be noted that these models are more applicable to the share market predictions and would no doubt produce an even more erroneous value of the entity’s assets.

I also have reservations over how this approach may impact other types of assets such as none market type buildings, and plant & equipment which although physically sound would be coming to the end of their functionality, a critical concept of the Fair Value approach.

I believe that the majority of issues currently being discussed by your committee would not have come about if it were not for the relevant State, local and Federal Government departments inactivity in seeking professional advice on the way in which Fair Value was to be applied and guidelines established; as was done at least at a State level here in Western Australia.

I am in favour of guidelines being set up on the valuation of these types of unique assets, having personally observed some of the approaches currently being applied by some valuation organisations who are ignoring the basic concepts of valuation principle and practices such as town planning schemes and realistic economic life years of the assets.

Caroline Spencer Auditor General in Western Australia has raised these concerns in her report *Audit Results Report-Annual 2017-18 Financial Audits of Local Government Entities* to the president Legislative Council page 20 of her report raises concerns over the Inconsistent Valuation Methods where she makes note that:-

*“Valuation methodologies used for property, plant, equipment and infrastructure in the LG sector sometimes vary significantly across the different valuers. Some revaluations performed in 2017-18 yielded significant increments or decrements compared to the values of the previous revaluations, which were generally performed between 2013 and 2015. We concluded that most of the revalued assets were reported at amounts that materially represented fair value. However, in some instances, we asked LGs and their valuers to revisit the estimated values, resulting in some amendments.*

*Of particular concern is the inconsistent approach across different LGs, for valuing land assets that have restricted use. These include sports grounds, parks, gardens, sumps, foreshore, or land reserved as ‘bush forever’. One of the reasons for inconsistency is differing interpretations of the principles in Australian Accounting Standard AASB 13 Fair Value Measurement. In particular, the standard requires valuers to take into account the highest and best use to which a market participant could put the asset. However, the standard also specifies the need to take into account the characteristics of the asset, including any restrictions on sale or use.*

*Different valuers are applying different interpretations of these principles, resulting in significant differences in values attributed to these types of restricted use assets. This impacts comparability of the assets of local governments. Both the Australian Accounting Standards Board (AASB) and the International Public Sector Accounting Standards Board”*

When the Western Australian State Government embarked on the valuation of its assets Landgate (Previously the Valuer Generals Department) which I was on the original advisory panel to the Minister and Treasury, were tasked to come up with an approach to valuing non market type land as per the above example. The approach we came up with to valuing these assets was accepted by State Treasury and the OAG at the time, and to the best of my knowledge as still being applied. I believe it would benefit the AASB Committee to obtain Landgate’s input into their approach of applying low level land surrounding land values.

I am not by any means implying that the West Australian approach is a panacea for all the issues surrounding the application of Fair Value, but I am certain that the cost approach should not be applied to land in application of Fair Value. The correct application of Fair Value as the term implies is a valuation exercise in order to determine the exit value of the asset.

The methodologies applied in assessing the value of the asset must make economic sense to the recipients, and easily measured; after all Fair Value is foremost a valuation exercise which is critical to the application of accounting standard AASB116 Fair Value and AASB13 Fair Value Measurement.

I should also like to add that it would be prudent for the AASB Board to refer valuation matters to the two primary valuation controlling bodies of whom the vast majority of valuers are a member of; The Australian Property Institute (API) and Royal Institution Of Chartered Surveyors (RICS), both these organisations members have a wealth of valuation knowledge in the valuation for financial reporting and all other aspects of valuation of tangible and non-tangible assets.

Regards

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- ❖ Fellow Member of the Australian Property Institute (FAPI)
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