Guidance on Valuating PPE and Covid-19

Introduction

Recent natural disasters and the impacts of Covid-19, have increased the likelihood that some items of property, plant and equipment (PPE) will have material movements in fair value at 30 June 2020. This guidance identifies considerations arising from Covid-19. The guidance therefore only provides a brief summary of the requirements in AASB 13 *Fair Value Measurement* (AASB 13), and agencies should refer to AASB 13 when revaluing property, plant and equipment (PPE). Further guidance on PPE valuations is also contained in the following Treasury publication: TPP 14-01 *Valuation of Physical Non-Current Assets at Fair Value* (TPP 14-01).

1. What is the expected impact on PPE valued using the cost approach?

The impact on PPE fair values will depend on the valuation approach used for an asset, i.e. the market approach, income approach or cost approach.

While there are expectations that income-based may be significantly impacted for some assets, in general we expect no significant changes in the fair value of assets valued under the cost and market approach, except where assets have been destroyed or damaged, for instance by bushfires. This is based on the considerations below.

However, agencies should not presume that fair values have not been subject to significant changes. Particularly, in the current environment it is important valuers and management maintain professional scepticism and adopt a proper valuation process.

Cost approach

The cost approach (commonly referred to as 'current replacement cost' (CRC)), is widely used in the public sector, because assets are commonly used to provide services to the public, that are entirely or heavily subsidised. This means the income approach is not relevant. The cost approach is particularly suited to assets such as specialised buildings, specialised plant and infrastructure held for their service potential; and specialised or unique heritage assets, where there are no observable market selling prices.

The cost approach assumes fair value reflects the amount that would be required to replace the service capacity of the asset [AASB 13.B8]. More specifically, how much it would cost to reproduce an asset of equivalent utility taking into account physical, functional and economic obsolescence [AASB 13.B9]. If an asset is considered obsolete, over-engineered or has capacity greater than that required by a market participant, its CRC should be adjusted downwards.

Impact of Disasters and Covid-19
Natural disasters and Covid-19 may impact the fair value of PPE under CRC, in the following instances:

(a) **Damage** to the asset or **physical obsolescence** through additional wear and tear;

(b) **Economic** obsolescence due to changes in demand;

(c) **Changes to the costs** of constructing a modern equivalent asset.

(a) Physical Damage and obsolescence

CRC valuations include a component relating to the physical condition and expected lifespan of an asset – physical obsolescence. Therefore, any additional wear and tear resulting from recent unexpected usage or an unexpected lack of maintenance, could negatively impact fair value.

When an asset is damaged due to the natural disasters; to the extent it needs to be replaced, this should be accounted for as a disposal in accordance with AASB 116.67.

Damage to an asset which continues to be used should be accounted for as an impairment in accordance with AASB 136. 61 and Aus61.1.

(b) Changes in Demand
It is possible that natural disasters and/or Covid-19 may result in some assets such as public transport, schools, sports stadiums experiencing declines in demand for their services and potentially some surplus capacity. In these circumstances, agencies will need to consider whether surplus capacity requires adjustments to CRC.

Short-term surplus capacity should not affect CRC valuations, as it does not, on its own indicate obsolescence of those assets. In many instances the assets are likely to be fully utilised in the long-term, after Covid-19-related restrictions are lifted.

In other words, if there is a short-term reduction in demand for entities' goods and services, provided with the use of the assets valued using CRC, this alone should not affect the fair value of those assets.

In rare circumstances, it is possible that public sector assets may experience long-term surplus capacity. For instance, in areas with long-term reductions in economic activity due to the bushfires, e.g. areas abandoned by locals due to a high degree of damage to properties and infrastructure. Long-term surplus capacity may indicate obsolescence, because the cost to replace the reduced required service capacity may be lower than the current carrying amount. As a result, there may be reductions in fair values of such assets where the cost approach is used. However, it is important to note, that CRC allows for some growth in future demand.

At the same time, it is expected that some public sector assets will be utilised to a greater extent during the 2019-2020 financial year due to the bushfires/Covid-19, e.g. assets used in provision of relief to people affected, e.g. social housing. Again, temporary changes in utilisation of public assets are not expected to trigger changes in their fair value under CRC. However, agencies may need to consider whether the higher than expected use has an impact on the condition or useful lives of those assets.

(c) Changes to the costs of constructing a modern equivalent asset

Economic changes may affect the estimated costs to rebuild assets. Potential temporary effects on input costs to CRC valuations include:

- Increases in some costs, due to disruption of supply chains and movements in exchange rates; delays in construction due to Covid-19 restrictions; and increased international demand (e.g. for medical equipment); and
- decreases in some costs, due to the recessionary environment, such as certain labour costs; or commodity prices.

For example, the cost of materials may increase if these have to be procured in a different market, because the existing market becomes unavailable or less advantageous or if market demand for these materials increased due to Covid-19.

AASB 13 Appendix A requires that market participants, buyers and sellers, should be willing to enter into a transaction for the asset or liability, i.e. they are motivated but not forced or otherwise compelled to do so. This means that the fair value should be determined based on transactions that occur between non-anxious sellers and buyers and who are not forced. When the market is uncertain, this normally means that buyers and sellers tend to wait with their transactions until the market stabilises, while a higher share of sales that are occurring, are forced. i.e. mostly those market participants who have to sell their assets (due to financial difficulties or other reasons) are selling. Therefore, these few sales that occur in the uncertain market may not be indicative of the fair value, or more precisely, be may be lower than the fair value. Therefore, asset valuations in the current environment of uncertainty may require a higher degree of professional valuer vigilance, experience, and judgement. Accordingly, CRC valuations should be based on sustainable market prices, i.e. disregard effects of abnormal forced sales.

Current expectations

At this stage, in most cases it is likely there is not enough market information for entities to make a substantiated assessment about the impact of the natural disasters and Covid-19 on fair value under CRC as of 30 June 2020. Therefore, in most cases this impact is not expected to be material in the financial statements as of 30 June 2020. However, if there are any material enduring changes in the inputs prices for the assets valued under CRC at the reporting date, they should be captured in the fair values of assets at that date. Also, as discussed above, entities will need to perform an impairment assessment in order to conclude that the carrying amount of assets is equal to their fair value under CRC as of 30 June 2020 if, for example, the assets were damaged by bushfires.

2. What is the expected impact on PPE valued using the market approach?

The fair value of assets valued using the market approach may be impacted by natural disasters or Covid-19, where there have been significant changes to market prices at 30 June 2020. The market approach is mainly used for land and non-specialised buildings.

Covid-19 may also significantly increase uncertainty over market prices, for example where the market experiences low transaction volumes.

In extreme circumstances, significant market changes may require consideration of whether the market approach remains the most appropriate estimate of fair value. For example, where assets are held predominantly for their service potential, depressed market prices may no longer be the best staring point in measuring the fair value of that service potential.

Changes in Market prices
Similar to input prices for CRC valuations, market valuations should reflect market conditions as of the reporting date and disregard any distortions caused by a higher share of forced sales in the uncertain markets. Any material changes in market prices at the reporting date, should be reflected in estimates of fair values.

Decreases in Market Activity
Covid-19 may lead to substantial decreases in market activity, meaning less data is available. For some assets, there may be lack of current transactions to provide sufficient reliable market data at the reporting date, while transactions that occurred pre Covid-19 may now be less relevant. AASB 13 contains guidance on determining fair value when there has been a significant decrease in the volume or level of market activity (AASB 13.B37-B42). The first step is to determine whether the market approach or how it is applied under AASB 13.65 is still appropriate in the circumstances.

Assuming the market approach remains appropriate, the valuer will need to consider whether available quoted market prices represent fair value. Decreased market activity does not necessarily mean current market prices are not representative, but in some instances the valuer will need to adjust the market transactions or quoted prices (e.g. a risk premium for uncertainty).

Current Expectations
At this stage, it is understood there is no substantial evidence of significant declines in the market values of land and non-specialised buildings. It is not expected that this will significantly change by 30 June 2020. Further, much of the State's land has restricted zoning and valuation methodologies reflect the restricted use. Nevertheless, if evidence of significant declines in the market values of assets as of the reporting date, is received after 30 June 2020, this should be taken into consideration as an event after the reporting period (refer to Section 9 "Are any adjustments needed in financial statements if more information about fair values of assets is available after 30 June 2020?").

3. What is the expected impact on PPE valued using the income approach?

Assets valued using the income approach are those held predominantly to generate cash flows from the provision of goods and services. These include assets held by State-Owned Corporations to provide services such as water and electricity to consumers. Examples include infrastructure used to deliver water, wastewater and stormwater services; and the distribution of electricity.

For valuation techniques based on forecast future income, future cash flows are likely to have new risks and uncertainties that may be difficult to quantify. This has consequences for both the cash flows and potentially the discount rates used. If there are additional risks associated with estimating cash flows, then discount rates may increase, reflecting the additional risk premium market participants would expect to compensate for the greater risk.

The recessionary environment created by Covid-19 will have significant impacts on demand for goods and services. For some entities, this may result in significant changes to valuations under the income approach. Valuation inputs that may be subject to significant changes and uncertainty include:

- Projected cash flows;
- Risk free interest rates; and
- Risk margins.

Factors to consider in assessing changes to the income approach

There are a range of factors that need to be considered when using the income approach, in the current environment. These include:

- The extent of the impact of demand on cash flows;
- The duration of lockdown and social distancing measures;
- The period over which decline in cash flows is projected and the timing of the return to business as usual (i.e. the profile of the recovery);
- The impact of government's Covid-19 relief measures on projected cash flows, from both the agency's and the customer's perspectives;
- Any additional risks to cash flows that result in an additional risk premium that market participants would expect to compensate for the greater risk; and
- Whether the organisation's way of doing business will permanently change in future. For instance, whether an agency will significantly switch to online delivery of certain services. Meaning certain PPE will be permanently underutilised.

Current expectations

The impact of the current environment on the fair values of assets valued using the income approach, will depend on the industry and entity-specific circumstances.

4. What considerations apply to assets that are not subject to a comprehensive external valuation in 2019-20, as part of the 3 or 5 year cycle required by TPP 14-01?

Summary of Requirements in TPP 14-01

TPP 14-01 requires agencies to assess at <u>each</u> reporting date whether there is any indication that an asset's carrying amount differs materially from fair value. This is the case even where that asset is not subject to a comprehensive external valuation under the 3 or 5 year cycle. Where an indication does exist, that asset must be revalued to fair value.

TPP 14-01 does not automatically require a comprehensive external valuation. Instead it requires management to exercise judgement in determining whether and what type of valuation assessment is required. Agencies should refer to the full text in TPP 14-01, however, the guidance includes:

> Generally,
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> - an interim management revaluation should be undertaken when cumulative increases / decreases in indicators / indices are generally less than or equal to 20%. Interim management revaluations involve using management (or internal) expertise by applying the relevant indexation factors (refer section 8.2) to the carrying amount
> - an interim formal revaluation should be undertaken where there has been a cumulative increase / decrease in indicators / indices generally greater than 20%. Interim formal revaluations involve using external professionally qualified valuers (either to conduct the revaluation or to review the revaluation).

Note: these thresholds are indicative only. Agencies must apply professional judgement to determine whether an interim revaluation is necessary, and which type of interim revaluation is most appropriate.

TPP 14-01 section 8.1.3 page 33

What if Management's Assessment Indicates Fair Value may be more than 20% different to an Asset's Carrying Amount?

Management vs Formal Valuation

Where management has assessed an asset's carrying amount may be materially different to fair value, it will not always be necessary to conduct a formal valuation. The 20% threshold in TPP 14-01 is indicative only and management must make a decision based on the circumstances that have resulted in their interim assessment.

Interim valuations, whether formal or management valuations, do not necessarily mean a full comprehensive valuation. However, for valuation where the current environment has led to a high degree of uncertainty over valuation assumptions, management should consider the need to engage a professional valuer.

Management Interim Valuations

Management valuations can take a variety of forms. The appropriate form will depend on:

- The underlying valuation approach for that asset (i.e. cost, market or income);
- The assumptions/inputs that management has identified as potentially changing fair value. e.g. discount rates, cash flow projects, market indices;
- The availability of relevant and reliable data to management; and
- The degree of reliance on the specialist knowledge of external valuers.

Depending on the circumstances, management could use a combination of the following:

- Desktop valuations;
- Update the valuation methodology for the latest data, using the most recent external valuation report;
- Use of internally generated data, such as cash flow projections; and
- Valuations on a sample basis.

A management assessment is not the same as a management valuation. Management valuations need to use assumptions that are sufficiently granular and reliable to estimate and support the revised fair value. Management assessments can be broader.

Examples of assumptions and inputs that may be appropriate for management valuations, include:

- Published indices for each of the key materials and labour costs used in determining CRC;
- Published market indices for commercial property in the same location, when using the market approach;
- Assessment of physical, functional and economic obsolescence; and
- Internally prepared cash flow projections based on reliable historical data and external market predictors.

Formal Interim Valuations
Based on the above considerations, formal valuations are mostly likely to be required where PPE has been damaged through bushfires or floods, because the valuation changes will relate to the changed physical condition of those assets, rather than changes in market assumptions. Where management does determine a formal interim valuation is required for individual assets, consideration should be given to:

(a) Whether the factors that led to management's conclusion also indicate that other, similar assets should be revalued; and
(b) The appropriate form of the formal interim valuation.

There is no requirement perform formal valuations for all assets, where a particular asset in that class is revalued. This is because TPP 14-01 already contains processes to ensure fair value is considered by management at each reporting date for all assets.

The form of a formal interim valuation does not need to necessarily be a full comprehensive external valuation. Although management should consider whether that is required in the circumstances. Depending on the circumstances, management could use a combination of the following:

- Any of the techniques for a management valuation above, with a review by an external valuer; or
- Engage an external valuer to perform something less than a comprehensive valuation, such as a desktop valuation.

5. What if significant changes happen between Early Close and 30 June 2020?

Treasurer's Direction TPP 19-08: *Agency Direction for the 2019-20 Mandatory Early Close* (TPP 19-08) requires agencies to perform their cyclical comprehensive external valuations as at 31 March 2020, as part of Early Close Procedures. In many cases, external valuers then update their reports as at 30 June 2020. Given the potential for changes in market and economic information between 31 March and 30 June 2020, it is recommended agencies ensure their terms of engagement include this type of update by valuers.

Recommendation
It is recommended agencies discuss with their valuers, updates to valuation reports performed at Early Close, to ensure fair values are current as at 30 June 2020. This includes understanding the sources of data and assumptions used by the valuer. In particular, the age of data is likely to be critical in the current environment. Management will also need to consider the potential for new information available after 30 June that might materially change fair values, and whether this will constitute adjusting or non-adjusting events under AASB 110 *Events after the Reporting Period* (AASB 110).

It is possible that valuations performed at Early Close can be used at 30 June 2020, provided they materially represent fair values at the reporting date. However, valuations should be reviewed and if needed updated at 30 June 2020. Where appropriate, these updates can be desktop reviews.

Agencies are expected to obtain evidence from their valuers substantiating any material changes in valuation approaches, e.g. changed adjustment rates applied to restricted land in comparison to the ones used in prior years.

Management assessments and revaluations performed as part of Early Close for assets that are not subject to a comprehensive external valuation in 2019-20, need to be updated as of 30 June 2020 to reflect any changes since 31 March 2020. Further guidance is provided in *Covid-19 and Natural Disasters: A Practical Guide to Timing of Valuations of Property, Plant and Equipment.*

6. Expected changes to valuation reports due to Covid-19

The International Valuation Standards Council (IVSC) has published guidance on Covid-19 related topics for valuers[1]. In particular, IVSC noted that valuers should consider including a disclosure relating to significant valuation uncertainty in their valuation reports.

The Royal Institution of Chartered Surveyors (RICS), has suggested a sample disclosure statement as follows[2]:

"The outbreak of the Novel Coronavirus (COVID-19), declared by the World Health Organisation as a "Global Pandemic" on 11 March 2020, has impacted global financial markets. Travel restrictions have been implemented by many countries.

Market activity is being impacted in many sectors. As at the valuation date, we consider that we can attach less weight to previous market evidence for comparison purposes, to inform opinions of value. Indeed, the current response to COVID-19 means that we are faced with an unprecedented set of circumstances on which to base a judgement.

Our valuation(s) is / are therefore reported on the basis of 'material valuation uncertainty' as per VPS 3 and VPGA 10 of the RICS Red Book Global. Consequently, less certainty – and a higher degree of caution – should be attached to our valuation than would normally be the case. Given the unknown future impact that COVID-19 might have on the real estate market, we recommend that you keep the valuation of [this property] under frequent review."

Agencies should discuss the format of the proposed final valuation report with their audit teams at the earliest opportunity and encourage their valuers to engage with the auditors. In particular, **if management and auditors have any concerns regarding their ability to rely on valuers' reports, this should be advised to Treasury immediately**. Agencies should also consider providing relevant disclosures in the financial statements regarding significant uncertainties, in accordance with AASB 101 (see section 8 on disclosures below).

Examples of questions agencies should ask valuers, in consultation with their auditors:
- Are valuers able to determine fair values at 30 June 2020?
- Will fair values be provided as a point in the range rather than a range of values?
- Will valuation reports have scope, exclusion, caveats or qualifications due to Covid-19?
- Will the valuation reports contain sufficient appropriate evidence to support valuation assumptions?

[1] https://www.ivsc.org/news/article/statement-in-relation-to-the-covid-19-pandemic
[2] https://www.rics.org/oceania/upholding-professional-standards/sector-standards/valuation/valuation-coronavirus/

- Will valuation reports contain information regarding the impacts of Covid-19, including significant uncertainties?

Agencies should advise Treasury immediately it has significant concerns regarding asset valuations.

7. What to do if valuers cannot access PPE to complete valuations?

For many valuations, the normal valuation process includes the valuer <u>physically inspecting</u> the properties being valued. If physical inspection is required by the valuation process but is not possible due to Covid-19 lockdown measures, it is expected valuers can delay inspections until access is possible. If inspection is not possible within the timetable for annual reporting, then agencies and valuers should consider the use of technology, such as virtual inspections or drones.

If no other option is possible, a desktop valuation (based on indices, internal cashflow forecasts and discount rate estimates as applicable) can be performed. Such a desktop valuation should also factor in management's assessment of the condition of the assets. A comprehensive valuation involving inspecting the assets would still be required and should be performed at the next available opportunity.

It is important to understand whether the valuer will be able to assert compliance with valuation standards and the nature of any qualification to the valuation conclusion. The auditors will make their own assessment as to whether they can obtain sufficient appropriate audit evidence from such a desktop valuation.

8. What additional disclosures are expected in 2019-20 financial statements?

Determining fair values and impairments for PPE requires professional judgement and the use of estimation techniques. In the current environment, management should consider providing additional disclosures about key assumptions and critical estimates, including sources of estimation uncertainty. Refer to Treasury Guidance *Disclosures in Financial Statements and Covid-19* for more guidance.

AASB 101 *Presentation of Financial Statements*
AASB 101 *Presentation of Financial Statements* (AASB 101), contains the general requirements for disclosures, in particular for key judgements (AASB 102.122) and sources of estimation uncertainty (AASB 102.125). There are also specific disclosure requirements in AASB 13, AASB 136 and AASB 116.

Judgements
AASB 102.122 requires disclosure of judgements, apart from those involving estimation uncertainty. This could include judgements in respect of:

- Whether an item of PPE is impaired;
- Selection of the valuation approach; and
- Categorisation of the inputs used to measure the fair value of an asset at level 1, 2 or 3 of the fair value hierarchy.

Estimation uncertainty
AASB101.125 requires disclosures about the assumptions that management makes about the future, and other major sources of estimation uncertainty, that have a significant risk of resulting in a

material adjustment to the carrying amounts of assets and liabilities within the next financial year. Disclosures should include details of:

(a) assets and liabilities' nature, and
(b) their carrying amount.

Fair values of PPE are estimates. These estimates are impacted by both changes in the assumptions and inputs used, as well as the degree of uncertainty associated with those assumptions and inputs. Therefore, financial statements should disclose information about changes in assumptions and estimation uncertainty.

Examples of assumptions will include:

- Condition assessments;
- Useful lives;
- Projected future cash flows;
- Risk premiums to discount rates; and
- Adjustments to market prices for restricted use.

Information should be provided in a way that helps users of the financial statements to understand the judgements made by management where there is estimation uncertainty. The following are examples of the types of disclosure:

- Nature of the assumption or other estimation uncertainty;
- Sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
- Expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- Explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved [AASB 125.129].

It might be impracticable to disclose the extent of the possible effects of an assumption or another source of estimation uncertainty at the balance sheet date. If so, the entity discloses that it is reasonably possible, based on existing knowledge, that outcomes within the next financial year that are different from the assumption could require a material adjustment to the carrying amount of the asset or liability affected. In all cases, the entity discloses the nature and carrying amount of the specific asset or liability (or class of assets or liabilities) affected by the assumption [AASB101.131].

It is important to note disclosure is required for those assumptions and sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year.

AASB 13 *Fair Value Measurement*

AASB 13 contains extensive disclosure requirements and agencies should refer to that Standard. Changes in the fair value measurement affects the disclosures under AASB 13. In particular, entities are expected to disclose:

- changes in valuation techniques and inputs to valuations [AASB 13.91, 93(d)];
- changes in assumptions regarding inputs to valuations and reliability of these assumptions [AASB 13.91, 93(d)];
- for fair value measurements categorised within Level 3, quantitative information about the significant unobservable inputs used in the fair value measurement [AASB 13.93(d), except for the circumstances discussed in AASB 13.Aus93.1(d)];
- the amounts of any transfers into or out of Level 3 of the fair value hierarchy and reasons for these transfers [AASB 13.93(b) & 93(e) (iv)]; and
- for recurring fair value measurements categorised within Level 3, sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement [AASB 13.93 h(i) and Aus93.1 (with the exception assets of not-for-profit entities, where the future economic benefits from the asset are not primarily dependent on the asset's ability to generate net cash inflows)].

AASB 136 *Impairment of Assets*
Additional disclosures may be required to explain why assets were impaired, and what are the significant changes in assumptions regarding inputs to recoverable amounts estimates, reliability of these assumptions and the sensitivity of carrying amounts to changes in assumptions.

9. Are any adjustments needed in financial statements if more information about fair values of assets is available after 30 June 2020?

AASB 110 *Events after the Reporting Period* (AASB 110) requires agencies to:

- Adjust financial statements for events after reporting date which provide information about conditions that existed at the reporting date (adjusting events); and
- Disclose information about events that are indicative of conditions that arose after the reporting period (non-adjusting events).

Whether an event/information obtained after the end of the reporting period, 30 June 2020, is an adjusting event depends on the specific circumstances. For example, if information received in July-October 2020, provides evidence about fair values at 30 June 2020, it may necessitate adjustments to the fair values in the financial statements. For example, if new information is received about comparable sales that occurred before 30 June 2020 and this information would result in a significant change to the fair value, this should be adjusted at 30 June 2020.

Agencies should engage with their valuers after 30 June 2020 and as close as possible to the date of signing of the financial statements (agency's financial statements and TSSA respectively) to ensure all relevant information about adjusting events is correctly captured and adjustments to financial statements are made, if necessary. Similarly, for assets that are not subject to a comprehensive external valuation in 2019-20, agencies should update management assessments and revaluations as close as feasible to the date of signing of the financial statements.