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Impact of COVID-19 on valuations of non-financial assets

This article considers some of the impacts COVID-19 may have on the valuation of non-financial assets for financial reporting purposes. While the relevant accounting standards have not changed in 2019-20, the uncertainties and consequences of recent events need to be considered when undertaking 2019-20 asset valuations.

Do I need to undertake a comprehensive valuation?

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 at the end of each reporting period. The frequency of revaluations depends upon the nature of items of property, plant and equipment being revalued and the likelihood of changes in their fair values.

Revaluations of an asset class usually incorporate either or both of the following methods:

- comprehensive valuations undertaken by an independent professional valuer (or other relevant professional) or internal expert
- use of appropriate and relevant indices.

In our view, the maximum period between comprehensive valuations is between three and five years, including when indexation is applied in the intervening years. Although, if indicators exist that suggest an asset class has experienced a significant and volatile change in fair value, a comprehensive valuation should be performed.

Circumstances may differ from entity to entity, so it is not possible to propose a generic approach for all entities. Each entity's situation needs to be considered individually.

Is my pre-COVID-19 valuation still acceptable?

Some entities may have undertaken comprehensive valuations in recent years, or even during the current financial year prior to the COVID-19 outbreak. Understandably, these entities are wondering whether the valuations are able to be used for financial reporting purposes at 30 June 2020. Unfortunately, there is no easy answer to this question.

The requirements of AASB 13 and 116 still need to be complied with. Entities will need to assess whether, using all available information, the carrying amount of the asset class is likely to *differ materially* from fair value at the end of the reporting period. Generally, we would expect where a valuation is based on replacement construction costs, the movement may be limited. Valuations using the market or income technique may, however, experience more significant changes.

What if I have adopted a rolling revaluation of asset classes?

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 those charged with governance and with your audit team.

How do I measure fair value?

Fair value is determined in accord with AASB 13. AASB 13 contains valuation requirements that are relevant to the COVID-19 situation.

AASB 13 *Fair Value Measurement* defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Standard further specifies that fair value is a specific exit price estimate based on assumptions, including those about risks, that market participants would make under *current market conditions*. These assumptions are usually made using all available information, including information obtained through due diligence efforts that are 'usual and customary'.

Following the above requirement, the objective of fair value measurement is to convey the fair value of the asset or liability that reflects conditions as at the measurement date and not a future date.

What information do I need to measure fair value?

To calculate a fair value in accordance with AASB 13, information must be obtained, and/or assumptions made, about a range of factors, including but not limited to:

- the characteristics e.g. the condition and location of the asset
- which market a sale of that asset would take place in

- who would buy the asset and what they would take into account
- what is the highest and best use for the asset
- which costs are to be taken into account (e.g. transaction costs are not to be included, as per AASB 13).

AASB 13 does not mandate how the valuation information is sourced or applied. Valuations may be independently sourced, or they may be undertaken internally. The latter may be done where the assets are specialised, management expertise is present within the entity, and there are good controls over the valuation process. Further, the values may be derived through full application of valuation standards or through use of alternative supportable techniques such as indexation or desk reviews. However, the data used for the fair value calculation must reflect the information and assumptions that market participants would use when pricing the asset, not necessarily how the agency currently uses or intends to use, the asset. There may be situations where specific markets and/or market participants are not readily apparent. In such circumstances, entities should approach this by considering:

- what the asset can be used for
- who would use it for those purposes
- what would those parties take into account in determining a price to pay for the asset.

What about 'highest and best use'?

AASB 13 requires the fair value of non-financial assets to be measured at their highest and best use. The highest and best use must be physically possible, legally permissible, and financially feasible, and is determined based on the perspective of a market participant.

AASB 13 states the way an entity currently uses a non-financial asset is assumed to be the highest and best use, unless market or other factors suggest otherwise. Judgements about highest and best use must take into account the characteristics of the assets concerned, including restrictions on the use and disposal of assets arising from the asset's physical nature and any applicable legislative/contractual arrangements.

At the moment, no one can foresee how long the COVID-19 pandemic will last or how long its effects will linger. As of today, it may be too soon to conclude that an entity's highest and best use is different, but that may not always be the case.

What valuation approach should I use?

AASB 13 requires fair value to be determined using valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. To enhance comparability and disclosure, AASB 13 categorises inputs into valuations as follows:

- Level 1 - quoted prices (unadjusted) in active markets for identical assets
- Level 2 - all the inputs are observable, either directly or indirectly, but are not in Level 1
- Level 3 - unobservable inputs.

Given Level 1 and 2 inputs are observable, the increase in market volatility arising from COVID-19 should not change *the manner* in which fair value is measured.

Where Level 3 unobservable inputs are significant to the measurement of fair value, incorporating the increase in volatility attributed to COVID-19 into valuation models may pose a greater challenge.

The impact of the increased market volatility on inputs into valuations is discussed below for the three widely used valuation techniques: the market approach, the cost approach and the income approach.

Market approach valuations

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets or a group of assets. For items quoted in an active market, the market price at the measurement date provides the most reliable evidence of fair value. Fair value reflects the conditions and hence the value as at the measurement date.

For level 2 inputs, COVID-19 creates valuation uncertainty, because many inputs available for the valuation are likely to relate to the market before COVID-19 occurred and the impact of the event on prices may not be known until the market has stabilised.

While volatility in markets may suggest that the prices are aberrations and do not reflect fair value, it would not be appropriate for an entity to disregard market prices at the measurement date, unless those prices are from transactions that are not orderly. The concept of an orderly transaction is intended to distinguish a fair value measurement from the price in a distressed sale or forced liquidation. The intent is to convey the current value of the asset or liability at the measurement date, not its potential value at a future date.

Current replacement cost valuations

For current replacement cost valuations of public infrastructure and specialised buildings, we are not expecting a significant change in value as a result of COVID-19. Our experience tells us that these classes of assets are rarely volatile.

In terms of gross replacement costs, a lot of construction work will pause, meaning that there is less data available to make judgements. There is not yet evidence that construction costs will be higher or lower when work recommences. For accumulated depreciation, the condition and useful life of these long-lived assets is unlikely to change due to COVID-19.

Notwithstanding the above statements, our view is indexation of gross replacement costs is not appropriate if an entity has used indices for a period exceeding five years (and sometimes for shorter periods as well) and, therefore, a more comprehensive valuation of unit rates is required. Acknowledging that completion of valuations by independent valuers may not be possible for 2019-20 valuations, the following section outlines alternative procedures that can be undertaken to provide sufficient support for valuations.

Current replacement cost

AASB 13 defines current replacement cost as a valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset. The Standard states that current replacement cost is the cost to "... *acquire or construct a substitute asset of comparable utility, adjusted for obsolescence*".

Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence and is broader than depreciation for financial reporting purposes

Gross replacement cost

An asset's gross replacement cost is the amount it would cost at the revaluation date to acquire or construct a brand new substitute asset that has comparable utility and no obsolescence. Outlined below are factors to consider when indexation of unit rates is not appropriate.

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 entities have introduced new asset types (for example, due to expansion or the provision of new services) or changed 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 independent 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 engineering and finance staff have sufficient information to cost the modern substitute at unit rates applicable to the entity 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 independent 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 (entities should consider the age and validity of the published data to their 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.

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:

Regardless of whether COVID-19 is a factor, it is usually not necessary to engage external valuers to review useful lives. Where available, an entity's engineers or 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 comprehensive valuation is performed.

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.

If the impacts of COVID-19 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.

The table below summarises the forms of obsolescence, including incurable physical obsolescence discussed above, and how to measure them.

Form of obsolescence	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 (i.e. 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

Form of obsolescence	Sub-category	Adjusted against	Example	Measurement basis
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 students 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

Income based valuations

The valuation of assets prepared using income-based valuation models are likely to be impacted, with the main factors to consider being discount rates and cash flow forecasts, particularly trends post February 2020.

Entities will need to consider economic and financial announcements and directions, including ministerial directions issued that impact revenue and cost structures, fee relief, refunds, subsidies to customers, changes to asset maintenance programs, and revised cashflow forecasts due to changes in capital works programs and priorities. Entities should also consider the significance of the government-related COVID-19 economic relief packages (for example, the industry support package) on inputs to fair value.

With the current uncertainty and volatility, there may be some impacts when determining fair value with reference to market prices. While market prices may seem to be subject to a short-term fluctuation, or aberration, compared to a long-term value, market prices must still be used at reporting date. Where unobservable inputs are significant to the measurement of fair value, incorporating increases in volatility into valuation models may pose a significant challenges to entities.

When making critical assessments and judgements for measuring fair value, the entity should consider what conditions, and corresponding assumptions, were known or knowable to market participants.

What do I need to disclose about my revaluation?

Disclosure takes on heightened importance in periods of uncertainty and rapidly-changing market conditions. Entities should ensure their disclosures meet the objectives and requirements laid out in AASB 13. In particular, it will be important to highlight changes to fair value measurements due to COVID-19. Entities will need to consider making related disclosures that could reasonably be expected to influence decisions that the users of the financial statements may make based on the financial statements. For example, it is expected users of financial statements will want to understand changes in the inputs and valuation techniques used to measure fair value. Users of financial statements also may focus on reclassifications between levels of fair value inputs.

As the impacts of COVID-19 are still evolving, entities are also reminded to consider the disclosure requirements from other standards that are relevant to fair value measurement, such as AASB 110 *Events after the Reporting Period* on subsequent events and developments when asset values are significantly impacted subsequent to the reporting date. In addition, paragraph 125 of AASB 101 *Presentation of Financial Statements* requires information regarding the assumptions an entity makes about the future and other sources of estimation uncertainty at the end of the reporting period, where such assumptions have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

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