



AASB Submission

Land Valuation Methodology - Fair Value Measurement of
Non-cash-generating Assets of Not-for-Profit Public Sector
Entities.

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Outline

This submission has been generated on behalf of Australis Asset Advisory Group (AAAG). We have been recently made aware of an AASB special project into Fair Value reporting for Public Sector entities. Two documents have been reviewed: Staff Paper dated 16 April 2019, regarding meeting: AASB April 2019 (M170), as well as the Draft Exposure Draft Agenda Paper 6.2 AASB Meeting 14 June 2019 (M171).

The purpose of this submission is to:

- A. Provide our position regarding a proposal to change the methodology in the way specialised land assets are assessed, identified in the Proposed Amendment to Australian Accounting Standards – Fair Value Measurement of Non-cash-generating Assets for Non-for Profit Public Sector Entities and AASB Staff Paper (Project: Fair Value Measurement for Public Sector Entities).
- B. Outline the reasons as to why a change to the proposed methodology from current conventions is not suitable for land assessment.
- C. Submit our willingness to engage further and offer our expertise with stakeholders such as the API, AASB and Audit offices within Australia around this issue.

About Australis

AAAG has been incorporated for circa 5 years and is owned and operated by specialised valuers and engineers. The owners have all been working within the valuation industry specifically for Financial Reporting, Insurance and Asset Management since 2010-2011. Collectively, all have had experience in this specialised field of valuation before and after the introduction of AASB13, have worked on over 500 financial reporting valuation projects across the Asia Pacific region, and have engaged with many stakeholders involved in the valuation process of specialised assets (including Local and State Government Authorities and their auditors) on many occasions. Our staff have been specially trained in this field of specialisation or come with a background in this industry.

About the Valuers

Both valuers are Associate Members of the Australian Property Institute, Certified Practising Valuers, licensed to practise in all States and Territories, being registered with the Queensland Valuers Board Registered Valuers, and Western Australia Registered Valuer (Adam Wallace).

Both Adam and Elise have been in the valuation industry for over 13 years, with Adam having 3 years working as an Associate Director with a national asset valuation firm prior to joining Australis. They also guest lecture on Financial Reporting and Specialist Valuation for Bond University. In the last 5 years Adam and Elise have undertaken over 300 Portfolio Financial Reporting/Accounting and Insurance Valuations Australia wide for clients ranging from local and state governments, to ports, airports and church organisations.



Position Statement

The focus of this submission is specifically around the land valuation methodology proposed. Two 'Views' were presented as alternative approaches within meeting M170.

View 1: being the market or income approach.

View 2: being a 'Replacement Approach' methodology (known otherwise as deprival value).

Under document M170, paragraph 12, it is noted that:

"... a majority of members of the Fair Value Measurement Project Advisory Panel, argue that the fair value of the cemetery land in Example 1 should be measured using either the market approach or income approach in AASB13. This is 'View1'."

It was further recognised in paragraph 35 that a minority of panel members support View 2, though for supporters of this method:

"...some of them expressed reservations about the potential for overstating the fair value of specialised/restricted assets."

Even in light of the above, the Special Project Group still decided to adopt View 2 as the preferred approach.

We recognise that there is an ambiguity around the wording of AASB13 that allows for wide interpretation of the measurement of land values for Public Sector Entities.

Australis's position is that View 1 is the appropriate methodology for land valuation, and that by adopting a 'Replacement Approach' (View 2), the following would occur:

1. Values would align to an entry price methodology, which conflicts with the move in the standard toward exit price. Issues surrounding why an entry price methodology is problematic is discussed further in this submission,
2. The requirement for subjectivity for inputs required to a) reflect deprival value and b) adjust for obsolescence, would in some instances be greater,
3. The methodology would be counter to Court accepted methodology for assessing restricted or specialised land,
4. Values for many Local Government Areas would see significant (and in our view unnecessary) movement, and values will be overstated.



Delineation between 'Cost Approach' and Replacement Cost

It is posited that the 'Replacement Cost' approach is an appropriate valuation basis and consistent with the exit price of an asset. However the cost to replace an asset is realistically aligned with an entry price, whereas the 'Cost Approach' is the specific AASB13 methodology for Fair Value which is defined as:

'...the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, **adjusted for obsolescence** '

The last part of this sentence which we have emphasised is the crucial element that is required to be included to meet the 'exit price' concept. The AASB definition further defines:

'Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives)'

Entry Price vs Exit Price

We submit that adopting the currently supported exit price methodology is fundamentally what should be driving this discussion, and that the Replacement Cost methodology is primarily based on an entry price scenario. We reject the position that because specialised land has a limited market (and therefore there is no evidence of an exit price) that an entry price methodology should therefore be put in its place. Our position is that in applying most methods of valuation it is necessary for a Valuer to use market transactions for the purposes of obtaining basic information and any sales may be looked at by a Valuer for the purposes of establishing patterns of prices, and on this basis a land parcel subject to a restriction will carry a determinable base level of value for which evidence can be utilised and relevant. We refer to an excerpt from "The Law Affecting Valuation of Land in Australia", which speaks to the issue of absence of comparable sales; *"..in the absence of directly comparable sales evidence, a valuer, or a court, should look to those sales of lesser comparability, analyse them and make the necessary adjustments in applying them for the purpose of assessing the task at hand..."*

There are a number of issues with an entry price methodology when undertaking valuations that we have highlighted below.

1. Market Evidence for deprivation of land

As a counter to the submission that a lack of evidence for specialised land means an exit approach may not be suitable, we are of the opinion that there is a lack of robust evidence to show a trend that Councils undertake a process that involves replacing deprived assets, especially on a like for like basis. The most common method if this was to occur, so that the location and characteristics of the deprived property are the same/similar, would be through a resumption process. Even under a resumption process, the methodology aligned to assigning a value to the resumed land, which has been presented to the Courts, has been aligned to the methodology of View 1. It may be prudent to suggest that, like for improvements where 'real examples of consumption' should be referenced, an entity demonstrates a trend for replacement where they have been deprived of assets.



2. **Specialised Land is not commonly purchased, thus an entry price has been proved to be nil or low**
Historically, we have observed that many specialised land assets have been provided to entity by the State, or a developer or the like. Hence no entry cost (or a very minimal entry cost) has historically occurred. Again, a lack of evidence supports entry price methodology.
3. **Does Policy compel an entity to replace deprived land?**
In our opinion, if an entity is not compelled to replace an asset if deprived of it, then there is a strong argument to suggest they would not replace it if deprived of it. Hence, an entry price should not exist if a policy or pattern of behaviour does not exist. Many Community or Park Land assets may fall into this category, and for the purposes of providing an example, we present land used for a local sports club (zoned community or recreation) – in this example these land assets are utilised perhaps two times a week for training for not for profit groups, and every other weekend (for half a day) for home games. There is not a significant demand for the land to be utilised by others during the week, though to take non-conservative approach we could say the land receives casual visitation. In many cases, we have observed that a) an entity would not be compelled to replace the land asset if deprived of it given limited demand and b) if it did, the value should reflect the current or potential utilisation of the site (obsolescence).

Ironing out the subjectivity

We note that being in the valuation industry for public sector entities as long as we have, and having years of private sector valuation experience, we understand that there has been difficulty for clients and auditors in understanding how Valuers assess restricted land. There has been a significantly higher requirement for a Valuer to disclose methodology and adjustment factors within the State of Queensland since 2013. Specifically, how adjustments for specialised land assets are determined and applied. Due to the higher level of disclosure around subjective inputs for Level 3 assets, Australis has created a policy paper that identifies common land restriction types and further how the Courts or other entities have determined what adjustments are appropriate to reflect the specialised asset. This is on the basis that View 1 is the most appropriate methodology in assessing specialised land, as has been accepted in many a Court case. Based on this research, Australis has been able to provide a supportive framework around the adjustment's factors applied.

In our opinion the metrics and adjustments required for View 2 are potentially more subjective in nature than in View 1 and potentially with it carry a higher need for assumptions and 'what if' scenarios. Additionally, at this stage, we find a lack of information around the method with which advocates of View 2 propose to reflect obsolescence in a Replacement Cost scenario.



Public Sector Entity Dissatisfaction with the Replacement Cost Approach

Australis has undertaken numerous valuations where the prior valuers have utilised a Replacement Cost Approach. There are recurrent and consistent view with our clients:

- ◉ Dissatisfaction with the perceived 'over inflated' values.
- ◉ That this methodology does not make logical sense, how and why could a heavily restricted piece of land be measured so high?

There are examples where entities have attempted to sell land measured under this approach whereby, they have been unable to achieve a price anywhere close to the book value.

Under the Replacement methodology and the through the assistance of our clients, we have observed land under water being assessed at developable land subdivision rates and narrow drainage channels assessed as flat, elevated and regular shaped residential land. Our clients as well as the Valuers involved in the project have had great difficulty accepting the logic behind these values.

Adjustments are not always significant and/or required

Every asset should be measured on a case-by-case basis (rather than have one default full entry price policy). In the examples of Parks and Cemeteries, if the land is not actually in-use as the nominated use, then discounts may not be required, and the market approach (View 1) allows for this to occur. If there is surplus land that is vacant, unused, though perhaps zoned for community uses, full market value may be applicable to that land if it is market knowledge that the public sector entity has an appetite to dispose of surplus land.

We have provided a summary of our review of Example 1 – Cemetery Land, to appendix 1.

Characteristics – can they be 'easily changed'?

Section 11 from AASB13 (emphasis ours):

'11 A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability **at the measurement date**. Such characteristics include, for example, the following:

- (a) the condition and location of the asset; and
- (b) restrictions, if any, on the sale or use of the asset '

We understand that proponents of View 2 justify that restrictions 'may easily be changed' by an entity 'with the stroke of a pen'. However, this can delve too far into 'what if' scenarios that pretend the existing site conditions and characteristics do not exist, by continuing to suppose the assessment is required on its entry price and conditions that existed potentially years earlier. Further, using a Replacement Cost methodology is conditional upon the assumption that the asset will be continually used for its current



purpose and there is no intention to liquidate or significantly curtail operations. To assess the value of a parcel of land where the entity 'changes the zoning' or makes other pre-market alterations essentially goes against this criteria and may lend itself to the potential for an alternative use assessment.

Regarding the assertion as to how easily changed some characteristics can be, the claims that it is 'easy' may be an acceptable line of thinking, if it were to be excused that the 'legal and other proceedings' had no risks or costs - either direct legal and other costs, and/or time costs, as well as risk of not being able to obtain a change in zoning or use.

This 'easiness' also negates the actual site conditions and restrictions at the time of sale. While there is recognition of 'physically possible, legally permissible and financially feasible' elements, we also need to look at the practicality of the situation and what is 'reasonably foreseeable'. Community opposition can have a large impact on the reasonably foreseeable alternate use. There are often land lots owned by governments that are part of a community service obligation and are to be retained for public use. Cemeteries are indeed one of these items and often with extremely strong expectation of continued use.

Further – the 'legally permissible' argument directly relates to its town planning, zoning and government restrictions on the land – as **at the date of measurement**. If in the example of a cemetery, reading the town planning guidelines indicates that there is no other permissible use under the town planning scheme, a market participant would be cognizant of the existing legal restrictions on the site (at the date of measurement), and would have costs (time and direct costs) to put toward changing the existing zoning. How 'reasonably foreseeable' a successful change to zoning and restrictions is perceived by the market participant will influence how much they anticipate risk as well as additional costs will be, and therefore how much they will spend on the land. To convert the land to a 'market use' a market participant would also have considerable cost in removing the existing use (particularly in cemeteries), and with which also comes at a risk to the purchaser which would be a factor of the purchase decision. We note some Town Planning schemes dictate specifically that certain uses (such as Community zones) are to remain and never be anything but. In essence, our view is that entity specific treatments cannot be broadly applied.

A park example

Parks are provided as another example of restricted land. We agree that Councils do from time to time sell off park land – however these are specific cases, and often the park is either no longer in use and/or there is no community opposition to the process – therefore a 'reasonably foreseeable' alternate use is available. There are however countless examples of protests and legal action to oppose any proposed (or even rumoured) sale of community assets.

If council have changed the zoning of such land in order to sell – this only confirms that the market will pay full market pricing once the zoning has been changed and the land has been subdivided. Before that point, the market will not pay full commercial pricing on an asset where this is a risk, time, and/or cost factor to changing zoning.

In these examples the value of an asset should be on a case-by-case basis – noting observable conditions (current zoning and restrictions are in place) at the date of measurement.

We agree that if it is known that Council intends to sell off a park land asset, this is observable market data that a market participant would know of and their expectations of obtaining development approval are



greater. This should be reflected in the value. We do highlight that often the contract of sale to market participants are often predicated (conditional) on the purchaser achieving rezoning, or as mentioned above, the zoning has already been changed and land subdivided. Both scenarios remove the risk and cost elements from the buyer for which council absorbs.

However, if it is an asset of high community worth – e.g. if a park has been there for 50 years, council have not voiced any intent on selling off, and is in use by the community with the expectation by said community that its use will continue, it is reasonably foreseeable that it will continue as a park indefinitely. Being 'easy to change' and 'entity specific' as the default standard are not conducive to the actual situation 'on the ground'.

We further note, that in the case of Park (or Community Assets) where a Replacement Cost (View 2) methodology is utilised, if the Valuer is taking unrestricted land sales (such as residential subdivision land) and by using these rates directly or indirectly applying the following assumptions:

1. The current asset has an alternate use
2. The park or community improvements on the land are worth nil if the site is akin to residential subdivision land.



View 2 may create unintended consequences and/or time cost burden to value land assets

Should View 2 become the default policy, a feasibility would be required for all land assessments. Some questions need to be asked:

- ◉ Does the land have to be replaced?
- ◉ Is there an obligation on the Public Sector entity to replace the asset?
- ◉ Does it have to be replaced in the same location, or a lower cost location would be suitable?
- ◉ A number of assumptions are built into these questions (and subsequent application of Replacement Cost), which also introduces large levels of subjectivity into the values of these assets.
- ◉ If View 2 is to be adopted, and is not endorsed by the Australian Property Institute, how does this affect Financial Reporting assessments and/or Valuer's professional liability insurance?

Cost Approach – factoring in obsolescence

Under the Cost Approach, adjustment for obsolescence, condition, characteristics, and restrictions is required to meet the Fair Value (exit price) tests. In what way do these matters get treated under the Replacement Cost methodology? We consider that an adjustment, or assumptions on calculations need to be included to suitably account for these issues. In our view, this is then seen as an equivalent approach in applying a Market Value based assessment to the asset incorporating an adjustment. By also accounting for these obsolescence factors subjectivity would dictate that a Level 3 should be applicable.

Conclusion – Providing further disclosures

Australis's view is that the Cost Approach (the concept being different from 'replacement cost') is equivalent to the Market Approach when valuing restrictive land.

Under the Market Approach (Direct Comparison), the Valuer reviews the surrounding predominant land use and values to form a *pattern of pricing*¹, which are then applied to the subject property. The Valuer adopts an Adjustment Grid methodology for the typical differences in physical and legal characteristics – *and any adjustments which must be made to the information deduced from the analysis of the sales evidence in applying it to the property to be valued are... matters for expert opinion.*² These adjustments can (and should) be disclosed as part of deliverables to Public Sector entities to provide support to their Financial Reporting requirements.

The 'Replacement Cost' as proposed looks at the cost to acquire the land (this is the same process as above – surrounding predominant land value adjusted for characteristics). While it appears to omit the additional requirement of adjustment for obsolescence (as well as characteristics and restrictions), which cannot be ignored. The Cost Approach as defined by AASB13 is required to adjust for obsolescence for actual restrictions/conditions of use – and we are of the opinion that the adjustment for zoning and/or use in the Market Approach is equivalent to its application under the Cost Approach to account for these obsolescence matters.

¹ *Brewarrana Pty Ltd v Commissioner of Highways (1973) 32 LGRA 170 at 180*

² *Gosford City Council v Manufacturers Mutual Insurance Ltd (unreported, NSWCA, 28 October 1981)*



Australis's view is that no matter which approach is used, a discount, and/or adjustments are required to be made via either a Market Approach or a Cost Approach (defined as Replacement Cost including obsolescence), and should be disclosed within the Valuer's methodology report and/or working calculations as to inform the end reader.

Willingness to participate

The property team at Australis have had many discussions with industry colleagues, experienced in various facets of the valuation industry, whose views for the most part are reflected in ours. Our experience in this field of valuation in particular has provided us with a comprehensive understanding of the issues facing our government clients.

Australis welcomes the opportunity to support AASB with the adoption of traditional, industry accepted valuation methodologies and principles, and on this basis, representatives from our firm would welcome any invitation for further discussion on this matter, either by way of submission or in person. We encourage representatives of the AASB to contact Australis should there be any questions or requests for further engagement required.



Appendix 1

Summary of review of Example 1 – Cemetery Land

“The Writer” in this summary is expressed as the writer and owner of Example 1 published in the AASB Staff Paper ‘Progress Update and Items for Discussion’ dated 16 April 2019 (page 13 to 27).

1. There may be a misunderstanding with the writer that the percentage of discount may not be and should not be broadly applied, particularly where sites are not 100% utilised, and detail around the 95% discount factor is lacking. The writer refers to this rate a ‘deep discounting’ and the way it is presented suggests that View 1 would see a 95% discount applied to all cemetery land, in all cases. To provide further clarity on what we understand of this metric, there is a difference with cemetery land assets between areas that are ‘used’ or ‘zoned/earmarked and therefore unused at the date of measurement’. The 95% discount, which indeed is a percentage that has been sourced from an observable input, refers to the ‘used’ portion of land. Quite commonly, an entity will own one or the other, or have an asset with a combination of ‘used’ and ‘unused’ area. Sometimes, these areas are delineated with different titles. The writer has raised concerns over which value would be assigned to the land based on a rezoning.³ To provide clarity, it would depend on the establishment of the cemetery and its current service potential at the date of measurement. If the site had been purchased for \$10 million (assumed an arm’s length transaction and market condition remained stable since) and had not been utilised, or only part utilised with plots, the variance in value (\$10 million vs \$400,000) would not be so large, and there in fact would not be the “deep discounting” applied that the writer alludes to. What you may see is an equilibrium between a decrease in the land value and an increasing Community Service Obligation (CSO) value over time or as the site develops. The ‘when’ in this question will come down to the date of measurement and the service potential of the asset at this time. We must remember that tangible assets will be subject to change and augmentation over time, whether this is a physical or income based change (or both), which is why comprehensive valuations are important.
2. It appears the writer has not reconciled that the definition of Highest and Best Use (HBU) is applicable on the date of measurement, and that further on the date of measurement, historical site conditions cannot be factored into the assessment. In this example, observable market data would need to be viewed in light of:
 - The site having a restricted nature
 - The zoning of the site only legally permits cemetery use
 - There is a very sensitive community nature and use to the land.
3. The writer argues that *stepping into the shoes of the land holder means the buyer could only acquire a parcel of land by purchasing residential land because that buyer needs to compete for that land with other buyers who can generate much higher net cash inflows for that land.* This submission is

³ a) Does the effect of the land’s rezoning from residential land to cemetery land cause the land’s fair value to changes from \$10 million to either \$400,000 or \$500,00 (and, if so, which amount)?

(b) is the market approach appropriate for measuring the fair value of some arguably specialised assets and, if so, do the circumstances in which the market approach is appropriate (such as where there is observable market evidence of the amount of the above-mentioned discount) determine when the discount should affect the measurement of the land’s fair value.



significantly flawed for it does not allow for the fact that the function of the land has changed, and the economic potential of the land has changed. Hence, obsolescence has been ignored.

- 4 We do not endorse the assertion that supporters of View 1 believe that land can never be a specialised asset. Most Court cases that deal with complex land valuation issues where an exit price approach is adopted are in fact over specialised land assets, such as rights of way, easements, DOGIT land etc.
- 5 It is recognised that the most likely market participant of a specialised government asset (such as a cemetery) is another government entity. However, the assertion that another government entity/market participant will pay a *historical* price (i.e. \$10 million) for a property as a form of 'stepping into the shoes of the entity', is applying the assumption the market participant is an uninformed purchaser. In our opinion, a market participant can acquire the same characteristics as the land holder without having to revert to paying a historical price by way or paying for the current service potential of the asset at the date of measurement. If the site is relatively undeveloped/utilised and market conditions have remained stable for example, this value may be close to the \$10 million mark.
- 6 The view that stepping into the shoes of a land holder and paying the historical investment amount to gain the same 'characteristics' would be equivalent to stating that a specialised building assessed by way of the Current Replacement Cost needs to ignore the fact that this building may have changed over the time of ownership and thus condition, usage changes (and economic obsolescence), or design obsolescence are not to be factored into the assessment. Thereby, the Fair Value of the building would be the cost of construction of that building at the date of measurement.
- 7 We are of the opinion that the Example provided here oversimplifies a complex issue that will not apply to every asset in a Cemetery category, nor every specialised asset. Providing this as an example to support the Replacement Cost methodology (View 2) is erroneous given the complexity of the various ways the land could be developed and used.



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