

Issues with limited hierarchies and not splitting components into Short-Life and Long-Life Parts

INTRODUCTION

Some entities request APV to undertake their building valuations using either or both a very limited componentisation and a direction to not split components into short-life and long-life parts.

As valuers we take instruction from our clients. However, as the valuations are audited by external auditors and the net impact of such instructions can have major impacts on the final values and depreciation expense estimates we have a professional obligation to provide guidance to our clients before adopting the desired instructions.

This paper provides a brief overview of the issues and alternative solutions to ensure the valuation and associated depreciation expense calculations remain fully compliant while also satisfying the client's needs.

WHY LIMITED COMPONENTS?

There are many reasons why some clients desire the valuation be limited to a very small (normally about four) components. When this is the case, the components most commonly requested are –

- Structure
- Roof
- Fit-Out
- Services

The main reason however for using these four components is usually provided as *'because that is the way they have always been set up in the system and its too much work to change them'*.

Given the huge amount of work that system require to change the asset hierarchy we certainly understand that the time and effort involved in restructuring an existing asset register can be a very good reason for keeping the existing structure.

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WHY NOT SPLIT OUT SHORT-LIFE AND LONG-LIFE PARTS?

For many entities the reason provided is essentially the same as the reason for keeping the existing asset hierarchy. i.e. *The time and effort involved in effectively doubling the number of items in the asset register is a huge task. It is questionable whether the outcome justifies the effort required.*

REQUIREMENTS OF THE ACCOUNTING STANDARDS

It is important to understand firstly that –

- The valuations are to be undertaken in accordance with the Accounting Standards (AASB/ IFRS/ IPSAS) and
- The valuations will be audited by an external auditor who will assess the valuation for compliance against the accounting standards.

Given the huge materiality of both valuation and depreciation expense in the financial statements combined with the fact that both figures are based on assumptions and the exercise of professional judgement the ‘risk for audit’ is extreme (very material, very high consequence and very high likelihood of assumptions being wrong).

The main driver for ‘componentisation’ and the need to split components into ‘short-life’ and ‘long-life’ parts is a combination of asset management and accounting standard drivers.

Asset Management Drivers

The basic concept of asset management is for the entity to ‘provide an appropriate level of service over the long-term in the most cost effective way’. In order to achieve this the entity needs to optimise the ‘level of service’ provided by the asset against the assets ‘whole of lifecycle cost’. This includes the cost of acquisition, maintenance, operation, renewal and disposal.

In order to achieve this, asset management systems disaggregate assets into the different major components that experience different asset management drivers and therefore are managed and modelled independently of the other components. For example, the roof or a building verses the floor coverings or air-conditioning units.

Guidance on the level of componentisation is provided by guides such as IPWEA Practice Note 3 'Building Condition Assessment'. Typically, due to the different asset management drivers and strategies buildings are usually split into –

- Sub-Structure (such a timber bases on concrete stumps)
- Structure (such as timber with timber cladding)
- Roof (such as corrugated iron)
- Floor Coverings (such as carpet)
- Fit-Out (such as gyproc finish)
- Services –
 - Mechanical (air-conditioning)
 - Transport (lifts)
 - Electrical
 - Hydraulic
 - Fire
 - Security

Obviously for most buildings not all components are present. However, by breaking down to this level the asset managers are able to gain increased knowledge and understanding of their buildings and model alternative asset management scenarios and strategies.

Accounting Standard Drivers

The key driver is the requirement of AASB116 (IAS16 / IPSAS17) that deals with depreciation expense. Specifically, the standard (AASB116) states –

43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors.

AASB116 further defines –

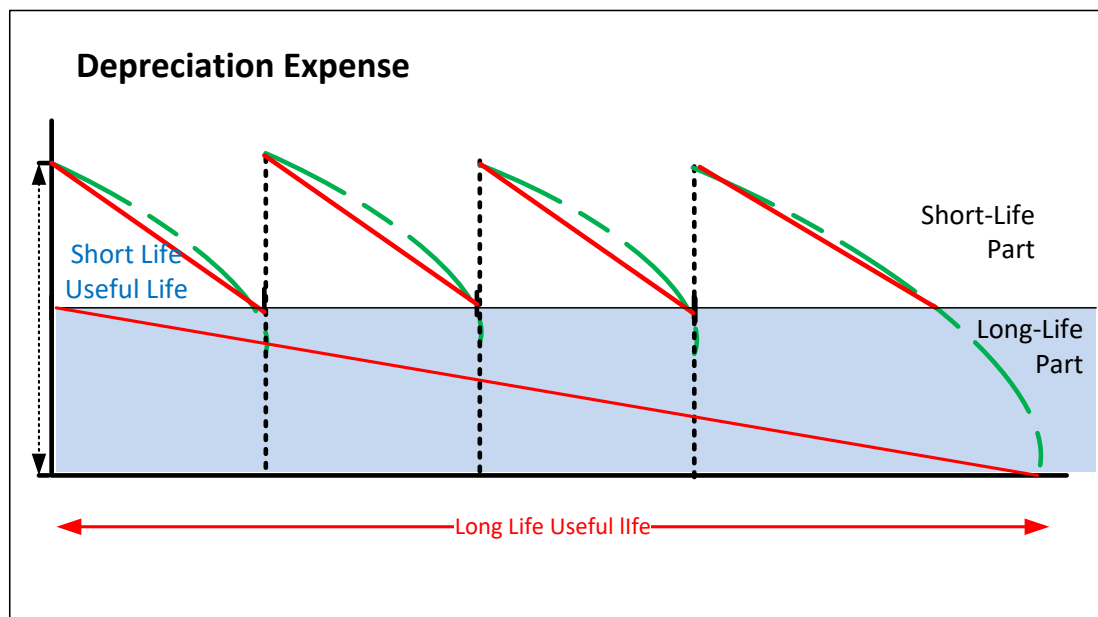
Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

The issue of splitting components into ‘short-life’ and ‘long-life’ parts was brought to a head in May 2015 with the AASB Residual Value decision.

In recognising that the cost of renewing a component (such as re-cladding a roof) is often less than the cost of the overall component (such as the roof including the cost of trusses as well) that this highlighted that many components have two different parts with each having a different useful life.

As a result AASB116 requires the depreciation for these parts to be calculated separately as shown in the image below.



If components are not split and depreciated in this way there is an extreme risk that the Fair Values will be understated and the Depreciation Expense will be overstated. Our experience indicates that the misstatement for depreciation expense is often in the range 30% - 70% which obviously has huge impacts on sustainability measures.

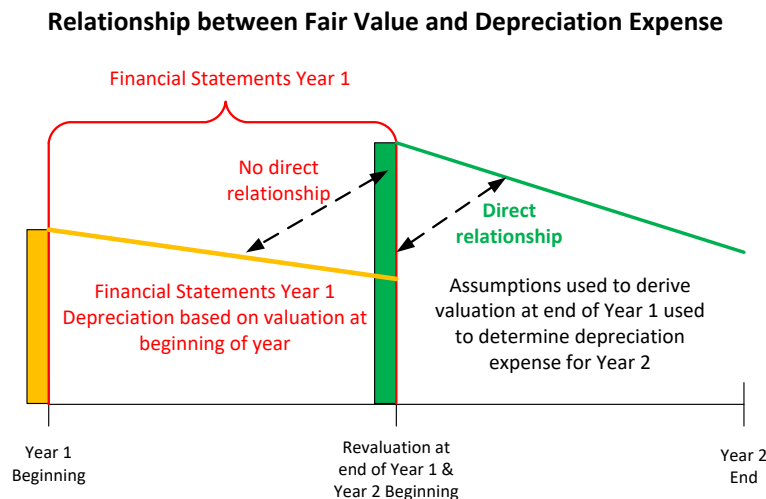
OPTIONS

To balance the needs of clients while still ensuring compliance against the accounting standards there are a range of options. These include undertaking the valuation with –

- Full compliance and make changes to GL
- Full compliance but roll-up figures to reflect existing GL
- Existing components but split components into short-life and long-life parts

Please note that using the existing components and not splitting into short-life and long-life parts is not considered an option for valuation because it represents a clear breach of AAASB116 and will result in material misstatement.

However, also note that how an entity depreciates its assets is wholly the responsibility of the entity and not the valuer. The depreciation expense figures provided as part of a valuation are simply the valuers estimates for the next financial year. There is no obligation for a council to adopt the same assumptions to calculate depreciation expense within their own GL for the financial year subject to audit.



Full compliance and make changes to GL

This is APV's preferred option as it provides full compliance but, because we use Asset Valuer Pro to deliver our valuations, also provides council with an extensive range of quality asset management outputs. These include a 50 year renewals projection and detailed analysis of the asset portfolio by component score, etc.

Full compliance but roll-up figures to reflect existing GL

This our second preferred option because the valuation is done exactly the same as the first option which provides council with all the valued-added outputs from Asset Valuer Pro.

The only difference is that an extra step is involved to manually add the various components together to arrive at figures for the components that currently exist in the GL. This includes –

- Gross (Replacement Cost or Market Value)
- Accumulated Depreciation
- Fair Value
- Residual Value (normally nil)
- Depreciation Expense
- Weighted average Useful Life
- Weighted average Remaining Useful Life

Existing components but split components into short-life and long-life parts

This is our least preferred option as it does not provide as detailed splitting that entities would typically require for asset management purposes and due to the lower level of granularity the resulting Fair Value and Depreciation Expense calculations will not be as accurate as the other options.

However, as the whole of building cost is being caught, the overall impact and assessment of associated materiality of differences in valuation and depreciation expense between this approach and the more detailed approach is a matter of professional judgement by the external auditor.

Yours faithfully

APV Valuers and Asset Management



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