

COVID-19 Coronavirus: Impact on Public Sector Reporting

Bulletin one

Implications of the COVID-19 emergency response, for revaluations of property, plant and equipment, and investment property.

(28 April 2020)

Introduction

The state of emergency in response to the COVID-19 coronavirus has significantly impacted most public sector entities. The consequences for the completion of annual reports and the annual financial statements are one part of this impact.

At Audit New Zealand we are developing a series of Bulletins. These are intended to provide high-level guidance to audit committees and those with responsibilities for the preparation of financial statements, performance information, or annual reports.

The situation with COVID-19, including New Zealand's COVID-19 risk level, the rules applying at each level, and the known and expected impact on the economy, public sector, private sector businesses and individuals, is changing and evolving.

The information in this Bulletin is intended as initial guidance to help audit committees and preparers plan and respond, and also understand the areas that auditors will be considering during the audit.

In this environment, there are likely to be further issues arising over time and the appropriate responses may change. We encourage you to engage with your auditor at an early stage as issues are identified, so that we can work through these challenges together. We will provide further guidance in response over the coming weeks.



Content of this Bulletin

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Aspects of this Bulletin may also provide useful guidance for other physical assets measured at fair value, such as forests and other biological assets.

The impairment requirements for assets will be covered in Bulletin 3.

► **Background question – when does GAAP expect fair value to be determined for property, plant and equipment and investment property?**

Many public sector entities have an accounting policy of measuring certain classes of property, plant and equipment at fair value (under PBE IPSAS 17 for public benefit entities or NZ IAS 16 for for-profit entities). Common examples of asset classes measured at fair value are land and buildings, and infrastructural asset classes, such as roading or water supply assets.

Both PBE IPSAS 17 and NZ IAS 16 require that for property, plant and equipment asset classes measured using the revaluation model:

Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period (NZ IAS 16.31, PBE IPSAS 17.44).

When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required (NZ IAS 16.34, PBE IPSAS 17.49).

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued (NZ IAS 16.36, PBE IPSAS 17.51).

Therefore, the fair value of property, plant and equipment assets measured at fair value needs to be assessed at each reporting date to see if there has been a material movement in value. If there has been a material movement, then a revaluation of the relevant asset class is required. If the fair value movement is not material then a revaluation of that asset class is not required this year. Evidence to support the fair value assessment needs to be provided to the auditor.

Those public sector entities that hold investment property are required to revalue this to fair value at each reporting date, if they have adopted the revaluation model under either under PBE IPSAS 16 for public benefit entities or NZ IAS 40 for for-profit entities.

This Bulletin sets out our initial views on some of the issues and challenges in meeting these fair value requirements in the current environment.

► **Are public entities still required to assess fair values for financial reporting in the current environment?**

Almost all significant public entities have a statutory requirement to produce their financial statements in accordance with generally accepted accounting practice (GAAP). This requirement has not changed. Our expectation is that public entities will continue to use their best endeavours to produce financial statements in accordance with their statutory obligations and therefore in accordance with GAAP. This includes assessing fair values of revalued property, plant and equipment asset classes and investment property when required by GAAP (refer discussion above).

► **Can fair values still be determined in the current environment?**

Whether fair value can be determined is primarily a question for valuers. We expect public entities to engage with their valuers to discuss the requirement to assess fair value at the reporting date. Our initial discussions with public entities and valuers has identified that there are some significant challenges (see discussion below) in assessing fair values, particularly for 31 March balance dates.

At this point, we expect that valuers should be able to determine fair values. However, we expect to see greater comments by valuers in their reports about significant uncertainties in their valuations, particularly for valuations as at 31 March. We have recently seen examples of listed private sector entities announcing revised property values as at 31 March, although the announcements also disclose that the valuations are still subject to audit.

If a public entity, after engaging a valuer, concludes that fair value cannot be reliably determined, then it is important to engage with the auditor on this and explain the valuer's rationale. If some public entities are unable to determine fair value where GAAP expects a valuation to be completed, then good disclosure explaining this to readers of the financial statements will be important. This is also likely to result in some form of comment in the auditor's report (refer discussion on audit reports below).

► **What will be the challenges in assessing fair values for land and buildings?**

For property, plant and equipment and investment property that are usually valued on the basis of either market transactions or using forecast future lease income (e.g. commercial property), the challenges in assessing fair value include the following.

A lack of market transactions that reflect the current environment at the reporting date. Transactions that occurred pre the COVID-19 emergency are now less relevant, given the uncertainties in the economy.

For valuation techniques based on forecast future lease income, these future cash flows have new risks and uncertainties which may be difficult to quantify. This has consequences for both the cash flows and the discount rates to use. If there is additional risk to cash flows, then discount rates will increase, reflecting the additional risk premium market participants would expect to compensate for the greater risk. These uncertainties arise from a range of factors including:

- » The ability of tenants to pay rent at current levels. We are seeing in the media multiple examples of tenants and landlords negotiating rent postponements or reductions, and of some large tenants refusing to pay rent based on their interpretation of contract terms.
- » Beyond the lockdown period, the impacts on businesses and the economy are uncertain. This may impact on tenants' ongoing ability to pay the agreed rents, as well as negotiations for future rental levels.
- » The potential impact of an economic downturn on future vacancy levels.

We expect valuers to set out in their valuation reports how they have considered the above factors (to the extent relevant to particular assets). We also expect valuers to provide information about the degree of uncertainty in their valuation assessments.

For many valuations, the normal valuation process includes the valuer physically inspecting the properties being valued. This is not possible at some lockdown levels. It may be that valuers can delay inspections until access is possible. If inspection is not possible within the timetable for annual reporting, then this may result in a qualification to the valuation. 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.

These challenges are particularly apparent at this stage for 31 March balance dates. It is possible that the level of uncertainty will be less for 30 June balance dates, but it may still be significant.

► **What are the expected challenges in assessing fair value for those assets measured on a depreciated replacement cost basis?**

A lot of public sector property, plant and equipment, such as infrastructural assets held by public benefit entities (such as a Council's roading or water supply assets) and specialised buildings (such as hospitals and schools) are measured using depreciated replacement cost (DRC) to determine fair value. In general, we expect limited impact from the COVID-19 pandemic on DRC values.

Key drivers of a DRC valuation are replacement cost, useful life and remaining useful life (linked to asset condition). We do not envisage significant changes to these factors from COVID-19 issues. It is possible that replacement cost rates may be subject to short-term changes due to shortages of materials or specialist labour. However, the replacement costs that are used in DRC calculations should reflect typical and sustainable market conditions. Short-term market fluctuations should be corrected by asset valuers. Judgement will be required to assess whether any changes in contract costs are likely to be short term or enduring. Preparers and auditors will need to carefully assess the reasonableness of any valuation assumptions in relation to price spikes made by valuers.

A further matter to consider is whether the changed economic environment has resulted in the property, plant and equipment having excess capacity compared to revised expectations of future demand. If this is the case, then an optimisation or obsolescence adjustment may be required in the fair value calculation.

► **What are the expected challenges in assessing fair value for cash-generating infrastructural assets measured on a discounted cash flow basis?**

Some public sector entities hold cash-generating infrastructural property, plant and equipment that is accounted for at a fair value determined using discounted cash flow (DCF) techniques. Examples of this include electricity distribution networks and some airport and port assets.

These DCF valuations will be impacted by any significant changes to future cash flows (including terminal growth rates) or the discount rates applied to them.

For some entities, their future cash flows have new risks and uncertainties which may be difficult to quantify. For example, to what extent will future cash flows be impacted by an economic downturn, ongoing travel restrictions or the COVID-19 impacts on their major customers? This has consequences for both the cash flows and the discount rates to use. If there is additional risk to cash flows, then the risk premium component of discount rates will increase.

We expect valuers to set out in their valuation reports how they have considered the above factors. We also expect valuers to provide information about the level of uncertainty in their valuation assessments. In some cases, this may include providing sensitivity analysis over key valuation inputs.

► **What if a public entity revalued their property, plant and equipment earlier in the financial year, prior to the COVID-19 emergency?**

Some public entities choose to revalue some property, plant and equipment prior to year-end in order to ease the year-end reporting burden (for example revaluing some property, plant and equipment asset classes at 31 December for a 30 June balance date). The requirement of GAAP is that the assets need to be accounted for at fair value at balance date or be not materially different from fair value at balance date.

In these circumstances, entities will need to review their pre-COVID-19 valuations to ensure that they still materially represent fair value at the reporting date. We expect in some cases the valuations will need to be updated to reflect the changed environment.

► **What are the consequences of significant uncertainties, exclusions, caveats or qualifications in valuation reports?**

Preparers and auditors should carefully read valuation reports and discuss with the valuer the valuation approach, the level of uncertainty in the valuation and how the key challenges arising from the current circumstances have been dealt with in the valuation. In particular, preparers and auditors need to understand:

- » any exclusions, caveats or qualifications to the valuation; and
- » the valuer's discussion of significant uncertainties or risks to the valuation.

Preparers and auditors will need to consider whether the valuation meets the requirements of GAAP. For example, the value will need to take into account the current circumstances (rather than completely exclude them). Also, although some valuers may be more inclined to provide a range of values for some properties, financial reporting requires a single value to be identified. It is important to understand any discussion of valuation ranges in the valuation report and understand what such a range means. Generally, we would expect the valuer to select a point in the valuation range as their professional judgement of fair value.

It is important that the significant uncertainties in valuations are adequately disclosed in the financial statements (refer disclosure discussion on the next page).

In some cases, significant uncertainties, exclusions, caveats or qualifications to a valuation may need to be commented on in the audit report (refer discussion of audit reports on the next page).

► **What level of disclosure is expected?**

The increased uncertainty in determining fair values means that clear, informative and transparent disclosure is essential. GAAP establishes significant disclosure requirements in relation to valuation methodologies, assumptions (including assumptions about the future), estimations and uncertainty.

As with all disclosures materiality applies. In assessing materiality of disclosures, it is important to consider the information expectations of users of financial statements. If users could reasonably expect that COVID-19 has a significant impact on the valuation of material assets, then an explanation of the impact (or lack of impact) should be provided.

Detailed information on GAAP disclosure requirements is set out in Appendix One.

► **What is the likely impact on audit reports?**

In the current environment, we are expecting to include some level of comment about COVID-19 impacts in many of the audit reports we sign. These can be qualifications to our opinion or comments we make to emphasise matters (such as uncertainties) disclosed in the financial statements.

Specifically in relation to fair value of property, plant and equipment and investment property, our audit report could comment on:

- » if valuers are unable to determine a fair value for material assets required to be at fair value;
- » valuations that have COVID-19 impacts excluded from scope or other significant caveats or qualifications;
- » material uncertainties in valuations;
- » the amount of evidence to support valuation assumptions; or
- » not providing adequate disclosure about COVID-19 impacts and uncertainties in fair values.

These possible audit report responses are a reflection of the changed environment and its consequences for some public entities, rather than a negative comment about an entity's performance or preparation of the financial statements.

► **Contacts for further advice**

Public entities who would like to discuss these valuation and audit matters further should contact their Appointed Auditor or audit team (and their valuer).

Appendix One: GAAP Disclosure requirements in relation to fair valuation of property, plant and equipment and investment property.

Both public benefit entities and for-profit entities have the same general requirements to disclose information about estimates and assumptions and about judgements in applying accounting policies:

GAAP reference	Applies to	Disclosure requirement
PBE IPSAS 1.140 (NZ IAS 1.125). (with minor wording differences)	Estimates and assumptions	An entity shall disclose in the notes information about (a) the key assumptions concerning the future, and (b) other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.
PBE IPSAS 1.137 NZ IAS 1.122.	Judgements	An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations, management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

The detailed disclosure requirements about fair valuations are different between public benefit entities and for-profit entities.

For **public benefit entities**, specific disclosure requirements come from PBE IPSAS 17 *Property, Plant and Equipment* and PBE IPSAS 16 *Investment Property* and include:

GAAP reference	Applies to	Disclosure requirement
PBE IPSAS 17.92(c)	Property, plant and equipment	The methods and significant assumptions applied in estimating the assets' fair values.
PBE IPSAS 17.92(d)	Property, plant and equipment	The extent to which the assets' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms, or were estimated using other valuation techniques.
PBE IPSAS 16.86(d)	Investment property	The methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence, or was more heavily based on other factors (which the entity shall disclose) because of the nature of the property and lack of comparable market data.

For **for-profit entities**, the specific disclosure requirements for fair valuations of both property, plant and equipment and investment property come from NZ IFRS 13 *Fair Value Measurement* and depend on the level of the valuation approach within the valuation hierarchy. Property, plant and equipment and investment property valuations will be either level 2 or level 3 valuations.

Level 1 inputs Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

Level 2 inputs Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs Unobservable inputs for the asset or liability.

The NZ IFRS 13 disclosure requirements are extensive and include the requirements below. Note for smaller for-profit entities that apply the reduced disclosure regime, there are disclosure concessions from some of these requirements.

- » Information that helps users of its financial statements assess the valuation techniques and inputs used to develop those measurements.
- » The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety.
- » For fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy:
 - A description of the valuation technique(s) and the inputs used in the fair value measurement.
 - If there has been a change in valuation technique, the entity shall disclose that change and the reason(s) for making it.
- » For fair value measurements categorised within Level 3 of the fair value hierarchy:
 - Quantitative information about the significant unobservable inputs used in the fair value measurement.
 - A description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period).
 - A narrative description of the 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. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

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