



LAND UNDER ROADS

THE SAGA ENDS?

INTRODUCTION

This paper has been prepared for presentation at the NT Finance Resource Group Conference held in Alice Springs in November 2008. It is hoped that the paper will assist the Group in forming a consensus view on the appropriate method of application of the Australian Accounting Standards to land under roads.

To this end, we will briefly review

- the history of the Australian Accounting Standards treatment of land under roads
- the current Australian Accounting Standards as they apply to land under roads, and
- the treatment proposed to be adopted in other jurisdictions.

A BRIEF HISTORY

It was clear right from the introduction of Australian Accounting Standard AAS 27 *Accounting for Local Governments* that the treatment of land under roads was going to be an issue. But to start with there was a 3 year transition period to enable local government time to recognise all of the other assets that had previously written off as they were constructed.

By the time that the 3 year transition period had expired, land under roads were put in their own special too-hard basket, and AAS 27A extended the transition period - *for land under roads only* - for a number more years.

In 1997 the AASB established a working party to examine the problem of establishing a realistic basis for valuation of land under roads. The working party's report has never been officially released, but in a 2001 discussion paper it reported that it had not been able to achieve a consensus. One member held "the view that land under roads could only be measured reliably if there were observable market prices for exchanges of roads", and a minority were "of the view that land under roads has no value to the [Council]". Some of the majority of the working party - whose recommendations were significantly different in some respects to the Victorian approach reported below - considered "that the measurement would require a substantial degree of estimation, sampling and extrapolation."

AAS 27A expired, and was replaced by AASB 1045, which ultimately extended the transition period for recognition of land under roads to **30 June 2008** - and that date has now passed.

The opinions expressed in this data sheet are the professional views of the authors and are intended to promote the development of improved accounting practices in Local Government.

They may not represent the best practice for your Council, which should be determined by consultation between the Council's officers and Auditor.

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In the meantime, the Australian Accounting Standards Board made a policy decision that all future accounting standards should be *principles-based*, rather than industry-based like AAS 27. This then brought the realisation that lands under roads is just another form of *Property, Plant & Equipment*, and AASB 116 was a principles-based standard that would automatically apply.

There was one minor problem - that there was no agreement within the accounting profession as to what a realistic basis of determining fair value really was, and the effluxion of time since the land was acquired meant that going back through the records to determine its cost was unrealistic. Hence AASB 1051, which permits an entity to elect to recognise, or not to recognise, as an asset, land under roads acquired before the end of the first reporting period ending on or after 31 December 2007 (or in our case **30 June 2008**).

It is sudden death - you only have one chance to make the election - and that is as at the first day of the new reporting period.

THE NATURE OF LAND UNDER ROADS

Public roads, or *public highways* as the common law usually refers to them, have special characteristics. Under the common law, any person may pass and re-pass along a public road at any time provided they are not committing a nuisance. Of course, if they are passing or re-passing in a vehicle, they have to comply with the *Road Traffic Act* (by whatever its name in your jurisdiction), and the vehicle itself must comply with any relevant legislation, and perhaps be registered and insured, again in accordance with legislation.

But the right to pass and re-pass remains, and is not limited to only the formed road surface but extends throughout the whole of the road reserve. The easiest example is a residential street, where vehicles use the formed road surface, and pedestrians are entitled to use the footpaths, whether these have been paved or not.

Private roads, where the landowner has the indefeasible right to prevent, limit and control access, are therefore excluded from the consideration in this paper as their valuation issues are different. So too are some freeways and toll roads, where the public does not have free right of passage. Passage may be conditional on use of a certain type of vehicle, or payment of a toll, or whatever - and hence these roads are NOT public roads.

For public roads, access can be limited only under certain special circumstances, such as:

- When the road becomes a workplace, such as for the staff of the road authority, a water or sewer authority, tree trimming and lopping, etc.
- For the purposes of emergency services (such as a road accident, when it is also the workplace of the emergency service personnel), or for the protection of public safety in an emergency such as a bushfire, etc.

The only other circumstances are when a Council closes the road for a public event, where the Council follows the required statutory procedure and gives public notice of the proposed road closure.

It is also the Council that makes the decision of precisely where, within the road reserve, the formed road surface will be, and has the powers to prevent other persons from encroaching, etc.

It is fair to say - not that the Council controls the public road - but that, to the extent that any body does control a public road, that body is the Council.

In Northern Territory, Queensland and Western Australia, Council does not have title to the road reserve, and should the reserve cease to be used for road purposes it automatically reverts to Crown control. The Crown may be said to have *reversionary title* (and may decide that it is appropriate to attribute a value to the interest in the land), but while the reserve is in use as a

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road, Council has control. The *Framework for the Preparation and Presentation of Financial Statements* states:

“57. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential: thus, for example, property held on a lease is an asset if the entity controls the benefits that are expected to flow from the property. ...”

The fact that the benefits do not flow entirely to the Council is irrelevant. Again, according to the *Framework*:

“Aus 49.1 In respect of not-for-profit entities in the public or private sector, in pursuing their objectives, goods and services are provided that have the capacity to satisfy human wants and needs. Assets provide a means for entities to achieve their objectives. Future economic benefits or service potential is the essence of assets. Future economic benefits is synonymous with the notion of service potential, and is used in this *Framework* as a reference also to service potential. ...”

Thus, because Councils control - to the extent that any body does - public roads, it is for Councils to account for them.

AASB 116 PROPERTY, PLANT & EQUIPMENT

AASB 116 is the accounting standard that principally controls the accounting for property, plant and equipment, and it first sets out a basic test that an item must satisfy in order to qualify for recognition.

“7. The cost of an item of property, plant and equipment shall be recognised as an asset **if, and only if:**

- (a) it is probable that future economic benefits associated with the item will flow to the entity; and
- (b) the cost of the item can be measured reliably. [our emphasis]

There seems to be a view in certain quarters of the accounting profession that, if an item has a value, then a number representing that value must be assigned in the financial reports. Paragraph 7(b) makes it quite clear that this is not so. A number may only be assigned if it represents a reliable measurement.

Paragraph 15 then specifies that the item, when it is first recognised, shall be measured at its cost, and paragraphs 16-28 discuss the elements of the cost of an item of property, plant and equipment, and its measurement.

Of particular importance for Councils, and particularly in relation to land under roads, is paragraph Aus15.1:

“Aus15.1 Notwithstanding paragraph 15, in respect of *not-for-profit entities*, where an asset is acquired at no cost, or for a nominal cost, the cost is its *fair value* as at the date of acquisition.”

The vast majority of our roads were acquired so long ago that it is not realistic to ascertain the original cost, or alternatively, were acquired for no or nominal cost - again many years ago - that it is not realistic to ascertain a fair value as at the date of acquisition. Thus recognition strictly in accordance with AASB 116 becomes a practical impossibility, and it is largely for these reasons that AASB 1051 provides the option **not** to recognise.

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FAIR VALUE

The alternative to recognition at cost is to recognise at fair value, and paragraphs 32 & 33 set out the basics:

“32. The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. ...”

“33. If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.”

We will consider aspects of market-based evidence shortly, but an income based approach is clearly inappropriate. This writer has particular difficulties with the concept of a (depreciated - but there would be no depreciation) replacement cost approach for land under roads. I have extreme difficulty in envisaging circumstances when it would be necessary to *replace* the land under roads, or more accurately, the land in a public road reserve.

I guess that it was done by Governor Macquarie in about 1812 in Sydney, when he flattened the existing tenements and pegged out York, George, Pitt Street and all the rest. But he was not attempting to derive a **reliable valuation basis** for the land under these roads.

It seems to me that any occasion when it would be necessary to replace the land under a road would similarly involve the total rearrangement of land holdings within the area, and that market-based evidence for such a rearrangement is totally lacking.

THE PICTURE IN OTHER STATES

Western Australia

Since 1993, the Local Government (Finance) Regulations have prohibited Councils from recognising any values for land under roads. Despite major changes to these regulations in the last 12 months, that prohibition has been retained. However, local government auditors have advised that they will be reviewing the materiality of any non-compliance with the Australian Accounting Standards, and may need to qualify their reports at some point in the future. In the meantime, they are urging Councils to make the elections required by AASB 1051 - notwithstanding the regulations - in order to minimise any non-compliance with the Standards.

South Australia

The 2008 SA Model Financial Statements reported:

“The Financial Management Project Group has formed the opinion that it is not possible to **reliably measure** the fair value of land under roads previously acquired. Further, the Group is of the opinion that land newly acquired for road purposes that adjoins land under an existing road then forms an integral part of the combined road reserve, such that the fair value of the combined area must be assessed as a unit, and hence cannot be **reliably measured**. This also applies to roads in a subdivision transferred to Council without cost, in that such land forms an integral part of the road network, and the contribution of value of the added land to the road network, and of the road network to the added land, cannot be **reliably measured**.”

“In accordance with AASB 116. 7(b), reliable measurement is an essential component for the recognition of an asset: in the absence of the ability to reliably measure the value of an asset, it is the opinion of the Working Party that the asset cannot be recognised.”

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The SA approach is based on the fact that there is no market for land under roads, and hence it is not possible to obtain market-based evidence. They point out that even in the case of land purchased for road use, or a road closed and sold, the actual sale is of freehold land, and the land is converted from freehold to public road after purchase, or converted from public road to freehold land before sale, in each case in accordance with the procedures in the Roads (Opening & Closing) Act.

They have not yet addressed the appropriate accounting treatment where land is purchased (otherwise than at no or nominal cost) for road purposes.

Victoria

Victoria have not yet made a final decision, but are giving serious consideration to recognition of land under roads in accordance with a methodology that has been developed by a working party for FinPro, the Victorian local government finance professionals association.

This methodology derives a value per unit of area as follows:

Site Value Rate

Less: Adjustment for Englobo Value

Less: Adjustment for Access & Carriageway Rights

Less: Adjustment for Infrastructure Assets

Equals Value of Road Reserve.

The adjustment for englobo value recognises that broadacre land sells at a lower rate per hectare than subdivided land, and it is considered appropriate to base the valuation on the broadacre rate. Studies on Melbourne's fringe suggest that "it is not uncommon in these circumstances for broad hectare land to be worth only 30 – 40 percent of the same or similar land in its subdivided form." On this basis, a discount of 60% - 70% of the site value rate is suggested. This proposition is reasonably testable in relation to freehold land, and because the site value is an expression of freehold land value, it is an appropriate basis.

The adjustment for access and carriageway rights relates to the fact that adjoining landowners have right of access to the road from their property, and it is suggested that "it could be dependant on such things as the extent and frequency of the access, whether foot or vehicular, what proportions of the land are affected and duration of the right." After stating that the allowance for these rights could be variable / site specific, they recommend "that an allowance of 15% be made in all circumstances."

The methodology document does not suggest any manner in which the amount of this allowance could be tested in the marketplace. Indeed, the document states that "it would be a matter of professional judgement" and that "there is no right or wrong answer".

In relation to the adjustment for infrastructure assets, the methodology takes "account of the fact that a mixture of infrastructure easements for water, sewerage, drainage, electricity, telecommunications and gas etc. generally encumber roads. "It would be standard practice in valuation methodology to allow a relatively small amount to accord with blight on title - 10% would be generally accepted as appropriate."

The methodology document does not suggest any manner in which the amount of this allowance could be tested in the marketplace.

The result is "that a total negative adjustment / deduction of 85% to 95% should be applied, depending on the level of urbanisation of the area in question."

The South Australian approach would emphasise that none of the access and carriageway rights allowance, the infrastructure easement allowance nor the end result are testable in the marketplace, and that the resulting value cannot be regarded as being based on market-based evidence. They would therefore suggest that a value determined in this manner would not comply with the Accounting Standards.

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Acquisition of Land for Road Purposes

Where a Council acquires land for road purposes (at other than no or nominal cost), AASB 116 paragraph 15 requires that it be measured at cost, which in this instance CAN be reliably determined.

The Victorian methodology suggests that its fair value *as land under roads* is between 5% - 15% of the freehold value.

AASB 136 *Impairment of Assets* would therefore come into play, and it would be appropriate to immediately recognise a provision for impairment for about 85% - 95% of the acquisition cost, thus largely writing off the cost of acquisition to expense.

New South Wales

The Local Government Accounting Advisory Group has commenced consideration of the matter, but has not yet reached a consensus or made a recommendation.

Queensland

The Department of Local Government has been giving the matter active consideration, but are awaiting Treasury advice before continuing their deliberations.

Tasmania

We have been unable to ascertain the current situation in relation to Tasmania.

A TIME FOR CONSENSUS

It is important that the approach adopted in Northern Territory is firmly based in the Australian Accounting Standards, or else there is potential for future qualification of Council statements on these grounds.

Both the South Australian and the Victorian approaches meet this requirement. They differ only in the interpretation of what constitutes a reliable, market-based, measurement.

If the consensus is that it is not possible to reliably determine a fair value determined from market-based evidence (AASB 116.32) it will then be necessary to consider the accounting procedure to be adopted after initial recognition of land for road purposes acquired other than at no or nominal cost. (Remembering that AASB 116.15 requires that it be initially recognised at cost.)

One option would be to continue to measure the land at cost, making sure that there is clear disclosure that this represents only a tiny proportion of the total land under roads controlled by the Council.

Another option would be to require that land under roads be measured, at each reporting date, at fair value - and that fair value cannot be reliably determined, hence effective requiring the write-off of any such acquisitions at the end of the year.

DISCLOSURES

AASNB 1051 requires that Council's election to recognise, or not to recognise, land under roads at 30 June 2008 must be reported in the Notes.

We suggest that the opinion (of the consensus) that a fair value cannot be reliably determined on market-based evidence, or (in the Victorian approach) of the basis of that determination should also be reported.

We also suggest that the length (or area) of road reserves under the control of Council should also be reported.