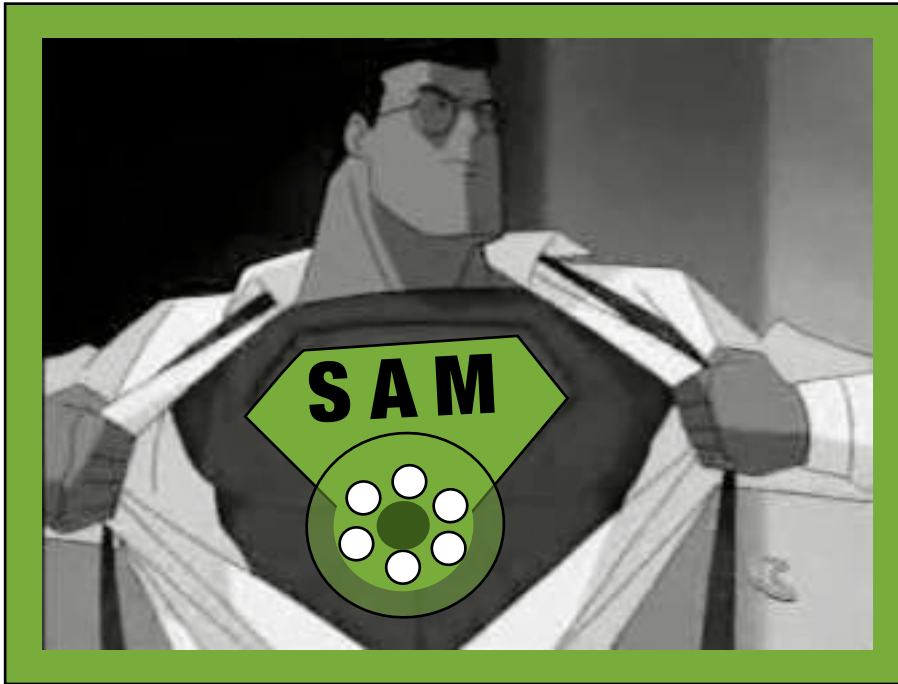


**Issue 268 SUPPLEMENTARY 15th June 2009**



## **VALUING LAND**

**When buying land there are a number of costs that need to be incurred but do not increase the market value of the land. When should they be capitalised and when expensed?**

**In this supplementary issue, David Edgerton, FCPA, and Director of Australian Pacific Valuers (APV) shows how the accounting guidelines are to be interpreted.**

**Further useful material can be found at the APV website**

[www.apv.net](http://www.apv.net)

**Supplementary pp 1-5 Land Acquisition Costs  
Supplementary pp 6 Decision Tree - Costing of Assets  
Supplementary pp 7 Decision Tree - Valuation of Assets**

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Rakesh Sing of the Brisbane City Council asked what costs of land acquisition should be capitalised in the following two examples:

Case 1:

Council acquires a parcel of property to increase its Bushland Program. In this example, let's say Council takes the property and its costs are :

- Cost of the land itself say \$1m
- Council also is prepared to pay to move the present owner-compensation (Owner might claim disturbance/loss of proximity etc..) \$200k.
- Cost of house and improvements-Compensation (which we would demolish) \$300k.

Disturbance costs here are all types of costs that we would have to settle with owner that is not a land acquisition costs, it can include valuation, interest, legals, business interruptions etc. *These are project costs but should these all be capital?*

Case 2:

Council could be building a major asset and in doing so it has to acquire land and the land had improvements on it (eg House). Council knows that once land is acquired it will demolish the house as the road will go over it. *The same question here is how should the house be treated?*

*In such cases, you can't go wrong by asking the experts. David Edgerton, Australian Pacific Valuers provided the most complete answer. I have given his response to Case 1 below. You can find the full response, including answer to Case 2 in 'SAM 268 Supplementary' now available in the subscribers section on the website, [www.amqi.com](http://www.amqi.com) (where you download SAM online)*

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Both scenarios need to be considered in light of the Australian Accounting Framework and Australian Accounting Standards. In particular AASB 116 "Property Plant and Equipment". Relevant sections of the Standard are detailed following the analysis of both cases.

The definition of an asset is covered by the Australian Accounting Framework. The Framework defines an asset as –

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

As result, an asset must –

- be controlled by the entity
- be a result of past events
- produce future economic benefits.

IN CASE 1 there are four distinct costs incurred -

- Land value (\$1 million)
- Legal and other costs incurred by council (\$100k)
- Compensation to current owner (\$500k)
- Cost to demolish house and clean up site for public use (\$200k)

As a result the total cost council will incur = \$1.8 million.

The overall “future economic benefit” provided by the acquisition relates to the provision of green space that can be used for social and physical recreation as well as satisfying numerous environmental objectives. The cost can be reliably measured (actual costs incurred) and is a result of past events. Therefore the expenditure satisfies the definition of an asset.

The question is what should be capitalised and what should be expensed.

Costs are defined in AASB116 as –

6. “Cost” is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction

In this case, all four costs were necessarily incurred in order to acquire the asset so that the entity could obtain the future economic benefit associated with the asset. Therefore all four costs should be capitalised.

The land and associated legal costs are obvious costs to be capitalised.

The compensation paid was “necessarily incurred”. The property could not have been obtained without payment of the compensation and therefore represents a “cost” of the asset.

The cost to demolish the house once settlement occurs is a bit more complex. The future economic benefit delivered by the overall asset is not that it has a house that can be used for accommodation. The demolition of the house enhances the service potential of the overall site and produces future economic benefit. If the house is not demolished the full benefit of the site cannot be obtained. *Therefore its demolition enhances the future economic benefit of the site and must be capitalised.*

In all cases, the future economic benefit of the four costs are tied directly to the future economic benefit of the land. While the land remains as “bushland” with its purpose being for the community’s social and physical recreation and environmental aims, there will be no loss of future economic benefit and therefore no depreciation.

When revalued to “Fair Value” the appropriate valuation basis is Depreciated Current Replacement Cost. This is different to Market Value. Therefore the Fair

Value will also include allowance for the costs necessarily incurred (\$1.8m) in acquiring the asset.

In summary – at cost the land should be capitalised at \$1.8m. If immediately re-valued to Fair Value it would remain at \$1.8m.

If at some later point the land was no longer considered necessary and its status was changed to an “Asset Held for Sale” its valuation basis would change to Market Value and the asset would require a write-down to the value of the land component. This is because there is no longer any “future economic benefit” provided by the other costs that were initially incurred.

### Case 2:

Council could be building a major asset and in doing so it has to acquire land and the land had improvements on it (eg House). Council knows that once land is acquired it will demolish the house as the road will go over it. The same question here is how should the house be treated?

In this case the cost of the house (and its demolition) has the same treatment as in Case 1. The future economic benefit provided by the house is not that it provides accommodation. The costs to acquire the house for later demolition is essentially the acquiring of a right to enable the construction of the road.

The cost is necessarily incurred (no demolition = no road), can be reliably measured and provides future economic benefits.

This is similar to the scenario of building a dam spillway. This typically involves the entity having to compensate other agencies for the infrastructure that will be inundated by the rising water. Most often this is done by the entity building new assets (above the high water mark) and then gifting them to the third parties immediately upon completion. While the physical asset is transferred to a third party the entity does not lose any future economic benefit by transferring the asset. Likewise the third party simply replaces the original asset with the new asset.

### Extracts from AASB 116

6. “Cost” is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction

“Fair value” is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. (para 6)

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.

#### Initial Costs

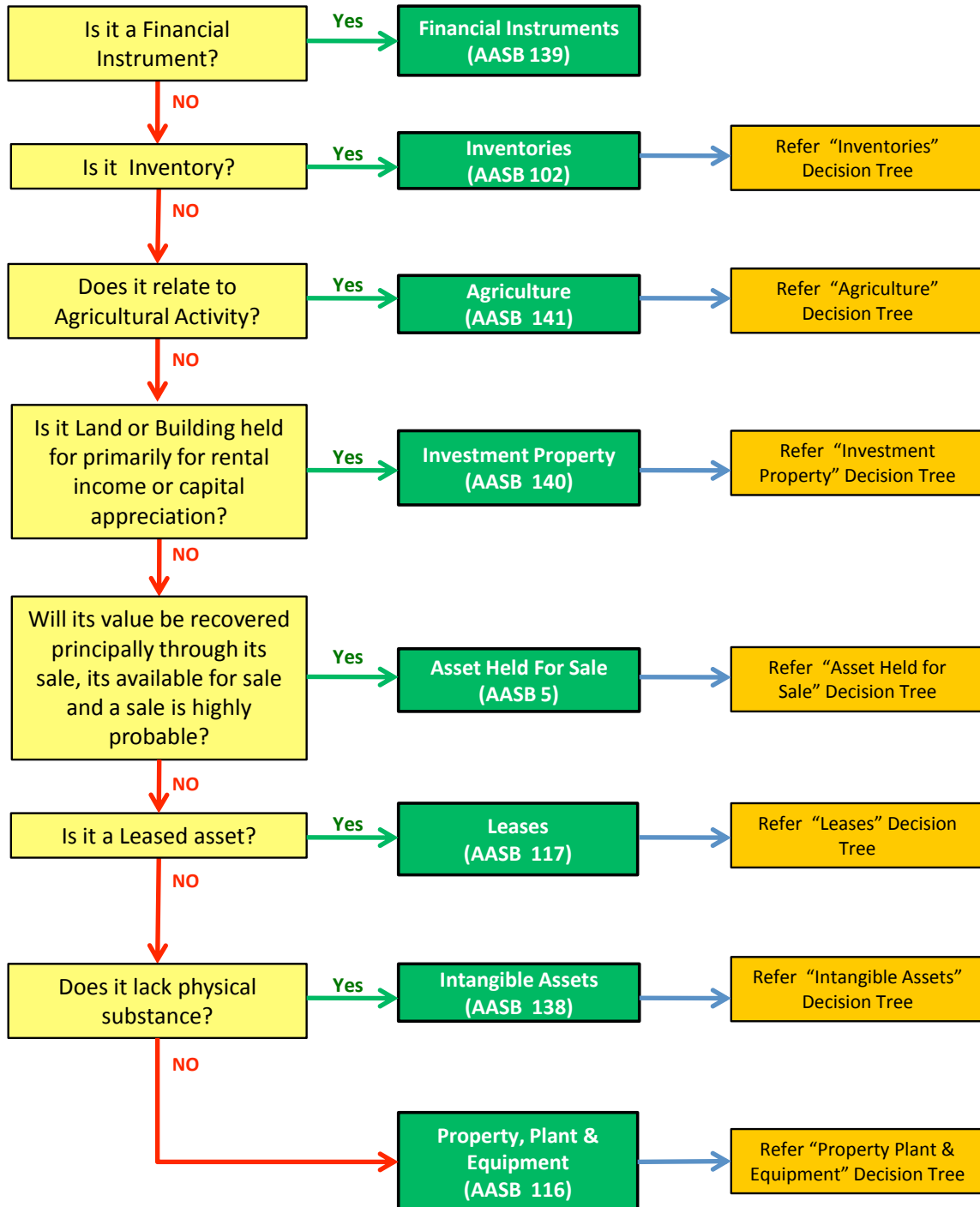
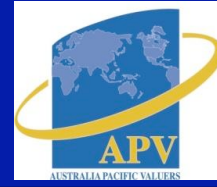
11. Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had it not been acquired.

#### Elements of Cost

16. The cost of an item of property, plant and equipment comprises:
  - (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
  - (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and
  - (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.
17. Examples of directly attributable costs are:
  - (a) costs of employee benefits (as defined in AASB 119 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
  - (b) costs of site preparation;
  - (c) initial delivery and handling costs;
  - (d) installation and assembly costs;
  - (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
  - (f) professional fees.



# Valuation of Assets Decision Tree



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