Audit New Zealand
AUDIT AND ASSURANCE SERVICES

Rest Assured

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HERITAGE ASSETS

DISCUSSION PAPER

Contents

Local authorities are currently wrestling with the thorny issue of not only how to account for heritage assets but what actually constitutes such an asset. Head-scratching challenges may include the most appropriate method of valuing such diverse assets as a native moth collection, a century-old town hall building and a tree.

Audit New Zealand sees strong value in encouraging debate within the sector and an exchange of ideas on best practice. To that end, we have prepared a discussion paper covering the sector's likely approach, directing local authorities to relevant guidance, and providing suggestions on areas such as valuation and capitalisation of expenditure for a variety of asset groups.

This paper is not a policy document, but rather a means of engendering discussion. We hope you find it helpful and encourage you to provide feedback on the paper and on your own experience, concerns and solutions. We will address that feedback in later articles both on our website and in our Rest Assured newsletter.

EXPECTATIONS & PRINCIPLES

- If heritage assets meet the definition of property, plant and equipment (PPE) in FRS-3 – which appear to do – then they must be accounted for under FRS-3 at 30 June 2002.
- There are practical concerns over accounting for heritage assets such as:
  - Why value them because we are never going to sell them?
  - How can one ever get a reliable measure?
  - To attempt to put a monetary value on them will undervalue the historical or cultural significance of them or give offence to particular people groups.

However:

- Many public sector assets have restrictions on their use or sale
- GAAP requires estimates of value to be made in a wide variety of situations involving subjective estimates of values
- GAAP valuations are prepared for accounting purposes on certain bases, and do not purport to reflect the intrinsic value to particular people groups.

- Expectations on **classification or categorisation** of heritage assets;
  - grouping of similar items
  - establishing whether the groupings are a separate class or part of a bigger class of assets.

  These expectations should be viewed in the context of paras 5.19 – 5.21 of FRS 3 relating to component level accounting.

- Expectation relating to **subsequent expenditure** on heritage assets.
  - expenditure is capitalised when it increases or unlocks the economic benefits over the total life of the item.
  - all other expenditure is expensed

    (Refer para 6.1 of FRS 3)

- Expectations on **Valuations**
  - Valuation approaches

    FRS-3 sets out three main approaches to PPE valuation. They are, flowing down in order of priority:
    - The sales comparison approach (comparable sales method, direct market comparison);
    - The income (capitalisation) approach (including discounted cash flow analysis); and
    - The cost approach (depreciated replacement cost).

    Therefore, for heritage assets and other collections, one would review the availability of market information, or failing that consider a depreciated replacement cost (DRC) based approach - except rather than determining the DRC of a replacement (modern equivalent asset) ascertain **the reproduction cost** of the asset concerned.

The reproduction cost of an asset is the cost of reproducing the asset with exactly the same appearance and character, with the use of the same materials where available or where these could be specially manufactured. Reproduction cost is most applicable when valuing assets of a special character, which are intended to be retained in their present form e.g. a heritage building.

A property that is described as a heritage asset has some cultural, environmental or historical significance. Heritage assets include historical buildings and monuments, archaeological sites, conservation areas and nature reserves and works of art. Heritage assets often display the following characteristics (although these characteristics are not necessarily limited to heritage assets):

- Their economic benefit in cultural, educational and historic terms is unlikely to be fully reflected in a financial value purely based on market price
- Legal and/or statutory obligations may impose prohibitions or severe restrictions on disposal by sale;
- They are often irreplaceable and their economic benefit may increase over time even if their physical condition deteriorates; and
- It may be difficult to estimate their useful lives, which in some cases could be several hundred years.

  - Qualifications of Valuers

  Heritage assets valuations should be conducted either:
  - by an independent valuer; or
  - an employee sufficiently experienced to conduct a valuation, so long as the basis of valuation has been subject to review by an independent valuer.

  Independent valuers are to hold a relevant professional qualification and have experience in the category of heritage assets being valued (FRS 3 paragraph 7.6). Employees sufficiently experienced to conduct valuations are those who possess expertise and experience in the category.

  Because of the scarcity of specialist external valuers, it is more likely that internal valuations will be conducted, with the valuation basis, methodology, and assumptions reviewed by independent valuers.

- Expectations relating to **depreciation**
  - Heritage assets must be considered consistently with other property, plant and equipment. Specifically, their useful lives must be assessed and the assets must be depreciated over those lives. This does not preclude heritage assets having a very long life. Where this is the case, the depreciation charge each year is likely to be very small.
  - For some collections with appropriate storage regimes and conservation programmes for heritage assets it is conceivable that the life is so long and that a zero depreciation charge may not be unreasonable. However, for this to be acceptable, rationale and analysis must be done on the assets to justify that decision.
  - FRS 3 states, in para 4.53

"It is very rare for items of property, plant and equipment other than land to have unlimited useful lives …. Some heritage assets, such as archives, art works, and museum collections, may have very long but not unlimited useful lives".

GUIDANCE

Industry guidance on Heritage and Collection Assets.

The following guidance is available

- Draft guidance on the valuation of cultural and heritage collections.

  NZ Treasury: Accounting Policy Team June 2002

- Accounting for Heritage Assets

  Auditor-General's Second Report to Parliament, 1997

- Guideline on heritage assets

  NZ Society of Local Government Managers, 1995.

PRACTICAL APPLICATION TO PARTICULAR ITEMS OF HERITAGE ASSETS & COLLECTIONS

In this part we cover specific issues relating to certain types of heritage assets and other collections.

- Historic Buildings
- Monuments, Memorial Gates, Obelisks, Cenotaphs
- Statues, Outdoor Sculptures
- Fountains
- Library Collections
- Artworks
- Artefacts and Relics
- Protected Trees

Historic buildings

Characteristics

- Protection order from Historic Places Trust (HPT) with Category I, II or III rating. Thus there may be very limited flexibility for Council to vary what the HPT decide.

- Usually there are conservation plans for historic buildings. These plans will set out:
  - what standards and values the building should reflect
  - the maintenance regime
  - any work required to restore or rehabilitate the building to the authentic heritage character.

Valuations

- The basis of valuations should be Depreciated Reproduction Cost.
- Reproduction Cost represents the cost of replicating the asset with the same form, appearance and character.
- Reproduction costs would normally be assessed within the following parameters.

  - *In situ* location of the building (i.e. can't be moved because the historic characteristic is usually integral to the location).
  - Replacing building material with the same materials as the original building. If this is not possible (e.g. unavailability or legal restrictions on obtaining native timber), then the nearest equivalent material of similar characteristic.
  - Costs of safety and security are included such as disabled access, lifts, fire protection, alarm systems and climate control. These costs are likely to be higher than normal because of the need to be unobtrusive and in keeping with the historic character of the building.
  - Use of modern building techniques wherever possible. The reproduction cost basis does not mean that renovations have to be done in the historic manner (hand tools etc).
  - No 'optimisation' applied to Heritage Historic Buildings valuations.

- Where a heritage building has recently been restored, its valuation should be equivalent to the assessed reproduction cost. If, however the building is not restored or need further work to reach the desired heritage values, then the valuation of the building must reflect a lesser figure than the reproduction cost. Effectively this is an "impaired" value of the building.

How do we arrive at the lesser value?

- For specialised assets, the normal course of action is to assess the depreciated replacement cost, i.e. making due allowance for age, deterioration and obsolescence.

- For historic buildings, however, the same precepts may not apply. Depreciation on an historic building is weighted toward the physical deterioration, not to age or obsolescence. In fact the greater the age, the greater the heritage value. Obsolescence does not apply.

- It is essential in valuing an historic building that is not fully restored or is in need of restoration, that one must consider the issue of impairment and the impact that this has in reducing the reproduction value of the asset.

- Steps to arrive at the lessor or impaired value could include

  - A clear articulation (usually in the conservation plan) of the standards and values of the historic building

  - A robust assessment of the cost forecasts to restore the building. (These are restoration costs only; not maintenance or operating costs). These cost estimates should be prepared by qualified experts.

  - Agreement on the basis of an inflation rate on costs forecasts (if any).

How do we measure the loss of service potential (depreciation)?

- The issue here is two fold; is there a loss of service potential each year and, if so, how and where we measure and disclose this in the financial statements.

- Is there a loss of service potential?

Yes, although the degree of loss may not be significant year on year, and it is unlikely to be even.

The loss of service potential is related more to physical deterioration than to age or obsolescence.

- Measurement of Loss of Service Potential

  As noted above the loss of service potential should focus on the physical deterioration that would be expected. The maintenance regime or conservation plan should be used as a guide It would be expected that the maintenance of an historic building would be more intensive than a normal commercial building in order to preserve the physical condition.

  The depreciation rates applied could be in two streams. For "modern" component assets that are needed as part of the safety, security or to meet building code standards, the depreciation rates should be at the normal, industry standard rates.

  For the asset components that make up the historic characteristics (which will be the majority) then a factor should be added to the expected lives of assets that reflect (hopefully) higher maintenance regimes and preservation efforts. Remember that the expected lives may not be economic lives. By their nature Heritage assets are not measured in economic terms. Thus the expected lives of historic asset components will be longer than economic lives.

  It would also be expected that the condition of historic building is systematically measured in order to provide information on preservation management and the life expectancy of assets.

- Disclosure of the loss of service potential will be through the Statement of Financial Performance as an expense (as is normal)

Capitalisation of expenditure on historic buildings

Normally we capitalise expenditure, which increases the service potential of an asset.

With historic buildings, the term 'service potential' could be replaced with the term 'heritage values'. It is unlikely there will be much expenditure that <u>increases</u> the heritage values; by its very nature the concept of heritage is intrinsic.

However capitalisation will definitely be in order if there is expenditure that restores the heritage values. There may be associated improvements to aspects of the building, or surrounding area in which case the usual FRS-3 subsequent expenditure rules should be applied.

The hard part is to clarify the grey area between maintenance and restoration expenditure. As previously noted, maintenance regimes on historic buildings are likely to be more extensive (and expensive) than normal buildings.

Monuments, Memorial Gates, Obelisks, Cenotaphs

The distinguishing features of these heritage assets are the memorial and commemoration for war victims.

While most historic buildings are usually restored to their original state, the defining difference with memorial is that they may not be. Over recent years there has been a move away from "hard" assets in memorial testaments. A modern equivalent memorial could be characterised by:

- No listing of names etched into a surface
- Less concrete/marble
- Use of natural features sculptured into a memorial theme.

Thus, when we are considering the valuation of a WWI or WWII memorial, the modern equivalent material may not be the materials that currently make up the asset. More than likely, councils will not have considered this, so it is perhaps presumptive for a valuer or council officer to optimise the valuation to an asset with different characteristics.

In the absence of any Council policy on the nature or timing of a replacement to the existing memorial, we would have to assume that the memorial will be rejuvenated/replaced like with like. In other words "reproduction" costs.

Statues, Outdoor Sculptures

Statues may or may not be heritage assets depending on the policy or actions of the Council. Usually statues will be heritage assets.

Over the years statues have often been moved from location to location, which could mean that their valuation doesn't have to be on the basis of their existing site.

Sculptures, especially those commissioned by councils, will also usually be regarded as heritage assets.

Both statutes and sculptures will usually be comprised of permanent materials and, with (usually) no moving parts, they will have a long life provided.

- There is regular cleaning
- Effects of bird dirt are prevented
- There is protection from discolouration

Some materials may be of shorter life eg granite or softer natural substances which are subject to pitting, erosion.

In most cases the statute/sculpture will be regarded as one asset component, but it could be advisable to split it into the plinth, and the substantive work. Plinth assets will likely have a longer life.

If the feature of a statue (particularly the face) becomes coarse or indistinguishable (through pitting, scaling etc) then the heritage value of the asset will be adversely affected.

Fountains

It is arguable whether fountains, as a rule, should be regarded as heritage assets. Unless a Council has determined a fountain is a heritage asset, then they should be viewed as a 'normal' asset, which should be valued on a DRC basis, and depreciated in the normal way.

Library Collections

- A useful categorisation that *The Valuation of Library Collections – a Proposal (Prepared by Lyn Provost, Elaine Hall and Vic Elliott, May 1992)* guidelines have is:
  - Current use collections
  - Permanently retained collections

The former category is the limited life type asset. The latter category is a heritage category.

Based on the two types then a particular valuation basis is selected. With the arrival of FRS-3 the selection of a suitable valuation basis must be based more on the hierarchy in FRS-3, i.e.,

Step 1 Is there active market information? Failing this:

Step 2 Is there other market-based evidence? Failing this then:

Step 3 DRC.

- Current Use Collection

  A current use collection is a collection that is used in the day-to-day operation of the entity and has a pattern of declining use and/or wears out over time.

- Permanently Retained Collection

  A permanently retained collection is a collection for which there is verifiable evidence:

  – that the asset has cultural, aesthetic, historical, or heritage value worth preserving perpetually; and

  – that the owner intends, and commits sufficient technological and financial resources, to preserve and protect the service potential of the asset.

  Given the difference in purpose for which collections in these two categories are formed, it is appropriate that they should be valued and depreciated in different ways.

  The 1992 guidelines are still useful but should be applied with care. For example, mention is made in respect of DRC revaluations that a 3-year rolling average could be used. This is not appropriate because the replacement cost figures must reflect replacement cost close to the valuation date.

- The 1992 guidelines make the following comments about the valuation of permanently retained collections:

  VALUATION METHOD FOR PERMANENTLY RETAINED COLLECTIONS

  There is general agreement that the issues raised here relate not only to library collections but also to cultural collections in, for example, museums and art galleries. Agreement to date indicates that the same principles should be applied consistently across categories of materials in differing types of institutions.

  A twofold approach is necessary for the valuation of permanently retained collections, with consideration being given firstly to high-value components and secondly to the balance of the collection. High-value collections, such as, for example, some collections of works of art, should be valued by an independent valuer. This relates mainly to museums and galleries rather than libraries. The rest of the collections should be valued 'in house' at estimated market value by category where this value can be determined (that is, where there is a market). To establish estimated market value, such sources as readily available auction records and book dealers' catalogues may be used. For those collections which are not of high value and for which there is no market, a replacement value would be appropriate. In some cases it may not be possible to ascertain this market or replacement value. However, it may be possible to adopt benchmarks based on the values used for other collections. In rare circumstances, there will remain a residue of materials for which a monetary value cannot be determined that would need to be described in a note to the financial statements without any monetary value being ascribed.

Permanently retained collections are not seen to have a limited service potential. Indeed, care is taken to preserve items in such collections. Accordingly, some of these collections may not need not to be depreciated. That is not to say that these assets do not deteriorate, as over time assets do deteriorate. However, the rate of deterioration is reduced to such an extent through, for example, proper care and conservation, that it may be regarded as negligible.

Artworks

Artworks could be categorised into the following:

- Artworks purchased in an open market ("arms length") transactions.

  Valuation would be at market value. Normally no depreciation would be taken on these, but if, at a subsequent revaluation, the value declined then the reduction would be:

  (a) Through a separate artworks revaluation reserve, or
  (b) A charge against the bottom line if the AAR is nil or there is no revaluation reserve.

- Artworks on long term loan

Frequently Art Galleries obtain collections from overseas on long-term loan, or for extended viewing. If the loan period is more than a year then there is the likelihood of capitalising the costs of bringing the collection (freight, insurance, loan fee, plus charges like security incurred at the gallery to facilitate viewing) and amortising the costs over the display period.

- Artworks gifted or bequeathed

  These artworks may or may not have had open market values, but the usual situation is that the entity must retain ownership and display the Artwork i.e. no right to sell. Thus the valuation needs to consider the best available information regards market value, and as appropriate factor the legal restrictions into the valuation.

  Normally no depreciation would be charged.

- Original Artworks commissioned

  These could be in an Art Gallery, but could also be specially commissioned to be part of a building (murals, tapestries, Maori carvings, paintings etc).

  If these were intended only to be a feature of the particular building (not a heritage asset) then the value would be historic cost and depreciated.

  If the item was given heritage status, then valuation should be at reproduction cost, with depreciation that recognises only the physical deterioration that might occur.

Artefacts and Relics (Including Archaeological Remains)

The need to value these heritage assets is perhaps the most arguable. Some would say that these items are irreplaceable and therefore any value is inappropriate. Moreover there may be cultural insensitivities to put monetary values on artefacts and relics.

It must therefore be remembered that we are valuing such items based on the methodology required by FRS-3. We are not necessarily seeking to demean the "priceless" value that individuals or groups may attribute to such items.

The main conservation effort is to preserve these assets as long as possible. In the event that work can be done to restore the relic then the cost of this work should be capitalised.

Whether there is depreciation or not depends on:

- The preservation environment that such artefacts are kept in;
- The materiality of any possible depreciation figures.

Protected Trees

Protected trees are heritage assets. They are documented in official registers of protected trees. Their valuation is problematic as they are "live" assets. Our suggestion is that they be valued at a nursery value only. This doesn't recognise their real value, but then no monetary valuation would. There is no depreciation on protected trees given that they are living assets. There may be impairment, if and when, irreparable damage occurs or the tree dies.

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