

# Appreciation Model of a Public Entity Set of Assets in the Accounting System

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**Abstract** The introduction of accrual-accounting in university system has implied the need to explore some critical issues, including how to evaluate and develop property assets. This paper illustrates the solution implemented by the University of Salerno in order to adapt to changes in regulations, even though there are no specific rules and patterns on this subject. This solution, that can be placed within the framework outlined by the most detailed international accounting standards, is based on a model for estimating the depreciated reproduction cost of buildings. The use of this model, implemented in a software that allows automatic revaluation of assets, defines an experience that is submitted to attention of other universities and public entities as possible (best) practice in the management of real estate accounting.

**Keywords** Property Assets, Accrual-Accounting, Valuation Model

## 1. Introduction and Purpose

The Legislation from Financial-accounting to Accrual-accounting, specifically for the university sector (L. n. 18/2012<sup>i</sup>) and, in general, the problem of adaptation and consistency of accounting systems (L. 27/12/2006 no. 296<sup>ii</sup>, L. 31/12/2009<sup>iii</sup> n. 196 and D.Lgs. n. 91/2011<sup>iv</sup>) in all public entities, also promoted internationally, imposed a strong focus of the economic-business doctrine toward a new definition of Accounting principles.

Accrual-accounting, will promote more in information and transparency making it instrumental both for the purposes of accountability on the results, and for economic decisions about the allocation of resources. The increased need for accountability<sup>v</sup> has led in recent years, numerous changes in the accounting system of public entities, including but not limited to the need of referring to a process of detection, recognition and evaluation all of the assets controlled by the entity. We are going to illustrate the original model of automatic detection and evaluation of real estate, consisting of land, buildings and infrastructures that make up the University of Salerno Campus, in order to record the values in the annual budget of the University.

## 2. Accounting Principles and Rationality of Real Estate Evaluation

Regarding the value of land and buildings belonging to the category of so-called "tangible" to write in account equity, accounting standards that have inspired the definition of the model brought to the attention, are IAS<sup>1</sup>, issued by the private sector and already mandatory in our Country for some categories of businesses, and even international ones IPSAS<sup>2</sup> specific for public sector<sup>3</sup>. It is moreover clear in Italy the incentive, given the recent legislation mentioned in the introduction, to the reduction of the enormous distance

<sup>1</sup> In Europe, all IAS / IFRS have been adopted by regulation thus acquiring force of law.

<sup>2</sup> International Public Sector Accounting Standards, namely International Accounting Standards for the public sector. They are issued by 'I.P.S.A.S.B. - International Public Sector Accounting Standards Board - the International Accounting Entity that has precisely the goal of "work to the public interest, developing accounting standards for the public sector of high quality and promoting the convergence of national and international principles, so as to improve the quality and consistency of financial reporting around the world. " Unlike the IAS / IFRS, IPSAS are not mandatory at Community level; IPSASB is committed to encourage their adoption in all countries, but recognizes the right of states to develop their own rules. About the spread of IPSAS adoption at Community level [1], [7], [8], [9], [10], [11].

<sup>3</sup> In the development of IPSAS whose guiding principle is that the accrual basis, rather than that of cash basis, the Board has set two priorities: 1) the convergence with IAS / IFRS, although taking into account the unavoidable differences between vocations of public and private companies, 2) the drafting of specific accounting standards for the public sector, responding to needs that cannot be shared with those of private companies [12]. «... the same accounting standards for organizations of public sector are defined as they were residual, i.e. they refer if possible to the more general international principles, and only if it deems necessary because of some special, specific criteria are defined [13] ». The IAS / IFRS relate to the accounting systems of nation states, state agencies and local companies and local businesses with the exception companies under public control, which by their nature to their legal form are already target of international accounting standards in the private sector (IAS / IFRS). Compared to the latter, the IPSAS appear a natural derivation [6].

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between the accounting standards of public and international standards[6].

Property, plant or equipment may be recognized as assets when: a) It is probable that future economic benefits or service potential associated with the asset will flow to the entity, b) The fair value of the asset to the entity can be measured reliably.

We should specify the meaning of this criterion which, according to international standards, is "the amount at which the asset could be bought or sold in a current transaction between willing parties, or transferred to an equivalent party, other than in a liquidation sale". The fair value coincides, therefore, with the criterion that the Italian tradition estimation defines the most probable market value<sup>4</sup>.

Regarding the "evaluation" (measurement), we must distinguish between what the public entity runs at recognition, and one that performs at a later time<sup>5</sup>.

The IAS 16 and with greater specification the number 17 of IPSAS, which both relate to the accounting treatment of "Property, Plant and Equipment"<sup>6</sup>, assume their fair value as a criterion for initial recognition of the asset in case of no or nominal cost for acquisition<sup>7</sup>; it's instead the purchase cost or the market price<sup>8</sup> the reference in the case of sale, and it's finally the production cost of the property when it was self-produced.

For a building, the cost of production consists of costs directly related to the realization of the item and all indirect costs related to the period between the beginning of the manufacturing and the time at which the asset becomes objectively usable. They are part of the first category: the cost of construction, or the expenditure incurred for materials, labor, freight and transport, overheads and profit entrepreneur manufacturer, the costs for professional fees, costs for primary and secondary urbanization works if it is due. These amounts should be considered in their actual outlay that is, less any trade discounts or rebates on offer prices. Among the indirect costs attributable to the building may instead be included the borrowing costs to the extent to

they are considered capitalized<sup>9</sup>, while the general and administrative expenses (i.e. those that are normally charged to the promoter of the building transformation) should be excluded.

The international accounting standards require for under the cost model, subsequent to initial recognition, the asset is accounted or a) according to the cost model by placing it at the initial cost, net of accumulated depreciation and any accumulated impairment loss, or, alternatively, b) with the registration of a revalued amount (revaluation model), equal to fair value, net of accumulated depreciation and subsequent accumulated impairment losses. In this second case, the revaluations should be made with sufficient regularity so that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date<sup>10</sup>.

The cost model is more easily referable to a plant or equipment. A building cannot be considered like a plant. The concept of fair value would be more appropriate for the property.

Some properties of the public sector, or for highly specialized functions (special properties) or because are components of a complex and organic system, in which all together contribute to a single function that deprives each of an economic autonomy<sup>11</sup>, are placed outside the market, they haven't in local market factors for comparison (comparable properties sold recently), neither generate income<sup>12</sup>. For these the determination of fair value it is not applicable to the direct estimation of market value or the indirect appraisal of capitalization value.

In this situation it comes to the rescue the practice estimation<sup>13</sup> and the same international standards<sup>14</sup> which

<sup>4</sup> IAS 16 par. 30 and IPSAS 17 par. 40: «An appraisal of the value of an asset is normally undertaken by a member of the valuation profession, who holds a recognized and relevant professional qualification».

<sup>5</sup> The process of depreciation or appreciation of a building should begin when the asset is available for use according to the assigned destination.

<sup>6</sup> IAS defines the "Property, plant and equipment" as the tangible assets that: 1) are held by a company for use in the production or supply of items or services, for administrative purposes, or for rental to others; 2) are intended to be used for several years.

<sup>7</sup> This is the case of acquisition by expropriation if the payments do not match the full market value - a fact that, at least in Italy after the recent regulatory changes, could be achieved only if the reduction of the allowance provided by paragraph 1 art. 37 DPR 327/2001 and subsequent amendments is applied, when the expropriation of building land is intended to implement measures aimed at socio-economic reform; other cases are: the free assignment of areas inside compartments for processing construction, donation or confiscation of assets against third parties.

<sup>8</sup> The difference between the market price (historical data) and the fair value, i.e. the market value of the property reflects the difference between the actual measurement (economic size) and the provision thereof

<sup>9</sup> Under the alternative accounting treatment required by IAS 23: Interest expense accrued during the "construction period" rather than where it should be understood as the time elapsed from the first payments to suppliers at the time in which the asset is ready for use (including the time of monitoring and tuning) provided that these times are "normal", i.e. in the case in which strikes / inefficiencies / other causes drags on the building beyond the normal period, will not be possible to capitalize financing expenses incurred during that period increased.

<sup>10</sup> IAS 16 par. 32 and IPSAS 17 par. 44: «The frequency of revaluations depends upon the movements in the fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. Some items of property, plant and equipment may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant movements in fair value. Instead, revaluation every three or five years may be sufficient.»

<sup>11</sup> This is the case of infrastructure.

<sup>12</sup> Some public buildings may be subject to legal or social constraints that limit its use for the purpose income.

<sup>13</sup> Chapter 8 Annex F of [14]: «The use of the cost approach is suggested in the estimation of instrumental and special properties, of secondary properties and of minor components of complex properties. These are usually buildings and facilities that are often sold separately from the rest of the property or the production of which they are parties, which have a limited market, and which often show the shape and size for the specific purpose for which they are employed. The procedure is popular in accounting estimate of the company assets». The cost approach is most often used for public buildings, such as

suggests that when no evidence is available to determine the market value of a property, the fair value can be estimated by the depreciated reproduction - rebuilding or replacement - cost. In particular, it will cost to rebuild if it's possible the exact duplication of the asset, assuming that you use the same materials and now you can replicate the production techniques of the period in which the property was made, otherwise it will be necessary to refer to the replacement cost which provides the possibility of realization of a asset analogous to that in the estimation, for technical and functional utility, however, obtained with the use of modern methods of construction and materials now available.

This approach is based on the principle that no ordinary buyer or investor is willing to pay - for a property that has appreciated commodity - an amount greater than the amount corresponding to the value of the land and the cost of rebuilding or replacement of the building considered it in the condition of use in which it is at the time of evaluation<sup>15</sup>.

The procedure is known as depreciated reproduction cost, and it allows us to estimate the market value of a property indirectly through the sum of: a) the acquisition value of the areas and b) the cost of rebuilding or replacing, at current prices, buildings or other constructions made on the same areas, (including the technological systems), less deductions for physical deterioration and obsolescence<sup>17</sup>.

However, please note that the soil and the building, from an accounting perspective, can be imagined, and so it should be treated, as separate assets, even when they were purchased together. The soil has, in principle, an unlimited duration and therefore is not subject to depreciation, but you could easily see a growth in its market value due to the phenomenon of urban revenue. The part of the building constructed instead has a limited life and, consequently, it's a depreciable asset. Once you made this distinction, it follows that an increase in the value of the land on which the building stands does not affect the determination of the useful life of the building<sup>16</sup>.

Deductions for physical deterioration and obsolescence are the depreciation, which is referring only to the cost of reproduction building, in one of two terms considered (rebuilding or replacement), thus excluding the value of the area.

In terms of public finance and accountancy, the use of the depreciated reproduction cost, which precedes the assessment of a property, is *inter alia* a criterion which refers explicitly the Italian legislation. Circular no. 16 of the

Ministry of Economy and Finance, March 2010, clarifies that, asset accounting, are "confirmed the provisions on reporting capital brought from the Law of 3 April 1997, n. 94, and those contained in Articles 13 and 14 of Legislative Decree n. 279, 1997 and the Ministerial Decree 18 April 2002, published in the Official Gazette no. 24 of 30 January 2003 on "New classification of assets and liabilities of the State and their evaluation criteria."

This later decree reiterates that for the purpose of economic management of real property owned by the State, these properties must be evaluated on economic criteria, including market value, the value of the capitalization or the reproduction cost (Art. 3 and Annex 3).

Another accounting problem, is then formed by treatment modality, and thus by enhancement, of the costs incurred during the holding period of the property.

The costs of interventions that will lead to future economic benefits<sup>17</sup>, including indirect, or service potential that might have been expected to be available from the asset, in excess of those obtainable in the absence of such measures, must be considered costs eligible for capitalization. Under practical point of view, the costs incurred in order to prolong the useful life of the property (extraordinary maintenance on the building or on a part of it) or the costs for improvements that increase its production capacity or profitability, (the addition of a plant or its replacement<sup>18</sup> with one able to provide higher performance, or equivalent performance but with lower operating costs) are therefore considered costs to be capitalized.

The repair costs or maintenance expenses, performed to restore or maintain the previous level of performance-quality<sup>19</sup> of the building or part of it, are not capitalized.

Because a building consists of heterogeneous parts by type, function and technological features, which have different length of useful life<sup>20</sup> and that otherwise suffer the effects of spending time, it is appropriate to allocate the total cost of

schools and churches, because it is difficult to find recently sold comparable properties in the local market, and public buildings don't earn income, so the income approach cannot be used, either.

<sup>14</sup> IPAS 17 paragraph 42.

<sup>15</sup> «This comparative approach considers the possibility that an alternative to purchasing a particular property, an individual may purchase an equivalent modern building that provides the same utility .... Often the property object of estimation is less attractive than a modern equivalent one due to age and obsolescence ... it is required, therefore an adjustment for depreciation» [16].

<sup>16</sup> Reference [17] shows that the duration in the economic life of the building (i.e. the threshold for demolition) is a variable closely related to the dynamics of the value of the land on which the building is constructed.

<sup>17</sup> For example, fire safety regulations may require the installation of a sprinkler system or accessory scales. Although an economic benefit is not directly attributable to these interventions, they are improvements that must be recognized in the asset value of the property because they allow the use of it in compliance with the regulations.

<sup>18</sup> In this case the residual value of the replaced parts must be eliminated from the accounts. Residual value is defined by international standards equal to the value estimated at the date of its disposal, net of estimated costs for disposal, and assuming that the property is already in the condition expected at the end of its useful life. The international standards specify that the residual value of an asset is often insignificant and therefore is immaterial in the calculation of the depreciable amount. This hypothesis, in the case of buildings, is also sustainable for all the functional elements of it, with the only exception of the 'structure'. For the latter the cost of dismissal (demolition and waste transport) has high incidence (about 25% of the cost of new construction) thus causing a negative residual value. The proposed model takes into account this fact [17].

<sup>19</sup> So-called 'maintenance standards' used to define the thresholds of acceptable quality construction.

<sup>20</sup> The useful life of an asset is defined by international standards (IAS 16 and IPSAS 17) in terms of the asset's expected utility to the entity (i.e. the amount of products or units that the company or similar entity expects to derive from the asset).

building between its components (component approach) and for each of these to treat separately the phenomenon of depreciation. The criterion for determining the depreciation, i.e. the definition of an amortization rate to be applied at cost of rebuilding or replacement of each functional element of the building, must reflect the way in which the various depreciation factors act on the same functional element. The latter are distinguishable in the physical wear<sup>21</sup> and technical-functional obsolescence.

### 3. The valuation Model of Assets

On the basis of standards accounting listed we have been constructing the evaluation model of the University of Salerno asset property<sup>22</sup>. Please note that for the characteristics of location, size, concentration, integration and complementarity of functions, the specialization of many of these same functions, the assets of the campus of Salerno, with the exception of a few properties<sup>23</sup>, has no reference in the housing market, direct (price) or indirect (income). In such condition the best criterion suited to the initial recognition of the value (fair value) and to the subsequent enhancement is the most probable value of depreciated reproduction cost<sup>24</sup>.

Manufactured elements (buildings, infrastructure, etc...) and soils, including site areas, are therefore treated as separate products. The total cost of building is then divided into its main components. The breakdown of the cost in a structure that identifies the functional elements of the building, then allows for each of these the construction of a different time-value function or a specific mode of depreciation which takes account of the useful life of the element and how depreciation factors acting on the same element.

The model for estimating the value of the rebuilding or replacement depreciated cost is from [17].

In practice the process of estimating the depreciated reconstruction cost is divided into stages classifiable as in following schema:

- 1) estimate the reconstruction cost of building as a new;

- 2) breakdown of the building construction in functional elements, or homogeneous parts, and calculating the percentage of the cost of individual elements or parts;

- 3) based on certain assumptions and for each functional unit, definition of depreciation function;

- 4) for each functional element, estimate the depreciated reproduction cost;

- 5) aggregation of depreciated cost items relating to functional elements and calculation of total value of depreciated reproduction cost.

The text illustrates the operational aspects of the estimated cost of rebuilding or replacement of a building or infrastructure and the theoretical foundations of depreciation functions defined for the different functional elements that make up the building construction.

Compared to the old model, the key innovative aspect of the new algorithm implemented as a form of application Archibus<sup>25</sup> is the ability to determine automatically the evaluation (reassessment and / or depreciation) in the years after initial recognition.

In particular in the event that during the period considered there have been no costs capitalized, then the value of depreciated reproduction cost, noted at the beginning of the period, will vary:

- a) with decreasing, as result of further depreciation in the period and amount of individual rate of depreciation calculated of the functional elements;

- b) with increasing, as effect of possible and probable growth of the costs of building production. The automation of the calculation requires only the inclusion of year when you run the revaluation and the corresponding index ISTAT (Italian Statistical Institute) cost of construction of a residential building<sup>26</sup>.

If during the period in question it has been done an extraordinary maintenance on building or any other expense which has resulted in an improvement thus capitalized in its value, on this case, the model allows the automatic re-evaluation by identifying functional element on which action was taken, the year of implementation of the intervention and the amount spent<sup>27</sup>.

Regarding land, the revaluation is instead developed by input the new value that, in the reference year, the market attaches to undeveloped land, similar to location, use, and physical constraints.

<sup>21</sup> The depreciation from physical wear, only in economic terms, can be determined as the sum of depreciation for age pure (which reflects the inexorable approach of the end of useful life) and that one for earnings decay (connected instead to the progressive reduction of the efficiency performance of the property) [17].

<sup>22</sup> Among the models proposed in current literature on the establishment, evaluation and valorization of public real estate assets and on the construction of balance's indicator for the public-private bargaining, it is worth mentioning [18].

<sup>23</sup> Those properties assigned to student residences, car parks or sports facilities (e.g. swimming). If on the one hand they can posit the estimate for capitalization of income, on the other hand the question arises of pro rata allocation of value for the complex infrastructure which is to serve the entire campus.

<sup>24</sup> This approach has also the advantage to respond better to the need for a rational application of the fair value, taking into account that the basically value of the activity in order to avoid criticality of a system that entrusts the assessment of the assets only to picture of the market value attributed by operators and financial markets; critical issues identified thus in the possible volatility of the economic accounts [19].

<sup>25</sup> Archibus / FM - produced by Archibus, Inc., a leader in the field of Computer Integrated Facility Management (CIFM<sup>TM</sup>) - is a software that works in a "Windows-like", consisting of a complete and integrated suite of application modules designed for real estate management and related infrastructure. The module was developed by eFM Ltd. on behalf of the University of Salerno, on the basis of the algorithm developed by B. Manganelli.

<sup>26</sup> Because ISTAT cyclically changes the base year reference indexes, input phase requires the inclusion of the new base year and the coefficient of coupling between indexes with different basis.

<sup>27</sup> It is also possible to insert a new functional element implemented after the construction of the building or to select the complete replacement of the item.

## 4. Conclusions

This work aims at the end of the effort made by the University of Salerno, on one hand, to adapt to the changing regulatory framework in accounting, on the other to meet the practical need of revaluation / valuation of real estate. The need for the University of frequent re-evaluation of its real estate assets, even better if yearly, comes from the condition of strong dynamism registered in the past and projected future, of quality and size of the assets. The campus is in continuous expansion and, with reference to the older building, regular maintenance is extraordinary.

However, given the current Italian regulatory framework, for the moment free of rules and particular patterns in terms of accounting procedures, the response to the needs of the administration has been formulated in the context of the autonomy universities, within the framework outlined by the most detailed international accounting standards.

The application module of Archibus implements a model for estimating the value of depreciated reproduction cost of buildings already published and enriches it with two basic functions: 1) inclusion and capitalization in the value of all costs incurred to extend the useful life of property (maintenance on the building or on part of it) and / or of improvements that increase its production capacity or profitability, 2) automatic updating of the valuation after its initial recognition.

The module, which integrates and interacts with the already rich suite of applications Archibus for property management, is therefore a useful tool to support training of accrual-accounting of public entities, for all the elements of assets whose fair value is estimated using the depreciated reproduction cost.

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<sup>i</sup> Article 1: «In order to ensure transparency and consistency of accounting systems and procedures, to provide insight into the financial condition and assessment of the overall management, the universities have adopted a system of accrual-accounting and analytical accounting. » Article 2 "Accounting and financial statements": «The universities in the preparation of accounting documents referred to in Article 1, paragraph 2, shall comply with the accounting and financial statements prepared and updated by the Minister of Education, University and Research, in consultation with the Minister of Economy and Finance, after consulting the Conference of Italian

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University Rectors (CRUI), in accordance with the provisions contained in Legislative Decree 31 May 2011, n. 91, in order to consolidate and monitor the accounts of public entities.»

<sup>ii</sup> Article 1, paragraph 61, «Within six months from the date of entry into force of this Act, by order of the Ministry of Economy and Finance, (...) are established for monitoring purposes, how to introduce in all public entities economic accounting policy».

<sup>iii</sup> Article 2 (Delegation to the Government for the adjustment of the accounting systems), paragraph 1, «... the government is mandated to adopt, within one year from the date of entry into force of this Act, one or more legislative decrees for harmonization of accounting systems and schemes of government budget, excluding the regions and local authorities, and of related deadlines for submission and approval, according to the needs of planning, management and accountability of public finance. Systems and patterns in the first period are reconciled with those adopted in Europe for the excessive deficit procedure» paragraph 2, letter d) «co-locations for knowledge, the financial accounting system to a system and patterns of income and balance sheet accounts that are inspired by common methods of accounting.»

<sup>iv</sup> Title II, Art. 4 “Chart of Accounts integrated” paragraph 1: «In order to achieve the quality and transparency of public finance data, and improved consistency of government accounts with the European system of accounts under the accounting representations, the government using the financial accounting, are required to adopt a common chart of accounts integrated, consisting of accounts which collect the revenue and expenditure in terms of financial accounting and economic-financial accounts prepared in accordance with common methods of accounting».

<sup>v</sup> Accountability is a principle which is developed within the paradigm of New Public Management. This principle may be expressed succinctly in the need to act responsibly and to communicate in a transparent manner, how using the resources. On the issue of the New Management Public [1], [2]. About the concept of accountability for details [3], [4], [5].