Valuation of Local Government Assets in Portugal

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Abstract

The questions regarding the elaboration of a register of the State assets, comprising both public and private domain goods, has been a major concern from national official bodies. Indeed, an updated register of State goods allows the possibility of producing, *inter alia*, a comprehensive national balance sheet of public assets and liabilities.

After some failed attempts throughout the last decades, a profound reform in the public financial administration has been recently implemented in Portugal. The publication of the Official Plan for Public Accounting (POCP), from which stems one for the local government level, and the Cadastre and Register of State Goods (CIBE) constitutes a fundamental step for drawing up a register and valuation of public sector assets.

The main objective of this study is to critically analyse the methodology used in the valuation of the State assets in Portugal, with a particular focus on the local government level. This is done through a review of the national legislation and the relevant international literature on this issue. In addition, a survey conducted on specific local authorities to ascertain the way they produce the balance sheet is also used in the analysis.

The results of the study show that there are measurement problems in the elaboration of the financial statements, and there is a need for a clarification in definitions, particularly in what concerns the distinction between public and private domain of State assets. The study also suggests that a better account on the State assets, particularly on construction stock, has great implications for the management, repair and maintenance of the existing physical infrastructures.

Keywords: Construction stock, Portugal, State assets, valuation

1 - Introduction

The legal framework concerning the register of public sector assets, both public and private domain goods, has its origin in Portugal in the early 1980s. Legislative measures have been since then devised to set rules for Government departments and local authorities to prepare their financial reports and value their capital assets. The initial measure was the Decree-Law nº 477/80 which set standards and rules for the register of property and other assets belonging to public entities. The proposed objectives prescribed in the legal document for the existence of an up-to-date register of the State assets, were the following: to get an accurate knowledge of the public sector asset, which would provide information regarding its existence, nature, value and ownership regime; to assess the management of public sector affairs, assuring an efficient employment of the taxpayers money; to be the pillar of the political, administrative, economic, social, and intellectual life of the country; and as a basis for the elaboration of the Government balance sheet.

With the beginning of the reform in the financial administration of the public sector, in the early 1990s, several legislative initiatives have been undertaken to achieve the proposed aims. Such are: the Official Plan for Public Accounting, enacted by the Decree-Law nº 54-A/99, from which stems the Accounting Plan for Local Government (POCAL), by the Decree-Law nº 54-A/99, and the recommendations for the elaboration of the Cadastre and Register of State Goods (CIBE), enacted by the Administrative Order nº 671/2000.

These initiatives taken by the Portuguese Government are in line with the efforts made at the international level for the adoption of a more comprehensive framework for the public entities to record their holdings and prepare their financial statements according to the rules of the private sector. This exercise based in recognised national or international standards should lead to greater accountability and more efficient use of resources [1]. This surge in interest for valuing public properties is well explained by Lundstrom and Lind [2] for the case of Sweden - "…partly for ideological reasons, partly for financial reasons, there has been a growing interest in sales of public properties. The public sector has large holdings of real estate (land, special-purpose properties, housing properties and even commercial properties). Sales of real estate could raise considerable revenue…..The cut-back in public administration and public services has also led to vacancies, and an interest in selling properties that are no longer needed for their original purpose" (Lundstrom and Lind, 1996, p 32)[2]. A recent illustration, in the case of Portugal, was the purpose of the Government to sell and lease back a substantial amount of State real estate in order to keep the government accounts in conformity with the Maastricht criterion of budget deficit. However, this action was called off due to a political crisis.

In the first section, the paper presents the classification and the valuation methods used in public sectors assets in Portugal. This is done through a review of the national legislation, viewed within the context of the international regulatory framework on the issue. The next section, and based on previous research, presents the results of a survey on accounting and valuation practices in Portuguese municipalities. Finally, a concluding comment summarises the results of the study.

2 - Asset classification and asset valuation in Portugal

The Portuguese legislation prescribes that all public sector assets shall be recorded, but allows that the register might include assets accounted at zero value, while the valuation of other assets may derive from either on the basis of the market value, the salvage value, or the replacement value, among others.

Local government assets, like all public sector assets, are classified according to the following categories:

- **Public domain assets**- as "Assets which, belonging to a collective public right entity, are subject by law to a special juridical regime characterised mainly for being non-tradable, in order to preserve the production of their public use…"[3]. This category comprises the following assets: roads, parklands, water supply and sanitary networks, electric power networks and heritage goods.
- **Private domain assets**- as "Assets which, not being considered in public domain, are, in principle, integrated in the ownership regime established in the civil law and are, consequently, subject to the corresponding juridical trade….". [4]. Assets in this category comprise property, plant and equipment, which are not part of the public domain. This category is further divided in *non-disposable private assets*, which are those that are hold and used by the public entity to deliver its statutory services, *and*

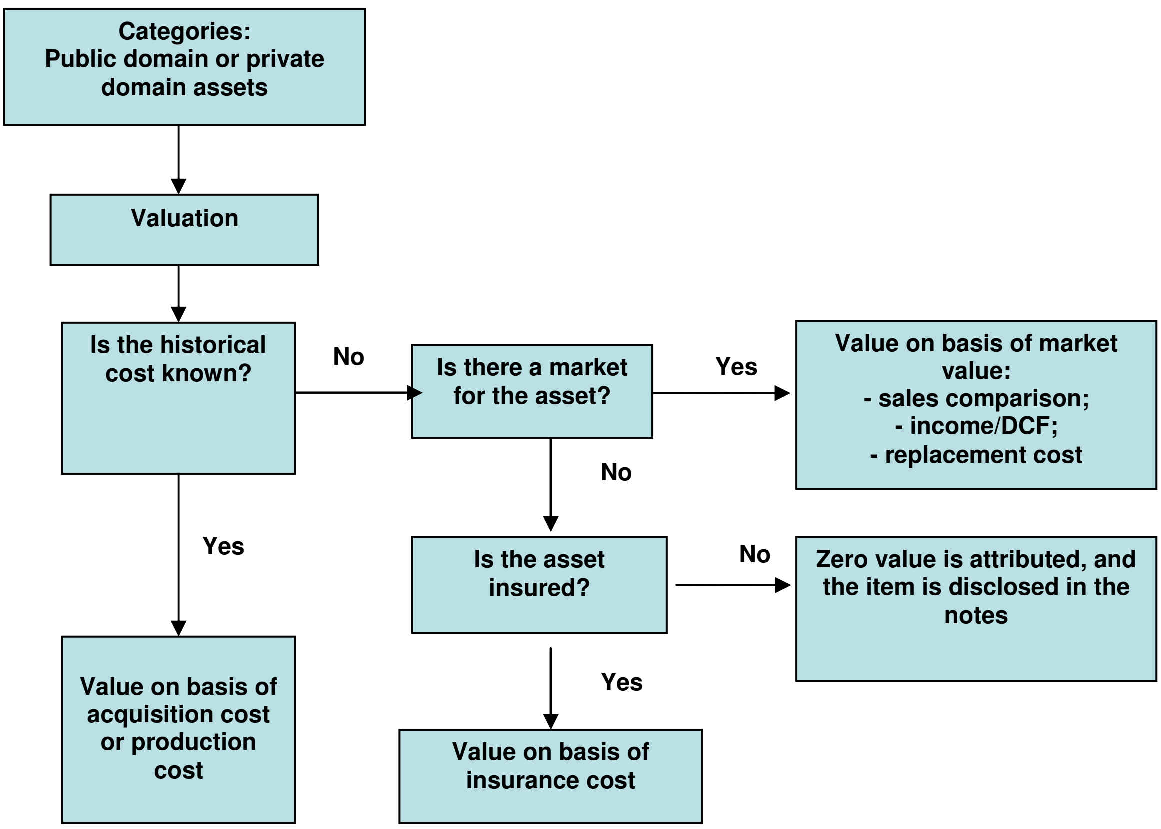
disposable private assets, which are occupied by the entity but can be transacted at any time.

As stated earlier, the Portuguese legislation stipulates that all type of assets administered by local authorities shall be registered. Thus, apart from the disclosure and classification, the public entity shall value all its assets, both public and private domain goods, in order to elaborate a comprehensive register of all assets to be accounted in the balance sheet and other financial reports. In the case of fixed assets, the POCAL prescribes that this exercise shall also comprise public sector assets in the administrative sphere of the entity, and even those that are in financial leasing regime.

According to the POCAL and CIBE, the production cost or acquisition cost approaches are used as a general rule in the valuation of local authority assets (Figure1). In the cases these valuation methods cannot be applied, or do not provide an accurate picture of the financial and patrimonial situation of the institution, other valuation methods should be used (present value calculated through the discounted cash-flow method, sales comparison method and replacement cost method). If it is not possible at all to value an asset, the notes in the financial statements must indicate which kind of assets is not accounted for, as well as the respective explanation. In this case, namely for historical and cultural goods, they must be recorded and accounted for at zero value, unless they are insured. In the latter situation the insurance value is the basis for the valuation.

The method used in Portugal for quantifying depreciation of public sector assets is the percentage depreciation method, according to the depreciation rates prescribed in the CIBE classifier, according to each type of goods.

Figure 1: Asset valuation in Portugal



At the international level, the IPSAS (International Public Sector Accounting Standard) 17 [5] prescribes that it is an option for the public sector entities to recognize in their balance the public domain goods that satisfy the recognition criteria of a tangible fixed asset. However, if they do opt for recognition they must follow the disclosure requirements, but not the valuation requirements. According to IPSAS 17 §13 and IAS (International Accounting Standard) 16 §8 [6], a good should be recognised as a fixed asset when two conditions are cumulatively met:

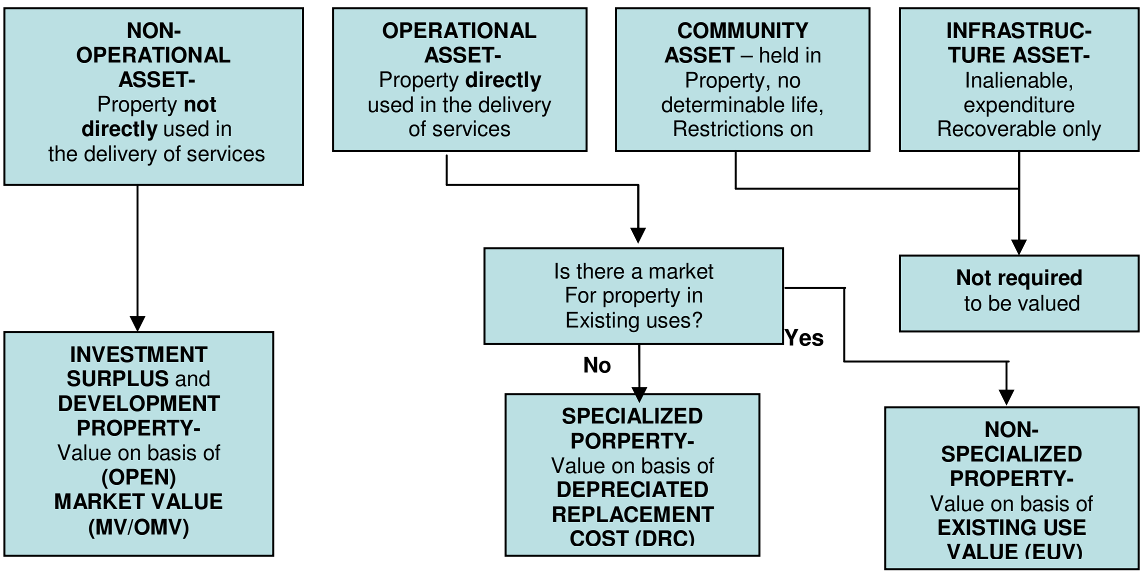
- It is probable that future economic benefits or service potential associated with the asset will flow to the entity; and
- The cost or fair value of the asset to the entity can be measured reliably.

However, the valuation of public sector assets has been subject to many controversies. Several writers [7, 8] have questioned the opportunity and relevance of the register and subsequent valuation of certain types of assets, namely heritage assets, military assets and public goods, which are rarely, if ever, transacted. Furthermore, there are differing points of view and debates, particularly in respect of definition and valuation practices (Pallot, 1997), cited in [9].

In order to place the Portuguese classification and valuation of public sector assets into a comparative perspective, the following categorisation and classification of public sector properties in United Kingdom is presented, according to the RICS *Red Book* (Connellan, 1997, p 216)[10]*:*

- **Non-operational assets**: as "Fixed assets held by a local authority but not directly occupied, used or consumed in the delivery or services. Examples …are investment properties and assets that surplus to requirements…."
- **Operational assets:** as "Fixed assets held and occupied, used or consumed by the local authority in the direct delivery of those services for which is has either a statutory or discretionary responsibility".
- **Community assets**: as "Assets that the local authority intends to hold in perpetuity, that have no determinable useful life, and that may have restrictions on their disposal…"
- **Infrastructure assets**: as "Fixed assets which are inalienable assets, expenditure on which is recoverable only by continued use of asset created. Examples are …highways and footpaths".

Figure 2: Classification and valuation treatment of assets in UK



Source: [10]

Thus, there is no significant difference between the Portuguese and UK classifications of Public sector assets except that the UK categories *infrastructure assets* and *community assets,* taken together, correspond to the Portuguese *public domain assets.* Regarding the valuation practices in the public sector, it can be seen (Figs. 1 and 2) that whereas in Portugal all kind of assets shall be valued, in UK there are some categories (community assets and infrastructure assets), which are not required to be valued.

3 - A Survey on the Practice of Local Authority Accounting in Portugal

3.1 - Method of Data Collection

As stated before, this section is based on a previous research [11], which was undertaken with twelve local authorities of a district in the north-eastern region of Portugal. The study consisted of structured interviews with representatives of the municipalities (city mayors and/or valuation officers) and was aimed to get acquainted about the way local authorities did register and value their fixed assets, as wells as to get a general view of how they did comply with the new accounting practices. The objective of those face-to-face interviews was to assess the criteria and methods used in each phase of the accounting process (classification, valuation and accounting) and to ascertain the main problems and difficulties they faced in their statutory responsibilities. A summary of the results is provided below.

The results of the initial study shows that, despite local governments are required by law to record their holding of property and other assets since the financial year 2000, nine (75%) of these entities had not undertaken at that time (2002) the register and valuation of none of their assets. The municipalities that had already undertaken the exercise used the valuation criteria prescribed in the POCAL and RICB (Regulation of Cadastre and Register of Local Authority Goods), most often on the basis of the acquisition cost or production cost whenever support documents existed. Other valuation criteria based on the market value approach were also used, namely in roads, public lighting, water treatment and water supply networks. These criteria, depending on the type of goods, are based on the fair value concept and cost replacement value, and are statutorily established by the *Valuation Commissions* whose members are designated by the City Councils. Out of the twelve local authorities analysed, only one had at the time an approved RICP, which limits to a simple transcription of the valuation criteria prescribed in the POCAL, and disregards the situations in which a valuation method should be used in detriment of others.

In order to complement and update the data obtained in the earlier study, a letter was sent in 2004 to the same local government representatives to provide the financial statements of the year 2003, which comprised, among others, the following documents: the annual budget of the entities as well as its execution, the balance sheet at December 31, 2003, and the notes to the balance sheet. Only six (50%) of the local authorities responded to the request.

In the methodology adopted in the study, the data were collected on the basis of the figures and information expressed in the aforesaid documents, namely the expenditure budget control map, the balance sheet and the notes.

3.2 - Results of the Survey

Classification and Valuation of Assets

Regarding the classification of assets, the analysis of the data indicates that all municipalities that responded to the request followed the legislation into force. It was, however, emphasised that there were difficulties in distinguishing between private domain and public domain assets, and often in establishing the ownership rights (whether local or central government) over the same assets. Another difficulty concerning all local governments analysed had to do with the lack of records and project designs, namely water and sanitary system designs.

With respect to the valuation of the assets, the data analysed show that 66.67% of the municipalities did not provide the criteria used in the calculation of the fixed assets. Only two, 33.33%, of the municipalities provided in the notes the criteria used in the valuation - the acquisition cost or production cost as a general rule. One of these two entities attributed a zero value to the public domain assets existing until the beginning of 2002, due to varied problems: lack of historical records; difficulty in establishing the ownership of the assets; and the lack of objective valuation criteria pre-established by the competent authorities. The other municipality, in the initial register, used other valuation criteria other than the production cost or acquisition cost for a set of public domain assets, for which information on the acquisition cost was not available. It is assumed that the valuation methods might have been either the replacement value or on the basis of market value approach. The choice of the valuation method was established by an expert commission. With the data available, it was not possible to ascertain the significance of each valuation method in the measurement of total fixed assets of the entities. As an example, for the case of the U K, the following results are presented regarding the valuation methods used in a set of local authorities: Replacement cost – 33%; Sales comparison – 32%; Income/ DCF – 20%; and Other – 15% [1].

For the quantification of depreciation, the valuation officers of the local authorities used the percentage depreciation method, following the prescriptions in the POCAL. As stated earlier, the annual depreciation is calculated on the basis of the depreciation rate defined in the CIBE classifier.

The Clout of Public Domain Assets and Total Fixed Assets

Drawn from the balance sheet of the local authorities, Table 1 presents the share of public domain assets and total fixed assets in the total balance of the entities. It can be seen that the share of the public domain assets varies widely across municipalities - from 4.6 % to 61.6%. This situation is explained by the fact that, as already noted, one municipality accounted at zero value all existing public domain assets in the reference year 2002. In some municipalities, the figures concerning the same category of assets correspond mostly to work in progress.

Table 1- Clout of Public Domain Assets and Fixed Assets in Total Asset

Municipality	***Public Domain Assets/ Total Asset***	***Total Fixed Assets/ Total Asset***	***Total Asset*** (€)
A	22.2%	83.6%	7,751,826
B	4.6%	92.4%	4,249,714
C	26.2%	98.6%	35,350,269
D	22.2%	94.1%	22,801,643
E	33.9%	96.2%	2,292,204
F	61.6%	97.9%	90,438,465

Source: Financial Reports from Local Authorities (2004)

The majority of the municipalities, which have undertaken the valuation of their public domain assets, claimed that there is a lack of trained valuation officers, which would allow them a thorough classification and measurement of their assets. This problem gets worse for the small municipalities are precisely those that present a lesser share of fixed assets in total assets. However, when asked about the importance of the disclosure and valuation of public domain assets, 90% of the interviewees found that that was very important for the majority of the expenditure of the municipalities referred to the production and management of public domain goods.

The picture that emerges from Table 1 (as wells other data from the financial statements) suggests that it is not possible to elaborate a balance sheet that provides an accurate picture of the value of fixed capital of a municipality, so as to allow a comparison between municipalities. In fact, it appears to be a daunting task to draw a comparison between two municipalities, in which one has a total asset valued at € 2,000,000 and the other a total asset of € 35,000,000, when, apparently, the differences between them are not much significant, both in terms of population and territorial dimension, and in terms of the amount of physical infrastructure. In an earlier study, it was pointed out that identical assets were valued trough different methods, for there are no clear rules about when and which methods to be used in each category of assets. This fact was, according tom that study, the main problem for the municipalities to comply with their legal accounting responsibilities [11].

Table 1 also indicates that the value of fixed assets represents, in all but one case, more than 90% of total asset. The share of other components of the total asset is almost residual. If we take into account that some municipalities did not value all of their fixed assets, the clout of this indicator will, in a further accounting exercise, become even higher.

Table2: Share of Capital Expenditure and R & M Expenditure in Total Budget 2003)

Municipality	***Capital Expenditure / Total Budget***	***R & M Expenditure/ Total Budget***
A	55.04%	0.19%
B	39.43%	0.73%
C	49.57%	081%
D	47.92%	0,61%
E	29.03%	0.81%
F	60.53%	0.24%

Source: *Financial Reports from Local Authorities (2004)*

Table 2 presents the share of Capital expenditure and R&M expenditure in the total budget of the municipalities in 2003. It can be seen that the former represented bout 50% of total budget and the share of R& M was insignificant. The latter is explained by the fact that repair and maintenance is treated as current expenditures in line with the Portuguese *National Accounts*. Thus, the expenditure on capital comprises only new construction and equipment and major repairs. Data from the financial reports indicates that construction (building and civil engineering) represents the major part of the capital expenditure of the municipalities. This, added to the fact that most of existing fixed capital is comprised of construction stock, is a significant aspect that reflects the importance of property in the economy of the municipalities.

According to a recent study undertaken by a CIB (International Council for Research and Innovation in Building and Construction) project group, after allowing for cyclical fluctuations, the general trend in construction activity in very developed countries is for construction activity to be in a relative decline [12]. The study also reveals that a noticeable feature of the activity of the industry in these countries has been the change in the *new build: repair and maintenance* mix over the last few decades. Repair and maintenance now accounts for almost a half of the industry's activity, as stock management has become a relatively much more important aspect, particularly in post-industrial economies. Although the share of R& M in total construction is about 7% (this figure is certainly underreported), it is assumed that the development pattern of the construction industry in Portugal will follow in the medium to long term the general pattern of the highly industrial countries [13]. As fair as local authorities are concerned, there has been a trend in shifting responsibilities from central to local government with respect to the management of infrastructural assets. The repair and management of this huge stock will become a central aspect in the activities of the municipalities.

4 - Conclusion

This paper has presented an analysis on the criteria and methods of classification and valuation of public sector assets in Portugal, with a particular focus on local authorities. The results of the study have shown that despite the municipalities are required by law to record and value their holdings of property and other fixed assets since the financial year 2000, some of the entities analysed in the study did not comply with their legal responsibilities. The entities that did undertook the exercise emphasised definitions problems in what concern the distinction between public and private domain goods, and lack of a comprehensive framework to the valuation practice in the public sector. Though the latter aspect is also an international concern, the problem is aggravated in Portugal due to a lack of clear rules for the classification and valuation of public assets.

The analysis has also shown that building (both public domain and private domain buildings) and civil engineering infrastructures have a significant impact on the economy of the municipalities, both in terms of existing capital stock and in terms of annual capital expenditure. Taking into account that the trend is the increase in the repair and management of existing in stock to the detriment of new build, this aspect may have implications for the management of the activities of local authorities, and certainly for all public policy in the years to come.

The sample analysed in this study is very small and may not provide a true picture of the valuation and accounting practices in Portuguese local authorities. Anecdotic evidence, however, suggests that, allowing for <major metropolitan areas, some patterns that were outlined still hold for the majority of the local authorities. Of course, the sample should be broadened and the underlying issues should merit a more thorough investigation. This is the subject for further development.

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