AUSTRALASIAN COUNCIL OF AUDITORS GENERAL

23 September 2019

Ms Kris Peach
Chair
Australian Accounting Standards Board
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AUSTRALIA

By email: standard@aasb.gov.au

Dear Kris

AASB's proposed amendments to AASB 13 *Fair Value Measurement*

Following feedback from the AASB's (the Board's) Fair Value Project Advisory Panel meeting in early April 2019, the Board has proposed modifications and guidance to AASB 13 *Fair Value Measurement* (AASB 13) in a working draft of Exposure Draft ED 28X '*Amendments to Australian Accounting Standards – Fair Value Measurement of Non-cash-generating Assets of Not-for-Profit Public Sector Entities'*, with the objective of addressing practical application issues of AASB 13 for the public sector.

The Australasian Council of Auditors-General (ACAG) acknowledge that the proposed changes are intended to address inconsistent and divergent interpretations and application of AASB 13 (the objective). ACAG does not believe the draft ED, without amendment and including significantly more guidance, will achieve the objective. The attached appendix details the practical application issues we foresee in applying the revised proposals. With the exception of one matter, as detailed below, ACAG reached a consensus view across all of the proposals in the draft ED.

As previously advised in our letter to the Board in June 2019, ACAG's main concern with the proposals is the departure from a principles-based approach by prescribing the cost approach for estimating the fair value of assets not held primarily to generate net cash inflows. Public sector assets and the nature and severity of the restrictions on those assets are varied in nature.

The majority ACAG view believes the proposals:

- will have widespread ramifications across most, if not all, jurisdictions at the local, state and Commonwealth government levels
- involve additional cost at initial application and on an ongoing basis because they will increase the number of asset valuations to address cases where legal restrictions can be removed by government
- are unlikely to add clarity and comparability for financial statement users as the basis of measurement of an asset differs solely based on whether it is in the public, private or not-for-profit sectors
- will result in different application issues (as detailed in the appendix) unless further guidance is provided, specifically in relation to how the unit of account is defined and used throughout the examples.

Given the above, the majority ACAG view believes the interpretation and application issues within the sector can be more effectively resolved by the Board providing public sector specific guidance and illustrative examples to help public sector entities apply the principles in AASB 13 rather than amending the Standard.

ACAG also recommends that the AASB consult with the relevant Australian and International valuation standard bodies in developing valuation guidance. It is critical that the valuers who will perform the valuations use valuation standards that are consistent with accounting standards.

I trust you find the comments useful.

Yours sincerely

Rod Whitehead
Chairman
ACAG Financial Reporting and Accounting Committee

Specific comments on proposals in the draft ED

Issue 1 and 2 – Appropriate valuation approach for non-financial assets held by not-for-profit public sector entities for their service capacity and not primarily for their ability to generate net cash inflows and the application of restrictions

ED Proposal

Modify AASB 13 to state that for assets held for their service capacity and not primarily for their ability to generate net cash inflows, the approach to determine their fair value should be current replacement cost (CRC).

With the exception of one jurisdiction, ACAG does not agree with the proposal to prescribe the cost approach as a valuation technique for assets not held primarily to generate net cash inflows.

Majority ACAG view

Whilst the prescription of the cost approach to estimate the fair value of assets not held primarily to generate net cash inflows may help reduce the differing interpretations of the fair value measurement requirements, particularly for assets subject to legal restrictions, the majority ACAG view is this prescription is not consistent with a principles-based standard. AASB 13 has established principles such as the use of an exit price, highest and best use that is physically possible, legally permissible and financially feasible, and maximisation of observable inputs, to help determine fair value. It is not clear how the proposed change to the standard is consistent with these principles.

The objective of AASB 13 is not to prescribe valuation techniques for particular assets or sectors, but to provide sector-neutral principles for application by all sectors (for-profit public and private sectors and the not-for-profit public and private sectors). A prescription specifically for the not-for-profit public sector will create inconsistent treatment between sectors, especially where assets held, whether by the public sector or the not-for-profit private sector, are for their service capacity and not for their ability to generate net cashflows. This will lead to less useful and comparable information within financial statements for users.

At face value, the majority ACAG view see merit in calling out 'assets held primarily for its service potential' and differentiating the approach to these assets. However, we do not believe this will resolve the matter of divergent practices, but potentially create other application issues as judgement is required to determine the 'primary purpose' of an asset. Examples of such include assets that generate significant income streams, such as venues and stadia, toll roads where rights have not been sold under a service concession arrangement or have been reacquired, etc. For these assets, judgement is required to determine 'its primary purpose' which will inevitably lead to differing interpretations and application.

The majority ACAG view is the interpretation and application issues within the sector can be resolved by the Board providing guidance and illustrative examples to help all entities regardless of the sector, apply the principles in AASB 13, rather than prescribing the valuation technique. This will maintain sector-neutrality of AASB 13.

In addition to the above, the majority ACAG view identified several specific issues with the proposals and illustrative examples in the draft ED:

1. The proposals and illustrative examples should be supplemented by further guidance to help preparers determine the 'unit of account' when valuing assets. For example, with a land and non-land component, how far should the 'asset' be componentised for the purposes of selecting the appropriate valuation technique?

2. In example 2 of the draft ED it could be argued that despite the income stream, the car park's primary purpose is to encourage commuters to use public transport, avoid congestion on roads and reduce pollution. It is unclear how such decisions could be made consistently. The majority ACAG view also question the premise of the example – that parking lots next to train

stations are income generating – as this is not the experience in some jurisdictions where most commuter car parks are free to use.

3. In relation to restrictions, the practical application issues identified by the majority ACAG view included determining the impact of:
    - legal restrictions, where:
        - the current practice in some jurisdictions when assets change hands as part of a machinery of government change, the exchange value is the fair value of the asset to the acquiring agency (after considering restrictions). If the acquiring agency has more or less capability to affect the restrictions, how should this be handled by both the acquiring and disposing agency? For example, if the Department of Planning and Environment acquires land, it may be able to remove a legal restriction that the previous agency could not, but to do so would not achieve its environmental objectives and it may be politically unable to do so
        - in some jurisdictions, there are for-profit agencies where the prices charged for goods and services are regulated, but they adopt the income approach in the valuation of their assets; this instance has not been contemplated by the draft ED
    - physical restrictions that are natural rather than constructed, for example:
        - land under water (such as marine parks), old growth forests (such as national parks) that are not readily replaceable or cannot be relocated to an alternative location
        - cemetery land, where the issue is not only the legal restriction for use as a cemetery but involves human remains that cannot be moved to another cheaper location should the entity be required to ‘replace the service potential’ (although paragraphs BC47-56 of the exposure draft indicate this would be taken into consideration)
    - restrictions relating to caveats attached to land (including land owned by either the state or local governments) because biodiversity rights have been sold through a biodiversity scheme and the land cannot be used for another purpose.

Furthermore, the majority ACAG view does not agree with the reasoning for prescribing CRC as outlined in BC10:

- the reference in BC10 to the basis of conclusions in AASB 2016-4 (BC16) is not relevant to the majority of situations encountered by the not-for-profit public sector, as agencies use an adjusted market value to measure restricted land rather than an income approach
- inferring that ‘scrap’ value of land is synonymous with fair value after considering the impact of restrictions is not appropriate, as the general understanding of scrap value is the value an asset can be sold for at the end of its useful life after its economic benefits have been expended.

Divergent jurisdiction’s view

This jurisdiction agrees with using CRC on the basis that there is no supportable reason to write-down the value of land if the improvements above/below the land are not similarly written down. That is, the decision to use land in an unprofitable manner should be treated in the same way as the decision to construct unprofitable structures on the land (structures being hospitals, roads and other specialised infrastructure assets, etc). Also, per the conceptual framework, the economic benefits for these assets are non-financial and that non-financial benefits are only able to be measured via the cost approach.

As such, there is no supportable evidence to apply an arbitrary discount (for example, 90%) and that the lack of discount represents reality; and that in practice, there have been no or little discount for the purchase or sale of land, as the private sector is often competing for that land.

Issue 3 – Nature of costs included in current replacement cost (CRC)

ED Proposal

Include all necessary costs linked to acquire the assets and calculated on assumption that the asset:

a) does not exist

b) requires replacing in current environment such as makegood costs that must be incurred for surrounding facilities disturbed

Example 3 of draft ED – Costs included in the current replacement cost of land

Conceptually, ACAG sees merit with the above proposal, however we have the following concerns with aspects of example 3:

1. It is unclear whether the CRC of the road takes account of the fact that the land under the road is physically restricted from a feasible alternative use.

2. There is a unit of account question around whether the road and the land under the road should be separately accounted for which we recommend the Board clarify in the draft ED.

3. The example does not provide any guidance about how to measure disruption costs. It is not clear what the Board considers to be 'disruption costs' and the likely elements that should be included. The inclusion of disruption costs is an area of significant judgment and insufficient guidance will lead to inconsistent interpretations and practice:
   - for instance, it may be cheaper to construct assets during regular hours, but because of concerns, largely political, regarding traffic congestion and commuter inconvenience, many road works are constructed at night at higher rates. Some constructed assets may include disruption costs in the value originally transferred from WIP. However, with the benefit of hindsight they would not have been incurred, or not incurred to the same extent. It is unclear to what extent these costs should be included in a subsequent valuation of these assets or how they should be measured. Also, there are different views as to whether to include disruption costs in the CRC as they don't represent the lowest cost to replace the asset with a substitute.
   - for a new road, it would be unreasonable to ask a hypothetical purchaser to pay for these costs which haven't been incurred yet. Also, recognising a day 2 revaluation gain for future costs contradicts the strong rule of thumb that fair value equals cost on initial acquisition. While the AASB appears to accept a Day 2 gain (BC 42), it should specifically address the requirement in AASB 13 to recalibrate / adjust models on Day 1 to acquisition price.

   The second part of the example does not address the valuation of the drainage assets in the year ending 30 June 20X1. It is unclear as to whether the $2.5 million is being added to the CRC of the road to repair the damage to the drainage works in addition to capitalising a separate drainage asset during the reporting period. If the $2.5 million in the road CRC is in addition to the separate asset, we are concerned this is double counting unless the other 'drainage asset' is impaired (because it would be technically damaged by the 'replacement' of the road).

4. The example does not provide any guidance on how an asset should be valued when a 'part' rather than the whole of an asset is replaced (often multiple times over the life of the whole asset). For example, a council may replace the road surface, but to do so will incur significant costs removing and disposing of the original surface. To what extent should these costs be included and how do they impact the value of the whole asset? Is it appropriate for the value of the componentised asset to exceed the value of replacing the asset as a whole?

Issue 4 – Economic obsolescence

ED Proposal

When measuring the FV of an asset at its CRC, economic obsolescence should:

a) not be identified if the asset has apparent 'excess capacity' that is temporary or occurs cyclically; and

b) not be limited to circumstances in which a formal decision has been made to reduce the asset's physical capacity

Conceptually, ACAG agrees it is reasonable for economic obsolescence to be identified when there is evidence of a decline in market demand for the reasonably foreseeable future, and there is only an insignificant chance the decline in demand would reverse. Preparers of financial reports would need to conduct sufficient analysis to support evidence of a decline, and the probability of any reversal.

Example 4 of the draft ED – Assets with temporary overcapacity

ACAG agrees that example 4 arrives at a reasonable conclusion for economic obsolescence, however, believe the example is simplistic. ACAG recommends including either a definition or further guidance on interpreting 'standby capacity' and 'temporary'. Without more explicit guidance, interpretation and application will differ amongst preparers and users. For example, should 'temporary' be considered in light of other factors, such as with regard to its proportion of the asset's remaining useful life or economic life?

Example 5 of the draft ED – Assets with overcapacity that is highly unlikely to reverse

ACAG does not believe example 5 provides sufficient clarity on identifying economic obsolescence and raise the following concerns:

1. Further guidance is needed on how to determine the judgements required in the example such as determining 'reasonably foreseeable' and 'insignificant chance'. It is not clear how this has been determined or by whom. As noted above, preparers of financial reports would need to conduct sufficient analysis to support evidence of a decline, and the probability of any reversal.

2. The example also does not adequately address how to measure the reduced capacity of the asset. Even though the school is underutilised as a whole, the common facilities and most, if not all, classrooms are all still in use. If they are still in use, and are likely to remain in use until an elected government makes a decision on their future, how can it also be argued they are economically obsolete? Is the gross (replacement) cost calculated based on the existing 500 student school, or the notional replacement 100 student school?

   To clarify the above overarching issue, ACAG suggests the example details how the asset values have been attributed an economic obsolescence adjustment including listing the assets:
   - that are retained at the original gross replacement cost, given those facilities will be needed regardless of the school's number of enrolments including those identified in footnote 4 (the administration office, cafeteria, toilet blocks, etc.) and other items that would likely fall into this category e.g. classrooms
   - where the economic obsolescence adjustment has been applied – how the adjustment was determined and why.

3. The appropriateness of treating the land as obsolete – the land is considered a separate unit of account that will realise its full value in time. For example, it may be possible to sell the surplus land to another market participant.

Issue 5 – Whether the CRC of a self-constructed asset should include borrowing costs

ED Proposal

An entity's decision whether to include borrowing costs in the CRC of a self-constructed asset should consider whether a market participant buyer of the asset would include borrowing costs in the pricing decisions about the asset.

ACAG does not believe the proposed guidance in the basis for conclusions on whether a public sector entity should include borrowing costs in the CRC of a self-constructed asset is sufficient to address the issues encountered by the sector. ACAG believes further guidance is required as the draft ED raises the following questions and concerns:

1. Determining the market participant – there are numerous market participants who can use different methods to fund an asset. Should the entity base the borrowing costs on a typical market participant (in many instances, these are other not-for-profit public sector entities), unless there is a restriction in place regarding the asset which would influence the type of buyer in the market?

2. Determining the rate – this depends on whether the asset is funded through borrowings or through a public private partnership. In addition, the rate that a government can borrow is less than what the private sector could borrow to construct an asset.

3. Where the market participant is a public sector entity, is it appropriate to assume they would not include borrowing costs, given the majority of not-for-profit public sector entities do not capitalise borrowing costs? Alternatively, should the borrowing costs relating to indirectly incurred debt be considered?

4. ACAG believes there is scope to consider the difference between general borrowings and specific borrowings in that the service concession asset revaluation in illustrative examples 6 and 7 of AASB 1059 include borrowing costs at the implicit rate of the arrangement (that is, a specific borrowing rate).

5. Furthermore, it does not seem appropriate to recognise an increase in the fair value of an asset immediately where borrowing costs were expensed on construction but included in the revaluation; or alternatively a decrease in the fair value if the costs were capitalised on construction but not included on revaluation. Given valuers have indicated diversity in practice, we believe guidance is required to address and resolve.

Proposed paragraph BC58 of the basis of conclusions notes that the treatment of borrowing costs and other finance costs when measuring the CRC of a self-constructed asset is not specific to not-for-profit entities in the public or private sector. The proposed paragraph concludes that, in light of AASB 13 not specifying the treatment of those costs for fair value measurements by for-profit entities, it would be inappropriate to mandate a particular treatment for not-for-profit public sector entities applying AASB 13. However, ACAG still believes that guidance for the not-for-profit public sector entities is required as the circumstances of the for-profit sector are different from the not-for-profit public sector in that the for-profit sector would capitalise borrowing costs on construction of the asset and use either a market or income approach to value the asset.

Issue 6 – Whether the fair value of the land component of a non-cash generating real property should always be measured in the land's present location

ED Proposal

Whether the FV of a land component of a non-cash-generating real property should be measured in the land's present location is dependent on whether:
a) the current location would generate highest returns
b) feasible alternative location

Conceptually ACAG agrees with the Board's view that it will depend on the individual facts and circumstances on whether the fair value of land should be measured in its present location when a cheaper alternative exists, as the location will be dependent on assumptions made by a market participant regarding the location that might generate the highest return.

ACAG believes further guidance is required on how to determine the appropriate market participant, as the proposals in the draft ED place too much focus on a hypothetical market participant that does not exist. The proposal in the draft ED to search for alternate locations that a hypothetical buyer might provide services does not clarify the application of the standard. The valuation under this approach becomes reliant on a judgement about a future decision that might or might not be made by management. It also ignores the fact that Ministers, rather than management, generally make these decisions.

Under the draft proposals, the decisions and judgements required to determine the appropriate hypothetical market participant and their hypothetical actions are likely to lead to greater inconsistency in practice. ACAG also believes that additional cost is likely to be incurred in the valuation process to explore scenarios about the most cost effective location of services and that these assessments of hypothetical actions are not required.

ACAG believes the approach in the draft ED should focus on providing guidance using existing information rather than searching for non-existent scenarios and provide examples that focus on:

- viable alternative uses to determine the highest and best use
- the reasons that preclude the land from being in another location (that is, example 6B being based on circumstances in which a social policy decision/legal restriction/operational requirements have been made that require that specific location).

Furthermore, the discussion in the basis of conclusions appears contradictory. Part of the discussion focuses on the current permitted use and do not include the possibility of a government being able to have parliament change a restriction. Yet later, the discussion in a private sector context appears to require the inclusion of an assessment of a further legislated change in use, which will require judgement and likely result in divergent interpretations and practice. Also, if the value of an alternative site is relevant, then the assumption would be that the current site would be sold at market value for an alternative use and the hospital services relocated. In this case, it is likely the market value would include a deduction for conversion costs.

Other issues

In addition to the above matters highlighted above, ACAG has taken this opportunity to raise the following matters in relation to the application of AASB 13 which we believe should be taken into account in the updated ED before it is released for comment.

1. Determining obsolescence

ACAG offices have observed issues in relation to determining obsolescence. One of the main such issues is determining physical obsolescence. The International Valuation Standards Council (IVSC) standards distinguish between incurable physical obsolescence and curable physical obsolescence. IVSC presumes a straight-line approach for incurable physical deterioration.

ACAG offices are aware of some valuers who have proposed that physical deterioration is based on a condition curve compared with an assumption of straight-line deterioration. Valuers are arriving at materially different fair values for the same asset depending on whether they measure physical obsolescence based on a curve or a straight-line, and therefore guidance is required. The condition curves are often treated as intellectual property by the valuers and lead to difficulties in obtaining sufficient appropriate audit evidence on the valuations.

2. Requirement to have two valuations

The proposals may in some instances require preparers of financial statements to obtain two valuations – one with the legal restrictions attached and one where the legal restrictions can be removed by government. ACAG questions whether this is the intent of the draft ED as this will create significant additional costs and complexity to the valuation process.

3. Adjusting for differences in utility between existing assets and modern equivalent

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset, that is the cost to a market participant buyer to construct a substitute asset of comparable utility. Practically this is interpreted in terms of the cost of a modern equivalent asset, built using current construction methods and materials and at current regulatory standards.

ACAG recommends the draft ED include guidance on how to adjust for differences in utility between existing assets and the modern equivalent. For example, the modern equivalent may have greater utility than the current asset such as a longer design life or increased capacity, or the existing asset may be overdesigned.

4. Guidance on the unit of account for an asset

ACAG believes that further guidance and clarification is required on how to determine the unit of account for assets. For example, is the unit of account for an infrastructure network the whole of the network, each component listed separately in the register, or something in between?

An interpretation of the unit of account commonly applied is that this is the smallest division of an asset that can function or be disposed of separately, or used for an alternate purpose, without affecting the overall asset. The proposals in the draft ED seem to move away from this by applying the broadest possible interpretation of what a specialised asset is.

Establishment of the ‘unit of account’ as a concept would be a very useful project for the Board. Delivery of services to citizens is now moving to a ‘precinct’ model, whereby the private and public sectors combine in a single location to deliver a range of services (hospitals and allied health care, policing and family services, etc). Yet within that precinct there are a range of assets, which under the current proposals may be measured in very different ways depending on how the unit of account is determined. The precinct as a whole might be considered to be a single asset, or the hospital, carparks, medical services buildings for allied professions, shops cafes and commercial services and the land upon which they are located could be considered separate assets. Each of these assets could be located anywhere, possibly at a lower cost, and could be considered a separate unit of account, as could the land on which it is located. Yet they are most effectively delivered in a single location as they all work together to some extent. Applying the guidance in the draft ED would lead to the conclusion that the entire precinct is a single asset, which is not an appropriate outcome.

5. Applying CRC to units of measurement

ACAG believes there are difficulties in applying CRC to a unit of measurement that includes both the land and everything on it. It is unclear whether the same measurement approach will be adopted for ‘self constructed’ restricted assets, acquired restricted assets, assets that are restricted because of environmental factors and assets that are restricted in their future use because of the sale of certain rights.

Where restricted assets are already classified, measured and disclosed using a smaller unit of measurement, how will the transition to the new requirements be handled and over what timeframe?

6. Topic areas identified by the Fair Value Measurement Project Advisory Panel

In 2017, the Fair Value Measurement Project Advisory Panel identified eight topic areas that required public sector specific guidance, which the Board agreed to include in the project.

ACAG believes the draft ED should provide guidance on the following two topic areas included in the initial scope of the project that have not been considered in the draft ED:

- the interaction of AASB 13 with other standards, particularly how to measure the fair value of right-of-use assets of specialised assets under AASB 16 *Leases*
- repurchased internally generated intangible assets (for example, licences) held by the issuing entity with no intention to be sold back into the market.

7. Proposed application date of the standard

ACAG has concerns with the proposed application date of 1 July 2020 and recommend the Board consider this in light of other new Standards impacting the public sector in the next few years.

Consideration should be given to proper transitional provisions, given revaluation cycles of agencies, cost associated with the requirements, etc.