AASB Staff Paper

AASB 13 Disclosures for Not-for-Profit Public Sector Entities – Staff Outreach and Alternatives for Progressing the Project

Purpose

1 The purpose of this staff paper is to consider:

(a) feedback of the results of staff outreach activity; and

(b) alternatives for progressing the project.

Summary of feedback received

2 Staff sought feedback from preparers, auditors and valuation experts operating in the NFP public sector as to the difficulties encountered by NFP public sector entities with presenting AASB 13 compliant disclosures, and the reasons for those difficulties. While in the main feedback was from those working with local government entities, staff also received feedback from other constituents. Staff also performed a limited desktop review of disclosures presented in published financial reports of various local governments and State governments.[1] The staff outreach activity was not targeted at NFP private sector entities.

3 Staff received feedback by email from a Big 4 audit firm, ANAO (gathered by ANAO staff from a range of sources), Department of Treasury and Finance (DTF) Victoria (feedback from departments and relevant agencies of the State of Victoria collated by DTF Victoria staff), Western Australia Local Government Finance Professionals, Local Government Finance Professionals NSW, and held face-to-face meetings and teleconferences with other preparers, auditors from State audit offices (2) and valuation experts (2). Staff were also invited to meetings of the Technical Heads of ACAG member offices and the National Local Government Financial Management Forum, where AASB 13 application was discussed. In addition, the issue was also raised at all CPA Congresses at which AASB staff presented – the AASB presenter received feedback after each session from at least one interested attendee, including an attendee from a Government Business Enterprise with significant infrastructure assets measured at fair value.

4 Overall, the feedback received was consistent with disclosure concerns being mostly in relation to property, plant and equipment (including infrastructure) (PPE) within the scope of AASB 116 *Property, Plant and Equipment* and measured on the fair value basis. The revaluation of PPE occurs widely for NFP public sector entities in Australia, and disclosures about the fair value of such property, plant and equipment are required under AASB 13 in addition to the requirements of AASB 116.

5 PPE is primarily categorised by NFP public sector entities as Level 3 in the fair value hierarchy, including for operational land and non-specialised buildings.

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1 This staff paper makes no comment on the appropriateness of the fair value measurement of the assets, valuation methodology selected, level of the fair value hierarchy into which assets are categorised or adequacy of disclosures presented.

6 Respondents held differing views as to whether modification of AASB 13 disclosures was required for NFP public sector entities. Preparers from local government entities expressed support for some relief from the disclosures, citing the additional costs of presenting the disclosures (time, effort, and extra dollar costs) and the lack of usefulness of the disclosures to users (in particular, ratepayers). However, some contractors engaged by local government entities to provide input into the financial statements did not consider relief to be necessary or the disclosures to be difficult to present, while others were of the opinion that the disclosures were of little benefit, and potentially misleading, to users. The majority of respondents who are auditors considered that departure from AASB 13 was unnecessary as they regarded concerns to be mostly transitional or educational in nature. However, these respondents were sympathetic to some of the complications that arise from application of the Standard for NFP public sector entities due to the prevalence of fair value measurement of PPE in the public sector.

7 Respondents raised the following points of concern with respect to the requirements of AASB 13 to disclose information about PPE measured at fair value:

Concerns giving rise to challenges with determining appropriate disclosure

(a) the need for better, and more consistent, intra-group and inter-group communication and interpretation between preparers, valuation experts (in-house and external) and auditors. Respondents held different views on the application of AASB 13, in particular, relating to the level of asset disaggregation and categorisation in the fair value hierarchy, and materiality of disclosures;

(b) the lack of guidance in/accompanying the Standard assisting the assessment of whether classes of PPE measured at fair value need to be further disaggregated for the purposes of making AASB 13 disclosures.[2] For example, entities queried the level to which specialised infrastructure assets for roads, rail and water is to be disaggregated. Some respondents indicated that they did not see a need for further disaggregation from the classes identified in accordance with AASB 116. A respondent commented that the appropriate level of disaggregation is important for producing disclosure that is meaningful – staff concur, and this is evident from some of the other points of concern noted;

(c) the lack of guidance in/accompanying the Standard assisting categorisation into the various levels of the fair value hierarchy, including the assessment of whether PPE measured at fair value using depreciated replacement cost as a valuation technique could be categorised as Level 2 in the fair value hierarchy in certain instances (for example, where the PPE was recently constructed or there were recent market transactions);

(d) the lack of guidance in/accompanying the Standard assisting the identification and disclosure of quantitative information about the significant unobservable inputs used in the fair value measurement of PPE categorised as Level 3 in the fair value hierarchy, including in instances when an external valuation is

2 Staff note that Illustrative Examples 15 – 17 accompanying IFRS 13 illustrate further disaggregation of investment properties and financial assets, but not PPE.

obtained. Some respondents noted identification of significant unobservable inputs (as compared to all inputs) to be challenging. In addition, staff think that part of the challenge in applying AASB 13 has been the balance between the identification of asset classes (and consequently, cost), and whether the resultant potentially wide quantitative range disclosed provided meaningful information to users. For example, staff observe that the State of Victoria 2013-14 annual financial report reflected as a significant unobservable input to the valuation of certain of its assets the community service obligation adjustment. This adjustment was reflected as being between 10%-90% for specialised land held by the Environment sector.[3, 4] Other financial reports identified unobservable inputs without disclosing associated quantitative information, disclosing only instead that the range of inputs varied (or varied significantly within the asset class). Staff observed from a desktop review of financial reports that where 'asset condition' was reflected as a significant unobservable input, the range of inputs was often disclosed as 'very poor to excellent';

(e) the variability in the extent of information provided by in-house engineers, asset management staff or external valuation experts, giving rise to further preparer costs in either having to seek further information to comply with AASB 13 disclosures, or in summarising the information provided. Some respondents also commented that additional costs were incurred to revisit previous revaluations that were not compliant with AASB 13 either with respect to measurement and/or information for the purposes of disclosure. (Some respondents also noted that certain assets had not yet been revalued on adoption of AASB 13 as the assets were revalued on a rolling basis and were not yet due for revaluation);

Concerns with specified disclosures

(f) the duplication of various disclosures across different notes in the financial report. Some respondents commented that the recommendation in AASB 13 to provide quantitative disclosures in a tabular format and the note as laid out in various model financial reports encouraged fractured disclosures;

(g) the relative additional page count resulting from AASB 13 disclosures. Feedback from the NSW Office of Local Government was that AASB 13 had added, on average, an additional ten pages to the financial report. Staff received feedback that the experience in local government entities in some of the other States varied (including between an average of two pages and 12 pages), arising from the State's interpretation and accepted approach to adopting AASB 13;

(h) the usefulness of AASB 13 disclosures, in particular the quantitative information about significant unobservable inputs required of assets categorised within Level 3 of the fair value hierarchy (AASB 13.93(d)), and the narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs and a description of interrelationships and how

3 National parks were separately identified.
4 Refer Note 22(i) of the 2013-14 Financial Report for the State of Victoria.

they affect the fair value measurement (AASB 13.93(h)(i)). Preparers questioned whether it was possible to provide meaningful information without excessive disaggregation. Respondents from local governments expressed the view that ratepayers and other readers of local government financial reports were unlikely to be interested in notes to the financial statements, and that questions were seldom received from the public about the financial statements (further, in NSW, staff received feedback that local government entities present in addition to the financial statements, Schedule 7, which provides information about the costs of maintaining assets and asset conditions). Staff also received feedback from some local government respondents that AASB 13 disclosures would not themselves affect local government funding decisions. Other respondents considered the disclosures to be useful as the information allows comparisons to be made across entities with similar assets as to the appropriateness and consistency of the observable input ranges or valuation technique. Similarly, respondents disagreed on the materiality or otherwise of these disclosures (see also (i) below).

Staff note that Illustrative Example 19 in IFRS 13 (IFRS13.IE66[5]) provides an example of a narrative description of the sensitivity of the fair value measurement required under AASB 13.93(h)(i), and that paragraphs BC207 of IFRS 13 clarifies that the intention of the disclosure is to provide users with information about the directional impact of the a change, and information about the pricing model for those users who are not familiar with the valuation of a particular class of assets or liabilities. Staff observed, from a desktop review of various financial reports, that entities generally adopted 'stock' wording similar to that presented in Illustrative Example 19;

(i) how the disclosures translated into 'value to ratepayers'. Some respondents questioned whether there is any more discharge of accountability, whether information about valuation risks is important to users of local governments whose assets have a community value and whose ratepayers do not make investment decisions based on the council's performance, and whether the disclosures provide any further insight into the condition of council assets. Others considered the disclosures to provide value as they provide the auditor with further insight into/ necessity of focusing on the valuation, and provides users with greater transparency of the fair value measurement of PPE and the robustness of the balance sheet;

(j) obtaining data for AASB 13 disclosures will be difficult on an ongoing basis as well as on transition for assets for which an annual revaluation is not

5 IFRS13.IE66 states:
For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, the IFRS requires an entity to provide a narrative description of the sensitivity of the fair value measurement to changes in significant unobservable inputs and a description of any interrelationships between those unobservable inputs. An entity might disclose the following about its residential mortgage-backed securities to comply with paragraph 93(h)(i) of the IFRS:

> The significant unobservable inputs used in the fair value measurement of the entity's residential mortgage-backed securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

performed. Some respondents noted that AASB 13 does not directly address such situations. Staff received feedback that entities have adopted different approaches on adoption of AASB 13, including not presenting AASB 13 disclosures for such assets, seeking further information to comply with AASB 13, and bringing forward the valuation schedule for assets revalued on a rolling basis; and

(k) the objective of making AASB 13 disclosures, as described in paragraphs 91-92 of AASB 13, may be lost due to the extent of the assets for which disclosure is required and the focus on getting the detail right. Some respondents also noted that AASB 13 disclosures should be considered having regard to the IASB's Disclosure Initiative Project;

Concerns related to the visibility of revalued amounts

(l) the difficulties in measuring fair value at the asset's highest and best use when the asset is in a specialised industry (e.g. water industry) or the asset is unique (e.g. continental shelf). Staff received feedback that the discount applied to the fair value of 'similar assets' to determine the fair value of the asset can be significant, and providing disclosures about such (and the impact of a change in the input) could be potentially misleading to users; and

(m) some respondents commented on the reliance of local government entity accounting staff on valuations or inputs into valuation models by engineers, asset management staff, or external valuation experts, noting that accounting staff were unlikely to have the expertise or knowledge required to query whether (or explain how) the information obtained was appropriate or reasonable, or to then identify the interrelationships between those inputs or assess the sensitivity or otherwise of the fair value measurement to a change in an input.

8 In addition, staff received the following feedback related to AASB 13 measurement concerns:

(a) Various respondents expressed concern about the lack of guidance on how the requirement to fair value an asset is applied when there is no market for the asset or where the asset cannot be sold[6], who "market participants" are, or how "highest and best use" applies to assets whose future economic benefits are not regarded to be primarily dependent on the asset's ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits, or where the asset's use is dictated by another entity. Some respondents questioned whether AASB 13 provides an appropriate basis for measuring the fair value of assets that have community value rather than commercial value;

(b) Some respondents expressed concern that there was a lack of guidance on identifying whether restrictions were entity-specific rather than asset-specific; and

6 Staff received feedback that in Western Australia, Crown reserves and the assets located thereon cannot be sold (as a going concern).

(c) Some respondents expressed a view that there is a lack of understanding/ consistency about the appropriateness of inputs in valuation models, especially a depreciated replacement cost model, and whether those inputs are observable or unobservable. For example, whether it is appropriate to apply the entity's estimate of an asset's useful life when estimating the asset's fair value by reference to its depreciated replacement cost, or whether to apply a market participant's estimate of the asset's useful life.

Staff Analysis

9 In summary, although staff are sympathetic to many of the concerns noted in paragraphs 6 – 8 above, staff consider that many of the concerns noted in these paragraphs relate to measurement, educational or transitional issues – rather than the suitability of the disclosure requirements of AASB 13. The staff view, consistent with the feedback from various respondents, is that much of the difficulties encountered by entities in presenting AASB 13 compliant disclosure arise from a lack of familiarity with AASB 13 and a lack of guidance in the Standard relating to non-financial assets other than investment properties/ land and buildings.

10 Further, staff do not think that concerns raised are specific to the NFP sector, as would be necessary under the AASB's *Process for Modifying IFRSs for PBE/NFP* (the Process)[7] for proposing modification to the Standard for application by NFP public sector entities. For example, staff note that various water and port GBEs also fair value their infrastructure assets (e.g. City West Water, North Queensland Bulk Ports Corporation).[8] However, staff note that the prevalence of the practice of fair valuing non-financial assets in the NFP public sector highlights concerns with the operationality of AASB 13.

11 While staff are sympathetic to the views of local government entities that AASB 13 disclosures add significant costs (relative to entity size) with little additional benefit, staff do not think that a similar cost argument applies to other NFP public sector entities such as State or federal governments. In addition, staff note that the disclosures relate to assets constituting a significant portion of the balance sheet for local government entities (generally in excess of 90%). Staff think that the costs of preparing the disclosures need to be weighed also against the benefit to users of information about the robustness of the balance sheet.

12 Staff note that AASB 13 does not mandate that disclosures required by the Standard be presented as a separate note, and accordingly, that (in addition to materiality) there remain avenues for reducing duplication in the financial report (and hence page count). For example, it would be possible for entities to simply disclose (where appropriate) that all PPE is categorised as Level 3 in the fair value hierarchy without reproducing this information in the tabular format suggested by Illustrative Example 15 of IFRS 13 and various model financial statements, and adopted by entities. The staff view, from its desktop review of various local government entity financial statements, is that there is scope for improving the disclosures (and potentially reducing duplication and the page count).

7 http://www.aasb.gov.au/admin/file/content102/c3/Final_Process_for_modifying_IFRSs_Oct_2009.pdf
8 Source: 2014 Annual reports of City West Water, North Queensland Bulk Ports Corporation, available at https://www.citywestwater.com.au/documents/annual_report_2014.pdf http://www.nqbp.com.au/wp-content/uploads/2014/09/NQBP-Annual-Report-2013-2014.pdf

Alternatives for Progressing this Project

13 Staff have identified the following alternatives for progressing this project:

(a) **Modify AASB 13 for application by NFP public sector entities.** The Board could direct staff to recommend modifications to AASB 13 for application by NFP (or NFP public sector) entities in accordance with the Process.

The Process requires issues relating to the nature of transactions, events and circumstances and their impact on NFP entities, costs of complying with the IFRS (AASB 13) and the benefits to users of complying with the IFRS (AASB 13) to exist before modification of a Standard (AASB 13) for NFP entities may be considered appropriate. While the Process is aimed at modifying Standards only for differences between the for-profit and NFP sectors, staff note that modifications have previously been allowed in relation to the NFP public sector.

Paragraph 20 of the Process notes that a particular IFRS requirement may have a disproportionate costly impact on NFP entities, perhaps because of the frequency of particular types of transactions and other events among NFP entities. Staff think that the prevalence of the practice of fair valuing non-financial assets in the NFP public sector will, in this regard, prima facie give rise to a disproportionate costly impact compared to most for-profit private sector entities who are more likely to measure property, plant and equipment (other than land and buildings) on the cost basis. Further, the relative cost (in terms of time, effort and dollar costs) is more significant for local government entities that hold a range of PPE at fair value but do not have the same resources available as other government entities. Staff acknowledge the views set out in paragraphs 7(h) and 7(i) above that ratepayers as a user group are unlikely to be interested in extended information relating to the fair value measurement disclosed in accordance with AASB 13. Staff also think this view could be extended to taxpayers in the broader State or Commonwealth entity level. Accordingly, staff think it is arguable that the benefits to general users of NFP public sector reports of certain AASB 13 disclosures are limited.

While staff are sympathetic to the costs incurred by NFP public sector entities, staff note that costs, benefits and user needs should be assessed at a NFP sector (or, staff think, at least a NFP public sector) level under the Process. Staff note that while preparers from local government entities were supportive of modification of AASB 13 disclosures, the feedback received from DTF Victoria did not express a view either way.

As noted in paragraph 10, staff think that the prevalence of the practice of fair valuing non-financial assets in the NFP public sector highlights concerns with the operationality of AASB 13. Staff consider that the current costs incurred (as arising from the concerns described in paragraphs 7 and 8 above) are largely symptomatic of underlying guidance, measurement, transitional and educational issues of NFP public sector entities, and these, once addressed, should alleviate much of the additional costs of disclosures of local government entities as the disclosures should become much more of a mechanical exercise. Accordingly, staff do not think there is a sufficient case under the Process for modification of AASB 13 disclosures for NFP public sector entities.[9]

(b) **Develop Australian Guidance to accompany AASB 13.** The Board could direct staff to develop Australian Guidance addressing the concerns of NFP public sector entities that arise from the lack of guidance in the Standard pertaining to where a variety of PPE is held at fair value.

Staff think that many of the difficulties and costs of applying AASB 13 are attributable to the lack of guidance in the Standard with respect to the application of the Standard to non-financial assets. However, staff do not think it is possible, under the AASB's sector neutrality policy, for the AASB to itself to develop guidance to address this (for example, as certain GBEs also fair value infrastructure assets). For this reason, staff do not think this is a viable alternative to address the disclosure concerns of NFP public sector entities.

(c) **Write to the IASB.** The Board could write to the IASB to request the IASB develop some application guidance addressing non-financial assets other than land and buildings, including to:

(i) clarify whether it is possible for a depreciated replacement cost measurement to be categorised as Level 2 in the fair value hierarchy;

(ii) clarify whether price per square meter is always categorised as a Level 3 input (Illustrative Example 17 in IFRS 13 illustrates this as such);

(iii) provide examples of possible asset classes under IFRS 13 for non-financial assets other than land and buildings;

(iv) provide guidance on how to identify a significant unobservable input;

(v) clarify how rolling valuations affect IFRS 13 disclosures, especially on transition.

In addition, the Board could write to the IASB about some of the measurement difficulties encountered with respect to non-financial assets.

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9 Staff did consider whether it is arguable that the costs of complying with the requirement in paragraph 93(h)(i) of AASB 13 to provide, for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a narrative description of the sensitivity of fair value to changes in unobservable inputs and a description of the interrelationships between inputs used, may be significantly additional without any corresponding increase in benefits, as the users of this information are likely to be specialist users rather than ratepayers and the relevance of the disclosure is likely to be minimal to ratepayers. The preliminary staff view is that these costs are largely once-off, as the disclosure is unlikely to change unless the significant inputs or the valuation technique is altered.

Staff also considered whether the costs of complying with the requirements to categorise non-financial assets into the fair value hierarchy, and provide disclosures of the valuation techniques used, the inputs into the valuation model, and quantitative information about significant unobservable inputs could be arguably said to be significantly additional. However, staff think that these requirements are similar to those previously required by paragraphs 77(c) and 77(d) of AASB 116, which required entities to disclose the methods and significant assumptions applied in determining fair value, and the extent to which fair value was determined by reference to observable prices in an active market or recent market transactions on arms' length terms or were estimated using other valuation techniques.

(d) **Publish a staff article.** The Board could direct staff to prepare a staff article explaining the role of materiality and judgement in applying AASB 13 to non-financial assets, and to provide some guidance in those areas giving rise to disclosure difficulties.

Staff think that a staff article, as another education avenue, will assist users with some of their disclosure concerns, and while it is likely that any principles described in a staff article would apply equally to for-profit entities and NFP private sector entities, a staff article arguably does not contravene the AASB's sector neutrality policy. However, staff note that AASB staff articles are not authoritative and therefore might not significantly reduce the incidence of disagreements about how to apply AASB 13.

(e) **Do nothing.** The Board could take no action at present, but wait until the IASB and AASB conduct their post-implementation review (not expected to be earlier than 2016) of the Standard to review the application of the Standard to NFP entities and consider the need for more guidance at that time.

14 Staff recommend both writing to the IASB to describe some of the operational issues noted, as well as writing a staff article as described in paragraphs 13(c) and 13(d) above.

Question for Board Members
Q1 Do Board members agree with the staff recommendation in paragraph 14 above?

15 In addition to the decision taken on progressing this project, the Board could also consider undertaking a project to consider whether AASB 1053 *Application of Tiers of Australian Accounting Standards* should require all local government entities to be subject to Tier 1 reporting requirements. AASB 1053 specifies that Tier 1 reporting requirements apply to local government entities for the reasons set out in paragraphs BC52 and BC63 of AASB 1053 (in particular, the coercive power to tax, rate or levy). The Board may decide to take on a project to reconsider its conclusions in AASB 1053 that all local government entities should be subject to Tier 1 reporting requirements.

16 Staff think that this would be a major project and is likely to require considerable formal due process and significant staff resourcing. Staff do not recommend the Board take on such a project at this time having regard to current staff resourcing constraints and the current Board work programme.

Question for Board Members
Q2 Do Board members agree with the staff recommendation in paragraph 16 above?