

## Staff Issues Paper

### Fair Value Measurement of Defence Weapons Platforms

#### Purpose

- 1 The purpose of this paper is to consider a request by the Department of Finance (DoF) for the Board to reconsider the requirement in AASB 1049 *Whole of Government and General Government Sector Financial Reporting* to require defence weapons platforms (DWP) to be measured at fair value for financial years ending 30 June 2015, with a view to determining any action the Board may wish to take in relation to the issue.

#### Background

##### GAAP-GFS Harmonisation

- 2 In December 2002 the Financial Reporting Council (FRC) issued a direction for the AASB to harmonise Government Finance Statistics (GFS) with Generally Accepted Accounting Principles (GAAP). This was in response to concerns about the potential confusion that arises from statisticians/economists and accountants both applying accrual principles but reporting different results for a public sector entity.
- 3 In the context of AASB 1049, GFS refers to the Australian Bureau of Statistics (ABS) publication *Australian System of Government Finance Statistics: Concepts, Sources and Methods*, 2005 and its amendments published on the ABS website.
- 4 The GAAP-GFS harmonisation project was divided into two main parts:
  - (a) Phase 1: Financial reporting requirements for the Australian Government and State and Territory governments and the sectors therein [General Government Sector (GGS), Public Non-Financial Corporations (PNFC) sector and Public Financial Corporations (PFC) sector]; and
  - (b) Phase 2: Financial reporting requirements for entities within the GGS including government departments.
- 5 Phase 1 was completed with the issue of the Accounting Standards AASB 1049 *Reporting General Government Sector by Governments* in September 2006 and reissued as AASB 1049 *Whole of Government and General Government Sector Financial Reporting* in October 2007.
- 6 A limited-scope post-implementation review of AASB 1049 was conducted in 2010<sup>1</sup> to help address practical issues associated with applying the standard, with limited amendments made in AASB 2011-3 *Amendments to Australian Accounting Standards – Orderly Adoption of Changes to the ABS GFS Manual and Related Amendments* (May 2011) and AASB 2011-13 *Amendments to Australian Accounting Standard – Improvements to AASB 1049* (December 2011).

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<sup>1</sup> <http://www.aasb.gov.au/Work-In-Progress/Project-Summaries/GAAP-GFS-Harmonisation-Project.aspx>

- 7 After the AASB had undertaken an exhaustive consultation process, it advised the FRC that there was insufficient basis for proceeding with Phase 2 of the project based on an assessment of the costs and benefits of the project. In March 2013<sup>2</sup> the FRC withdrew Phase 2.

#### AASB 1049 General requirements

- 8 AASB 1049 requires the financial statements of the whole of government (WoG) and the GGS to be prepared by:
- (a) applying the rules and principles of GFS where these do not conflict with the Australian Accounting Standards; and
  - (b) where Australian Accounting Standards permit optional treatments, the option to that aligns with GFS must be applied. An example of this is the measurement of property, plant and equipment (PPE). GFS requires PPE to be measured at 'market value'. Accordingly, AASB 1049 requires that the WoG and GGS financial statements apply the fair value measurement basis when valuing PPE.

#### Treatment of Defence Weapons Platforms

- 9 In April 2011, the ABS published amendments to the GFS Manual<sup>3</sup> that changed the treatment of expensing DWPs in the period in which they are acquired to recognising and measuring DWPs on the same basis as other PPE. The change required DWPs to be recognised as assets at market value. Consequently, DWPs would need to be measured at fair value under AASB 1049.
- 10 Following the change in GFS treatment of DWPs, in 2012 the Department of Defence (DoD) wrote to the AASB requesting an exemption from the requirement to measure DWPs at fair value under AASB 1049. This was on the basis that the fair value of DWPs cannot be measured reliably.
- 11 At its February 2012 Board meeting, the AASB discussed the issue and decided it would be inappropriate for AASB 1049 to be amended in the manner requested, noting that AASB 1049 already specifies that assets within the scope of AASB 116 *Property, Plant and Equipment*, for which fair value cannot be measured shall be measured at cost. The AASB also noted that the assessment is a matter for the preparers not the AASB.

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<sup>2</sup> Minutes to the AASB Board April 2013 meeting – As per Agenda item 1 – Chairman's Report on the FRC [http://www.aasb.gov.au/admin/file/content102/c3/AASB\\_Minutes\\_Meeting\\_130\\_Unsigned.pdf](http://www.aasb.gov.au/admin/file/content102/c3/AASB_Minutes_Meeting_130_Unsigned.pdf)

<sup>3</sup> "Defence weapons platforms (DWPs) are the structural systems from which destructive weapons such as missiles, bombs and torpedoes are launched or fired. They include submarines, warships, fighter planes and tanks. The ABS treatment of DWPs changed in July 2010 to treat DWPs as capital formation and the Concepts, Sources and Methods was updated in July 2010. Previously DWPs were fully expensed in the period they were acquired. This change means that DWPs are now seen as providing ongoing services beyond the period in which they were acquired and therefore they are treated on the same conceptual and valuation basis as other capital items recorded in government finance statistics and related economic statistics." (Chapter 2, Amendments to Australian System of Government Finance Statistics" of *ABS Information Paper Amendments to Australian System of Government Finance Statistics Concepts, Sources and Methods*).

- 12 Subsequently, in August 2012, the Commonwealth Department of Finance and Deregulation requested the deferral of the requirement to measure DWPs at fair value under AASB 1049. At the September 2012 Board meeting, the Board “noted the substantial practical issues relating to the reliable measurement of DWPs at fair value would mean that the impact would still be onerous. Accordingly, the Board decided to propose the deferral of the requirement to fair value DWPs for a further two years”<sup>4</sup>. DWPs would be subject to the full requirements of AASB 1049 for the first time for the financial year ending 30 June 2015. Following an exposure draft process, the deferral was implemented via AASB 2012-8 *Amendments to AASB 1049 – Extension of Transitional Relief for the Adoption of Amendments to the ABS GFS Manual relating to Defence Weapons Platforms*.

Department of Finance and Deregulation (DoFD) request (February 2015)

- 13 In February 2015, the DoFD wrote to the Chair of the AASB (refer Agenda Paper 2.3) requesting a review, in respect of DWPs, of the requirement to measure PPE at fair value under AASB 1049. The DoFD and DoD concluded that “applying fair value measurement from the 2014-15 financial year to DWPs would impose considerable costs on the Government to obtain an outcome that would not be reliable, practical or beneficial to users”. The DoFD outlined the following as the main difficulties in fair valuing DWPs:
- (a) **AASB 13 limits the scope of valuation technique** – The application of AASB 13 *Fair Value Measurement* is problematic for the public sector “as it narrows the possible options for determining fair value, including the specific lack of exit (sale) prices in the market for most DWPs ... This limits the scope of valuation techniques that may be employed in measuring DWPs. In particular, indexation methods, such as those employed by the ABS for GFS”;
  - (b) **reliable measurement is not possible** – Further work by the DoFD on the valuation of DWPs “strengthened their view that reliable measurement of DWPs is not practically possible and that there is considerable cost and effort in undertaking a valuation exercise for no discernible benefit”. In particular the “requirement, unique to the Australian public sector, to prove that a fair value measurement would be unreliable”; and
  - (c) **cost of fair valuing DWPs outweigh the benefits** – Due to the specialised and complex nature of DWPs, the cost to fair value these assets would be considerable (estimated around \$100 million) to “obtain either a figure of minimal value to users, or to prove that such a figure is not reliable”.
- 14 The DoFD requested that the Board provide an exemption from the requirement to measure DWPs at fair value under AASB 1049. In the event that the Board requires more time to consider the proposed exemption, the DoFD suggests a further one year transitional relief for DWPs.

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<sup>4</sup> Minutes to the AASB Board September 2013 meeting – Agenda item 16  
[http://www.aasb.gov.au/admin/file/content102/c3/2012\\_Sept\\_AASB\\_Minutes\\_Unsigned\\_Meeting\\_126.pdf](http://www.aasb.gov.au/admin/file/content102/c3/2012_Sept_AASB_Minutes_Unsigned_Meeting_126.pdf)

## AASB Staff analysis

### AASB 13 limits scope of valuation technique

- 15 Staff disagree with the assertion that AASB 13 limits the scope of valuation techniques in measuring the fair value of an asset. Staff are of the view that AASB 13 is not restrictive in the use of valuation techniques, rather the standard permits a variety of valuation techniques. This view is reinforced in AASB 13:
- (a) in determining an asset's fair value, an "entity shall use valuation techniques that are appropriate in the circumstances for which sufficient data are available to measure the fair value, maximising the relevant observable inputs and minimising the use of unobservable inputs" (paragraph 61); and
  - (b) in "some circumstances a single valuation technique will be appropriate ... In other cases, multiple valuation techniques will be appropriate ... If multiple valuation techniques are used to measure fair value, the results (ie respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances" (paragraph 63).

### Reliable measurement not possible and the costs of fair value measurement outweigh benefits

- 16 Staff are not convinced that a reliable measurement of fair value cannot be obtained for some or all DWPs for the reasons below:
- (a) while the market for the sale of DWPs may be infrequent and inactive, this should not necessarily preclude an asset from being measured reliably (AASB 13, paragraph 87). Where there are infrequent market transactions for assets or their components, reliable indexation of previously observed acquisition or replacement costs are possible valuation techniques; and
  - (b) other public sector (and non-public sector) entities have complex and specialised assets such as roads, rail tracks, rolling stock, ports and dams. These assets are measured at fair value. Staff note that the New Zealand Defence Force<sup>5</sup> also fair value their specialist military equipment.
- 17 However, staff agree that the magnitude and nature of the assets could make the fair value measurement of DWPs a difficult and costly task. Staff also acknowledge that the measurement of DWPs is virtually a single-entity issue within Australia (i.e. only affecting the DoD and the Commonwealth WoG).
- 18 The benefits to be derived by users of GGS and WoG financial statements at a general level were considered in the process of issuing AASB 1049. However, staff consider that further analysis is needed to specifically assess the benefits to users of DWPs information. In particular, staff would need to undertake analysis of matters such as what loss of information would arise from not fair valuing DWPs for a conclusion to be made on the costs and benefits of fair valuing DWPs.

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<sup>5</sup> <http://www.nzdf.mil.nz/downloads/pdf/public-docs/2014/nzdf-annual-report-30june2014.pdf>

- 19 For the reasons above, staff would recommend further analysis of the costs and benefits of measuring DWPs at fair value (refer paragraph 20 below).

Consideration of options available to address the issue

- 20 Staff have identified the following options for the Board to consider in the response to the DoFD's request.

(a) **No further extension to the transitional relief for DWPs**

This option would require DWPs to be measured at fair value for the reporting period ending 30 June 2015. Given the continuing practical issues outlined by the DoFD in relation to measuring DWPs at fair value, it would be unlikely that the DoD will meet the requirement to fair value DWPs by 30 June 2015.

Staff do not recommend this option as we consider further analysis of the issue is needed before making the necessary assessment of the issues raised by the DoD.

(b) **Amend AASB 1049 to exempt DWPs from the requirement to fair value**  
(as requested by the DoFD)

Staff consider that the introduction of AASB 13 has not changed the techniques available to measure the fair value of DWPs. Consequently, staff continue to agree with the rationale underlying the Board's decision at its February 2012 meeting that it would be inappropriate to amend AASB 1049 to exempt DWPs from fair value measurement.

An exemption from fair valuing DWPs is likely to trigger a need to reconsider the application of fair value to a wide range of PPE. Any consideration of the requirements of AASB 1049 more broadly, would need to be subject of a thorough due process.

Accordingly, Staff do not recommend the amendment of AASB 1049 to exempt DWPs from fair value measurement.

(c) **Treat the reliable measurement of fair value of DWPs as a research exercise**

This option would involve AASB staff considering DWP examples faced by the DoD and other relevant stakeholders. This option would require a one year extension to the transitional provision of the requirement to fair value DWPs under AASB 1049.

(d) **Undertake a review of AASB 1049**

This option involves a broader review of AASB 1049, including a cost benefit analysis as to whether the Standard continues to meet its objective.

This option would permit staff to review AASB 1049 by consulting the relevant stakeholders on implementation issues and the costs and benefits of

applying the requirements of the Standard, including considering the fair value measurement of DWPs.

This option would necessitate an extension to the transitional provision on the requirement to fair value DWPs under AASB 1049 for a period of at least one year.

**Questions to Board Members**

1. Based on the above analysis, which of the options outlined in paragraph 20, if any, do Board members wish to proceed with?
2. If Board members do not wish to proceed with any of the options outlined in paragraph 20, how do Board members wish to proceed?