

Issues Paper

Fair Value Measurement by Not-for-Profit Entities

Executive Summary

1. This paper considers potential issues affecting NFPs on the application of the forthcoming IFRS 13 *Fair Value Measurement*. AASB staff considered submissions from constituents on ED 181 and ED 199 and concluded that the issue of disclosing a sensitivity analysis and describing the interrelationship between inputs of the fair value amount measured as required by IFRS 13 would most likely see costs exceed the benefits of providing such disclosures. Therefore, AASB staff recommend an Aus paragraph be inserted in the Standard incorporating the forthcoming IFRS 13 to exempt NFPs from these disclosures.

Background

2. Staff have received a pre-ballot draft of IFRS 13 and see this as a suitable basis for considering the application of IFRS 13 by not-for-profit entities (NFPs) in the public and private sectors. Prior to the pre-ballot draft, the IASB has issued two exposure drafts – IASB ED/2009/5 *Fair Value Measurement* (ED 181 as the corresponding AASB Exposure Draft) and IASB ED/2010/7 *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* (ED 199 as the corresponding AASB Exposure Draft). IASB ED/2010/7 proposes to expand on the proposed disclosures in IASB ED/2009/5. ED/2009/5, published in May 2009, proposes replacing fair value measurement guidance contained in individual IFRSs with a single Standard incorporating a common definition of fair value, fair value disclosure requirements and guidance on how to measure fair value.
3. One of the IASB's objectives for the disclosures proposed in ED/2009/5 and ED/2010/7 is to provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorised within Level 3 of the fair value hierarchy. This is because those fair value measurements are more subjective than those derived from observable market prices. The first of those EDs (ED/2009/5) did not propose requiring entities to take into consideration the effect of correlation between unobservable inputs in the analysis. Based on IASB and FASB deliberations on comments received from constituents, the Boards decided to separately expose further issues that were not included in ED/2009/5. This resulted in the publication of ED/2010/7 by the IASB in June 2010.
4. ED/2010/7 added to the disclosures proposed in ED/2009/5 a measurement uncertainty analysis for fair value measurements that use significant unobservable inputs (Level 3 of the fair value hierarchy) for each class of assets and liabilities measured at fair value that takes into account the effect of correlation between unobservable inputs, if relevant.
5. Staff considered submissions from constituents on ED 181 and ED 199 for the purposes of this Issues Paper. The AASB received 14 submissions on ED 181 and five submissions on ED 199. The main NFP and public sector respondents to ED 181 that

are relevant to this paper are the Department of Finance and Deregulation, HoTARAC and Long-Life Asset Centre. The main NFP and public sector respondents to ED 199 that are relevant to this paper are the Department of Finance and Deregulation and HoTARAC. In particular, this paper notes issues raised by NFPs on those EDs and sets out the staff's views in respect of them. Since most of the issues presented in this paper relate to the application of the cost approach valuation technique and particularly depreciated replacement cost (DRC), staff have included a brief overview of DRC in the Appendix to this paper.

DRC Issues

Potential for ranking observable prices above depreciated replacement cost when the latter more faithfully represents fair value

6. In its submission on AASB ED 199, the Department of Finance and Deregulation noted that the DRC method is most commonly used for the valuation of specialised assets. Sales of particular specialised assets are infrequent and thus there is generally no readily available market. Therefore, most of the inputs to the valuation techniques to measure fair value would be considered to be unobservable and classified as Level 3 inputs in the fair value hierarchy. In this regard, the Department of Finance and Deregulation and HoTARAC (in its submission on AASB ED 181) expressed concern that the fair value hierarchy potentially places more credibility on observable data from markets that have nothing to do with the asset than that of the asset's replacement cost or discounted present value. They argued that depreciated replacement cost may represent more faithfully the fair value of not-for-profit or public sector assets than other inputs and should not be devalued or considered less useful to users than Level 1 inputs.

Staff comments

IFRS 13 prioritises inputs to valuation techniques used to measure fair value in three levels but does not prioritise valuation techniques (i.e., the market approach, income approach and cost approach). Although the cost approach generally requires Level 3 inputs, the IASB does not specify the credibility of the valuation techniques.

AASB staff consider the above-mentioned respondents' comments are symptomatic of concerns that some might read IFRS 13 as preferring an observable price for sale of specialised assets for scrap over DRC, and preferring prices in active markets for used motor vehicles over DRC for those vehicles.

- (a) The first, and more significant, of these concerns should not be realised under IFRS 13. This is because, for example, the Basis for Conclusions on IASB ED/2009/5 says the fair value of specialised assets that have a significant value when used together with other assets should not be measured at scrap value (i.e., on a stand-alone sale basis) [paragraph BC61].
- (b) The second concern probably would be realised under IFRS 13 because that Standard would seem to require the motor vehicles' fair value to be measured using market evidence of sales on a stand-alone basis. However, this issue should not affect significant holdings of assets for most entities. Moreover, this issue applies equally to all reporting entities.

Therefore, AASB staff do not think there is a PBE/NFP-specific reason for modifying the application of the IFRS by PBEs/NFPs.

Including a premium on DRC for time, risk and inconvenience factors

7. Based on the pre-ballot draft of IFRS 13, the cost approach is unamended from ED/2009/5 and focuses on two main points:
 - (a) determination of replacement cost; and
 - (b) calculation of an adjustment to replacement cost for various obsolescence factors.

Including a premium on DRC for time, risk and inconvenience factors (a point mentioned in the IVSC Exposure Draft *Proposed Technical Information Paper 2: Depreciated Replacement Cost*, which is examined in Agenda Paper J4.3) is not included in the consideration of the cost approach in IFRS 13. In its submission on AASB ED 181, the Long-Life Asset Centre argued that the cost approach as described in IFRS 13 is incomplete because an asset's fair value may exceed its DRC due to the premium market participants are often willing to pay to avoid time delays, risk and inconvenience.

8. The following explanation is given by Long-Life Asset Centre. Long-life assets take considerable time to plan, build and commission. The relevant time period can be anywhere from 3 to 10 years. During this period, the assets do not generate income. It is also common for construction projects for long-life assets to extend well beyond original time estimates due to unforeseen issues and end up being quite a distraction for entities. Buyers may be prepared to pay a premium over and above the cost of constructing or acquiring a new asset to overcome this waiting period and associated risks. Many long-life assets that are already up and running are coveted by market participants for a wide range of reasons, including the fact they can generate significant immediate income and that construction risks have already been successfully overcome.

Staff comments

AASB staff agree that the fair value of an asset can exceed its DRC because of time, risk and inconvenience factors. However, in the absence of Level 1 or Level 2 evidence of the asset's fair value (which may obviate the need to use DRC), it is doubtful whether the amount of that premium can be measured reliably. The commentator's concern is not uniquely related to PBEs/NFPs. Nevertheless, in the Australian environment, where revaluation occurs more widely for public sector NFPs, AASB staff acknowledge the issue would seem likely to be more pervasive for NFPs.

From a broader standpoint, AASB staff consider that this issue underlines the tension between defining fair value as an exit price and using the cost approach to estimate fair value. The AASB and FRSB commented on this tension in their submissions on IASB ED/2009/5. Whilst AASB staff agree with various commentators' view that DRC is the most relevant measure of the current value of specialised assets¹, staff consider that DRC has inherent

¹ And not necessarily just specialised assets!

limitations in faithfully representing an asset's exit price. (However, staff think excluding DRC would create greater problems and therefore, on balance, consider this concern acceptable.) The concern raised by the abovementioned respondent is simply one example of this broader concern. Staff consider further that the best place to address this concern is the Measurement component of the Conceptual Framework. Until that broader concern is addressed, staff see little merit in developing a PBE/NFP-specific modification to IFRS 13 to deal with a sub-set of that concern.

Lack of guidance

9. Numerous NFP constituents have expressed concern that the focus of the forthcoming IFRS 13 seems to be on financial instruments and other widely traded assets, and that the implications of applying the Standard's guidance to other types of assets and liabilities has not been adequately explored or addressed. For example, there is insufficient guidance about how the entity's own inputs can be adjusted to reflect hypothetical market participants. The pre-ballot draft only explains that, for Level 3 inputs, an entity may begin with its own data and adjust for 'reasonably available information' that market participants would use different data or there is an entity-specific synergy. For those NFPs that measure fair value of their PP&E using DRC, it is unclear how in practice this could be done in situations when there are only hypothetical market participants and no market evidence. Additionally, a Board member is of the view that additional guidance on the interrelationship between the fair value hierarchy and valuation techniques, and the choice of valuation techniques for certain assets would be beneficial.

Staff comments

AASB staff do not believe an entity is required to adjust its own data because it is presented as a recommendation rather than a requirement in the pre-ballot draft and ED/2009/5. Also, ED/2009/5 states that an entity need not undertake exhaustive efforts to obtain information about market participants' assumptions. However, an entity should not ignore information about the assumptions that is reasonably available. Staff is of the view that a NFP would not need to depart from its current practice when measuring fair value through the 'cost approach' valuation technique.

With regard to additional guidance for NFP or public sector entities that revalue their PP&E in accordance with AASB 116, staff consider there is more guidance in the soon to be released IFRS 13 than in AASB 116. Currently, paragraph 33 of AASB 116 regards DRC as a means of estimating fair value under the revaluation model and limits its use to circumstances where there is no market-based evidence of fair value. It does so because of the specialised nature of the item of PP&E and because the item is rarely sold, except as part of a continuing business. AASB 116 does not provide additional guidance on the use of DRC.

For these reasons, AASB staff do not think a PBE/NFP-specific modification of IFRS 13 is required at this stage. Staff recommends monitoring the application of the domestic Standard incorporating IFRS 13, to assess whether any additional guidance might be required. If that conclusion were reached, the ideal approach would be to request the IASB to add that guidance to IFRS 13. At such a time, if such additional guidance were warranted, it is likely

that other jurisdictions would be making similar requests to the IASB.

Staff also note that FRSB staff propose removing the PBE guidance on DRC from NZ IAS 16 when IFRS 13 is incorporated in New Zealand Standards. The PBE guidance is set out in Agenda Paper 9.3.

Other Issues

Highest and best use

10. Some may argue that the concept of highest and best use does not relate well to that of NFPs, as many non-financial assets would not be used for their highest and best use. Many non-financial assets held by NFPs could be used in a particular way that is likely to be different from how other market participants would use the assets.

Staff comments

AASB staff think that these concerns relate to *whether* fair value is the appropriate current value for these entities' non-financial assets, rather than how fair value is measured. AASB staff think fair value, if used, must reflect highest and best use and therefore propose no amendment to IFRS 13.

Onerous disclosures

11. Currently, entities that revalue their property, plant and equipment (PP&E) provide disclosures according to AASB 116 *Property, Plant and Equipment*. Paragraph 77 of AASB 116 states that:

- 77 If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed:
 - (a) the effective date of the revaluation;
 - (b) whether an independent valuer was involved;
 - (c) the methods and significant assumptions applied in estimating the items' fair values;
 - (d) the extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques;
 - (e) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and
 - (f) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

The forthcoming IFRS 13 encompasses the fair value measurement of non-financial assets (e.g. PP&E) and an entity would be required to meet the disclosure requirements of IFRS 13 and most parts of paragraph 77 of AASB 116. This creates additional disclosures for entities. This issue is amplified for entities that use unobservable inputs (i.e. Level 3) to measure fair value of PP&E, as IFRS 13 would require entities using

Level 3 inputs to disclose a sensitivity analysis and describe the interrelationship between inputs of the fair value amount measured. Although this issue is not sector specific, it is arguable that this issue is more prevalent for NFPs and may meet the requirements stipulated in paragraph 12 of the *Process for Modifying IFRSs for PBE/NFP*. Specifically, the issue of revaluation of PPE is prevalent in the NFP sector and the cost of complying with the disclosure requirements in this issue could exceed the benefit to users of financial statements of NFPs.

12. The Department of Finance and Deregulation and HoTARAC are of the view that these entities are more likely to be impacted by these additional disclosures (especially as they would revalue to fair value relatively more specialised PP&E such as major infrastructure, heritage and cultural assets). Generally, Level 3 inputs (mainly DRC) would be used to measure the fair value of these assets. The users that may benefit from these additional disclosures are likely to be specialist users with particular information needs. For other users who do not need this extra information, the relevance of what is disclosed is likely to be outweighed by the complexity of the disclosures.

Staff comments

Staff are of the view that the cost of disclosing a sensitivity analysis and describing the interrelationship between inputs of the fair value amount measured required by IFRS 13 could be likely to exceed the benefits of providing it. For this reason, AASB staff recommend further research be done on this aspect.

In its submission to the IASB on ED/2010/7, the AASB requested the IASB to provide guidance on the application of the proposed disclosure of measurement uncertainty and correlation of inputs to non-financial assets, particularly property, plant and equipment, or exclude non-financial assets other than investment property from the scope of those proposals. The pre-ballot draft of IFRS 13 does not exclude non-financial assets from the proposed disclosures and does not include illustrative examples. Therefore, at this stage the AASB staff is unable to ascertain whether the AASB's recommendations have been addressed by the IASB.

AASB staff have been informed that the use of DRC in revaluations by New Zealand entities does not differ between the sectors and, therefore, that in New Zealand, FRSB staff think there is not a PBE/NFP-specific reason to modify the disclosures in IFRS 13.

Staff Recommendations and Next Steps

13. AASB staff recommend further research be done by AASB staff on whether providing disclosures on sensitivity analysis and describing the interrelationship between inputs of the fair value amount measured would be likely to give rise to costs exceeding the related benefits. Because issues illustrated in this paper are mainly concerns from the NFP public sector, staff believes that part of the research should address whether the use of the revaluation model is prevalent in the NFP private sector as well. This would help determine if an exemption proposed should apply to both the NFP public and private sectors. AASB staff also recommend that no other modification be made to IFRS 13 for adoption by Australian NFPs.

14. AASB staff recommend that the results of the research be dealt with out-of-session and that the Board establishes a sub-committee to work with AASB staff.

Question for Board members

Do Board members agree with the staff views in the boxed text for each issue above?

APPENDIX

Depreciated Replacement Cost – Overview²

The cost approach estimates fair value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction. It is based on the principle of substitution, i.e. that unless undue time, inconvenience, risk or other factors are involved, the price that a buyer in the market would pay for the asset being valued would not be more than the cost to assemble or construct an equivalent asset.

The DRC method is a common application of the cost approach. In assessing what it might be prepared to pay for the subject asset, a potential purchaser may consider as an alternative to acquiring the subject asset, the cost to construct a similar asset having the same functionality. This represents the maximum that a potential purchaser would be prepared to pay for the subject asset if it were new at the date of valuation. Often the asset being valued will be less attractive than the alternative that could be purchased or assembled because of age or obsolescence. Where this is the case, adjustments will need to be made to the cost of the alternative asset. These adjustments are collectively known as depreciation.

² IVSC Exposure Draft *Proposed Technical Information Paper 2: Depreciated Replacement Cost*