ACAG
AUSTRALASIAN COUNCIL OF AUDITORS GENERAL

11 November 2022

Dr Keith Kendall
Chair
Australian Accounting Standards Board
PO Box 204
Collins St West Victoria 8007
AUSTRALIA

Dear Dr Kendall

Fatal Flaw Review Version – AASB 2022-X – *Amendments to Australian Accounting Standards – Fair Value Measurement of Non-Financial Assets of Not-for-Profit Public Sector Entities*

The Australasian Council of Auditors-General (ACAG) welcomes the opportunity to comment on Fatal Flaw Review Version – AASB 2022-X – *Amendments to Australian Accounting Standards – Fair Value Measurement of Non-Financial Assets of Not-for-Profit Public Sector Entities*. Unless otherwise indicated, the views expressed in this submission represent those of all Australian members of ACAG.

ACAG supports the Board's efforts to provide additional guidance to help public sector entities more consistently apply the principles in AASB 13 in relation to determining the fair value measurement of non-financial assets not held primarily for their ability to generate net cash inflows.

ACAG supports the Fatal Flaw Draft and has included suggestions, changes and recommendations on the highest and best use assumption, market participant assumptions, application of the cost approach and estimating the replacement cost of a reference asset and the illustrative examples in the attachment to this letter.

The attachment also includes other minor editorial changes ACAG has identified during our review.

ACAG appreciates the opportunity to comment and trusts you find the attached comments useful.

Yours sincerely

Margaret Crawford
Chair
ACAG Financial Reporting and Accounting Committee

Attachment

Additional guidance and changes to the fatal flaw draft

Highest and best use

One of the conditions that an asset must meet for it to be considered highly probable it will be used for an alternative purpose, is that the 'change in an asset's use is expected to be completed within one year from the measurement date' (paragraph Aus29.2(b)(vi) of the Fatal Flaw Draft). In some circumstances, a change in use to the intended new use will take longer than 12 months to transition to, such that the asset is not being used for the previous purpose during the transition period.

ACAG suggests providing guidance on how paragraph Aus29.2(b)(vi) applies in practice through an implementation example or in the basis for conclusions as this may vary depending on the stages an asset may go through to change its use. For example, if a public sector entity proposes decommissioning a school in 3 years' time in order for the site to be redeveloped for commercial and residential purposes, the condition in Aus29.2(b)(vi) is not met and the land and buildings' current use as a school is still considered its highest and best use. Alternatively, if the public sector entity proposes decommissioning the school within the next financial year (even though demolition and redevelopment will happen much later), ACAG is of the view that the condition in Aus29.2(b)(vi) is met as this would be a surplus asset within one year and therefore would represent a change in use. The change in the asset's use is evidenced by discontinuing using the asset as a school.

Paragraphs Aus29.1 and Aus29.2 refer to 'distribution' and to AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*. Distribution in the context of AASB 5 is a distribution to owners. A distribution in the public sector can be a distribution within the wholly-owned group (e.g. whole-of-government) as well as transfers to entities outside the reporting entity or whole-of-government. ACAG suggests the AASB clarify which definition of distribution is intended to be used in the Fatal Flaw Draft.

Market participant assumptions

One jurisdiction's view is that the proposed change has little effect on the current requirements and does not appear to achieve the intended relief from needing to determine hypothetical market participant inputs. The illustrative examples also do not appear to support the intended relief. Refer to the comments on the illustrative examples below.

This jurisdiction also recommends deleting the first sentence of paragraph F6 as it appears contradictory with paragraph F5. Paragraph F6 states 'if no relevant information about other market participant assumptions is reasonably available' whereas paragraph F5 refers to when 'some' of the market participant data are readily available. The majority ACAG view support paragraphs F5 and F6 of the Fatal Flaw Draft.

This same jurisdiction also believes that it is very unlikely that another local government as referred to in paragraph BC90, will acquire operations or activities in another local government's jurisdiction. In many situations, it is only the particular public sector entity that will provide those services in that particular jurisdiction. Exceptions include the use of land, buildings that can be used for offices, and some residential housing used for social housing. Furthermore, any adjustments from operations in another jurisdiction to the jurisdiction of the reference asset are unlikely to be observable.

Application of the cost approach

ACAG recommends removing the reference to a service concession arrangement in paragraph F9(a) as it is very unlikely that an asset designed by a public sector entity (i.e. the grantor) subject to a service concession arrangement will be different from the same asset operated by the entity itself e.g. a road.

ACAG notes that in practice, differences between the subject asset and the modern equivalent (apart from 'gold plating service potential') are related to building and construction standards, for example fire safety, the number of elevators etc.

Estimating the replacement cost of a reference asset

Site preparation costs

Paragraph F12(c) states that [the reference asset's replacement cost should include,] if the subject asset is fixed to a parcel of land, site preparation costs for the reference parcel of land on which the reference asset would hypothetically be constructed, unless those site preparation costs are reflected (explicitly or implicitly) in the fair value measurement of the subject parcel of land.

ACAG does not believe there is currently enough guidance to clarify whether certain site preparation costs e.g., decontamination costs should be reflected in the fair value of the land or the land improvements. For example, illustrative example 4 suggests that this is an accounting policy choice for the agency to make. ACAG believes the current guidance could lead to divergent practice.

One jurisdiction believes that paragraph F13(b) is confusing and contradictory to the other proposed guidance, particularly when an entity uses its own assumptions. The costs to remove and dispose of existing structures are not an observable input and will therefore not be readily available. Consequently, under paragraph F5, an entity will use its own assumptions. This data should be consistent with paragraph F13(a) of the entity's cost in preparing the land. Therefore, if the land that existed prior to the construction was vacant, no additional costs would be added.

Piecemeal replacement

One jurisdiction notes that paragraph BC153 appears to contradict the requirements of paragraph F12(b). The typical scenario for a road replacement is for detours to occur at night rather than during the day or for one lane to be kept open so that the road can continue to be used. Paragraph F12(b) appears to concern part replacement and covering these extra brownfield costs (e.g., high road traffic control). However, paragraph BC153 indicates that the road is unavailable for months/years when it is initially constructed (which is akin to a greenfield cost environment – low traffic control as road is closed long-term). This jurisdiction believes that fair value information is useful if it aligns with capital expenditure budgets (i.e., with their expected actual future costs in stages rather than the cost of a full replacement approach that will never actually occur). Paragraph BC154 also underestimates the difficulty to implement paragraph BC153 as there is either no or very little data available (internal or external) for unplanned projects that have no or little historical precedent. This jurisdiction believes that the drafting could be interpreted as requiring, in the longer term, public sector entities to incur additional unnecessary costs to develop costs for such situations that are not planned.

Calibration

One jurisdiction does not agree with the inclusion of paragraph BC150 to not apply calibration to a 'day 2' valuation.

Two jurisdictions do not believe that the AASB's argument about paragraph Aus15.1 of AASB 116 *Property, Plant and Equipment* is relevant to the discussion on calibration. The aim of paragraph Aus15.1 of AASB 116 is to address situations where an entity receives an asset for free (e.g., via a gift or grant) or at a heavily discounted price, so the transaction price is definitely not fair value and therefore calibration is not relevant.

Hypothetically, if the AASB believed that calibration was appropriate, then it could include an Australian modification to correspond with the Australian modification in paragraph Aus15.1 of AASB 116.

Illustrative examples

Example 1 - Costs included in the current replacement cost of a road

Example 1 is a recent 'brownfield construction' valued in a brownfield environment. ACAG recommends that a more appropriate example is of a road constructed in a greenfield environment (with no traffic disruption costs) whose components will now need to be replaced in a brownfield scenario. For example, it could be expressed as an asset constructed several years ago that is now situated in a densely populated area, with relevant replacement cost estimates being provided by an independent valuer (ignoring the impact of any obsolescence).

If the example is retained as a 'brownfield construction' then $2 million of removal costs and $1 million of disruption costs need to be included in the table of direct physical costs as they were part of the capital WIP project.

ACAG also recommends that the AASB clarify in the example's fact patten whether there are other market participants.

Example 2 – Difference in the asset's operating environment affecting the current replacement cost of a road

Example 2, is based on the circumstances in Example 1 with the inclusion of the following additional facts:

- another entity's drainage works were situated under the road
- if the road was replaced at the measurement date the other entity's drainage works would be disrupted
- the amount of costs required to restore the drainage works disrupted during a hypothetical replacement of the components of the road.

Subject to any changes arising from ACAG's comments above, ACAG believes it may be more appropriate to include a new example that does not relate to the circumstances of Example 1, as it is not logical that the initial construction of the road would not disrupt the drainage works but the replacement of the components of the road will.

Example 3 – Whether to adjust the entity's own assumptions in measuring a non-financial asset

As noted by one jurisdiction in 'Market participant assumptions', this illustrative example does not appear to support the intended relief in paragraphs F5, F6 and F11(b) for an entity to use its own costs. In this example, there are no other market participants, and it is only the department (controlled by the State Government) that would construct the railway tracks in that jurisdiction. Consequently, the decision to construct overseas or local, is not observable. This jurisdiction believes the example should be reworded to focus on the absence of other market participants, the lack of observable inputs, and the need for the entity to use its own assumptions.

Example 4 – Costs of decontaminating land

One jurisdiction expressed the view that example 4, as it is currently worded, implied that the land had been valued on a current replacement cost basis.

ACAG believes that the example should be updated to illustrate any differences that would arise between a current replacement cost and market approach valuation of the land, or otherwise confirm that the basis of valuing the related land is irrelevant to the outcome. The majority ACAG view is that land would generally be valued using the market approach as it is likely to have a reference point to the market.

When determining the fair value of the land, the land should be valued with the characteristics that will transfer to a market participant. Two jurisdictions noted that after decontamination, they would expect the land to be valued as decontaminated land and the expected $5 million decontamination costs adjusted against the surrounding contaminated land to arrive at an estimate of the fair value of the decontaminated land owned.

One of the two jurisdictions above, notes that the scenario is simplified in that the fair value of the decontaminated land will equal the fair value of contaminated land and an estimate of decontamination costs. However, this is unlikely in practice as contaminated land owned by other entities is subject to a large variation of possible decontamination costs and variations in the levels of contamination. This jurisdiction suggests that the AASB clarify as to what happens in practice when actual decontamination costs are different to the estimated costs.

ACAG also notes that:

- fact (d) of the example refers to an accounting policy choice for the recognition of site preparation costs, however there is no accounting policy choice in the implementation guidance in paragraph F12(c). Paragraph F12(c) states ‘if the subject asset is fixed to a parcel of land, site preparation costs for the reference parcel of land on which the reference asset would hypothetically be constructed, unless those site preparation costs are reflected (explicitly or implicitly) in the fair value measurement of the subject parcel of land’. As stated in ‘Site preparation costs’ above, ACAG believes the current guidance could lead to divergent practice
- one of the simplifying facts specified in (c) is to remove the profit margin attributable to any site preparation costs for market participants. There is no explanation provided for why an adjustment should be made for the profit margin. The AASB should clarify that, if the profit margin is not ignored, it should be included, as this is what a market participant decontaminating land would pay. This is also an amount we expect the government would pay, as it is likely they will have to contract to the private sector to decontaminate land.

Example 5 – Kitchen with underutilised potential

ACAG suggests amending the example to emphasise that the:

- running of classes below the physical capacity of the kitchen was part of the original design,
- classes are still scheduled as intended,
- amount of equipment aligns with the intended number of students per class, and
- kitchen would be replaced by one with the same physical capacity.

As currently drafted, it appears that every situation where the physical asset is not being used to its full capacity (something very common in the public sector, and particularly for schools such as woodwork and metalwork classrooms) requires an assessment to rebut possible economic obsolescence. Economic obsolescence (per the International Valuation Standard 105) is any loss of utility caused by economic or locational factors external to the asset, none of which have occurred in the example.

Editorial Amendments

ACAG recommends making the following editorial amendments to the Fatal Flaw Draft.

- Market participant assumptions – aligning the wording in paragraph BC 91 with the wording in paragraph F5. Paragraph F5 states ‘…., if both the market selling price of a comparable asset and some market participant data required to measure the fair value of the asset are not observable, ….’, whereas BC 91(a) states, ‘if some data of other market participants to measure the fair value of an asset are not observable,….’.
- Estimating the replacement cost of a reference asset – one jurisdiction (different to the jurisdiction that made the comments on piecemeal replacement above) believes that paragraph F12 should explicitly mention that 'the market participant does not possess the asset'.
- Economic obsolescence – rewording the final sentence of paragraph F19 to emphasise that construction costs are not linear relative to size and may vary due to economies of scale. For example, the construction costs for administration offices would be smaller than those needed for a 500 student school but would not be 20% of that of a 500 student school (a proportionate reduction from 500 to 100 students). ACAG also suggests changing ‘cafeteria’ to ‘canteen’ as this is the common term used in Australia.
- Example 3 of the Implementation examples – In the second sentence of the first paragraph ‘carriages’ should be ‘railway tracks’.