Ref: Liquid Pacific - ED320 Comment

The Board
Australian Accounting Standards
PO Box 204
Collins St West
VIC 8007

Dear Sirs/Mesdames,

Re: ED 320 - Fair Value Measurement of Non-Financial Assets of Not-for-Profit Public Sector Entities

In response to a public invitation, Liquid Pacific submits its responses to questions and topics raised in ED320.

This response is framed by Liquid Pacific's experience in the valuation of non-financial assets for inclusion in financial statements. Liquid Pacific's members are professional independent valuers accredited by the Royal Institution of Chartered Surveyors as Chartered Valuation Surveyors and the Australian Property Institute as Certified Practicing Valuers.

We wish to stress; accredited valuation professionals are providers of independent advice. The independence of the valuation profession is recognised in legislation and valuations are considered by the courts as legal documents. When providing fair values (market value) for use in financial statements, the accredited valuer is assisting their client to fulfil their regulatory requirements. They are not acting as consultants or advocates for their clients and have no pecuniary interest in the valuation outcome.

We make these pronunciations because many public sector entities are unaware that valuation is a profession with its own set of international standards. That valuers are regulated and recognised by legislation to fulfil the requirements of providing professional valuation advice.

The context in which we provide comment on the important topics set-out in ED 320 pivot on the following valuation principles.

1. Fair value and market value are one in the same
2. All valuation methodologies result in the same fair value (i.e., Market Approach = Income Approach = Cost Approach).
3. Under the same assumptions, there cannot be more than one fair value
4. Fair value reflects an asset's highest and best use

Thank you for the opportunity to address the issues raised in this exposure draft and we trust the consultation will bring about any necessary changes which will benefit both the reporting entities and the users of financial statements

Yours faithfully

……………………………………………….
Martin Burns
Director: Liquid Pacific
Chartered Valuer, RICS,
Certified Practicing Valuer, AAPI

For context, Government is the largest single owner and manager of assets in Australia. There are in excess of 5,000 public sector entities, (not all are NFP's or reporting entities in their own right), and the Australian Bureau of Statistics estimates these entities hold assets with a value of some $2.74 trillion. For comparison, the total capitalised value of Australia's 200 ASX listed companies is $2.19 trillion (depending on the day).

SPECIFIC MATTERS FOR COMMENT

Scope

1. *Do you consider that the proposed authoritative implementation guidance should be applicable also to NFP entities in the private sector? Please provide reasons to support your view.*

   Liquid Pacific considers if it is decided a guidance is required, then there should be only one guidance for Fair Value Measurement, and it be applicable to all reporting entities, not just the public sector. The principles of valuation hold regardless of which sector controls an asset.

   It follows, Liquid Pacific has issue with the concept an asset may have a different fair value (market value) dependent on who owns the asset or the purpose for which it is held. It is inconceivable that should an asset pass from one entity to another, the value of that asset may move up or down dependent on who the new owner is. Or, even more disconcerting, the value of an asset may change dramatically only when the owner of that asset decides it no longer wishes to hold the asset.

2. *Do you agree with the AASB's conclusion that determining appropriate measurement techniques for measuring the fair value of land and improvements on land subject to public-sector-specific legal restrictions is best regarded as relating to detailed valuation assessments and should not be mandated in Australian Accounting Standards (see paragraphs BC164–BC170)? Please provide reasons to support your view.*

   The legal, technical, and economic framework in which assets exist (all assets) is constantly evolving. The methodologies used to value assets are also evolving to meet these changes, and so we do not see how mandating measurement techniques could ensure a consistent and contemporary approach to the fair value measurement of assets for any ownership group.

Market participant assumptions

3. *In respect of the assumptions used in measuring the fair value of a non-financial asset of an NFP public sector entity not held primarily for its ability to generate net cash inflows, do you agree with the proposals in paragraphs F4–F7 that:*

   (a) if the market selling price of an identical asset is directly observable, that price (which incorporates implicitly the assumptions that other market participants would use when pricing the asset, negating the need to identify those assumptions) should be used to estimate the fair value of the asset; and

   (b) if the market selling price of an identical asset is not directly observable, the entity would need to explicitly estimate the pricing assumptions that other market participants would use. In this case, to maximise the use of relevant observable inputs and minimise the use of unobservable inputs:

   (i) if all relevant information about other market participant assumptions needed to estimate the fair value of the asset is reasonably available, the entity should use those assumptions in measuring the fair value of the asset; or

(ii) *if not all relevant information about other market participant assumptions needed to estimate the fair value of the asset is reasonably available, the entity would need to develop unobservable inputs in measuring the fair value of the asset. When applying paragraph 89 to develop unobservable inputs, the entity should use its own assumptions as a starting point and make adjustments to those assumptions if reasonably available information indicates that other market participants would use different data; or*

(iii) *if no relevant information about other market participant assumptions is reasonably available, the entity should use its own assumptions in measuring the fair value of the asset?*

We agree the prime objective of the valuation methodology is to define a fair value (market value) by reference to markets. We disagree that an entity would not find any relevant information on which to base their assumptions.

Further, it is not clear in the above paragraphs what alternatives the AASB is contemplating when it states *the entity should use its own assumptions in measuring the fair value of the asset*. Does this mean the entity should not adopt another entity's assumptions? Or reject WoG policies which mandates assumptions?

From a valuer's experience, fair values (market values) can vary dramatically depending on the underlying assumptions adopted for a valuation. In undertaking valuations for fair value (market value) it is part of the valuer's task to recognise and adopt the relevant assumptions which are realistic and reflect those of market participants.

Where significant variations in fair values (market values) for similar assets occur across the same sector, it is typically the assumptions adopted by the reporting entity which are the root cause. Unfortunately, we do encounter assumptions which are designed to present an entity's financial statements in a favourable light (i.e., Residual Value AASB TAD 2015) and as long as entities seek to adopt these assumptions there will always be divergence in fair values.

Liquid Pacific considers only those professionals with expertise in the valuation of assets can provide relevant and point-in-time valuations which reflect the valuation framework at the date of valuation.

4. Paragraph F8 provides examples of assets for which:

(a) market selling prices of an identical or a comparable asset are unlikely to be directly observable; and
(b) no relevant information about different assumptions of other market participants is likely to be reasonably available.

Do you agree with the examples in paragraph F8? Please provide reasons to support your view.

"F8 Examples of assets for which market selling prices of an identical or a comparable asset are unlikely to be directly observable and no relevant information about different assumptions of other market participants is likely to be reasonably available include infrastructure (eg roads, drainage and sewerage works), prisons, parliament houses, fire stations, police stations, war memorials, traffic or pedestrian facilities, community facilities (eg toilet blocks) and most defence weapon platforms."

We disagree with the premise some assets cannot be valued with reference to market forces.

For valuers, the question of what is observable and what is unobservable is not just defined by the market for the asset type being valued but all markets for assets of a similar nature. When valuing an asset, a valuer will seek to place an asset into a relevant market framework. If a direct market for an asset does not appear to provide all the information required to assist with formulating an opinion of value, they will likely reference a secondary or sub-market looking for additional information, and so on.

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As an example, the valuation of an industrial unit in a location where few industrial properties exist. The valuer may need to consider the income approach to valuation if there is an investor market and/or sales of industrial units to establish a value by direct comparison (market approach). If there is little information on industrial unit rents and purchase yields, and/or limited sales information, a valuer may seek to set boundaries on the potential value of the industrial unit by referencing financial returns and sales of commercial and/or retail units. In this way, the valuer has accessed the secondary markets of commercial and retail properties to assist in narrowing the potential value of the industrial unit.

Similarly, the valuation of public sector assets can be derived from alternative markets. Purchasers willing to spend hundreds of millions, or even billions of dollars on large unique assets (such as network infrastructure) have a range of assets which are comparable, where comparability is defined by the purchaser's investment criteria. An entity contemplating purchasing an Australian electricity network (poles and wires) will likely look at a range of international projects for which returns are comparable, regardless of the asset type. It would therefore be relevant to investigate the market returns evidenced from large infrastructure transactions, to determine the market forces which would lead to an asset's fair value (market value).

The examples listed in F8 do not always constitute assets *'not held primarily for their ability to generate net cash inflows'*. For example, a number of water authorities deliver significant profits to the entity and Government (by way of dividends) and use the income approach to value their asset base. However, even if assets are not held primarily for their ability to generate net cash inflows, doesn't mean they are incapable of doing so. Valuers can impute cashflows by comparing these assets to similar assets in the marketplace and derive fair values accordingly.

The emergence of public private partnerships, (and variations thereof), to construct, own and manage public sector assets has also given rise to market inputs which would assist in the valuation of what have historically been referred to as specialised assets. For example, there are a number of prisons in Australia owned and operated by private entities on behalf of Government which would indicate there is a 'market' for prisons.

Further, the examples provided at F8 imply the assets (and asset types) are ones that have no relevant market influences. This implication appears to be based upon a perception the asset is providing a unique service delivery not found in the marketplace. The approach of categorising assets by their service delivery fails to recognise an asset's actual use. By componentising an asset's use, a valuer can begin to recognise which components of the asset may be influenced by market forces.

Parliament houses are typically ornate heritage listed buildings in premium locations. But their main use has become the provision of administrative offices. Commercial buildings are valued excluding the tenant's fit-out, therefore the fair value of a Parliament House may be loosely referenced to office accommodation in a similar location whilst adding back the depreciated replacement cost of the House's unique structural modifications and fit-out. Such an approach may not completely define an asset's fair value (market value), but it does reference market inputs and helps set value boundaries.

Similarly, the majority of the floor space in a police station is used for office accommodation and/or recreation. Suburban fire stations and ambulance depots closely reflect office/warehouses and car repair workshops, regional country fire services are more often sheds with attached offices, and community facilities are usually defined by their fit-out rather than the building itself.

As an example, a Local Government client purchased a modern ground floor retail strata unit and fitted it out to be the local library. The only specialised aspect of that asset was the fit-out (as is the case with most libraries).

Liquid Pacific considers the framework by which a valuation is to be conducted and the inputs deemed relevant to that determination of value is a highly complex one. Attempting to categorise assets for inclusion and exclusion to specific valuation techniques would lead to erroneous implementations.

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Highest and best use

5. *Do you agree with the proposal in paragraphs F9–F11 that, for a non-financial asset of an NFP public sector entity not held primarily for its ability to generate net cash inflows, the presumption in AASB 13 paragraph 29 that the asset's current use is its highest and best use should be rebutted when, and only when, the appropriate level of the entity's management is committed at the measurement date to a plan to sell the asset or to use the asset for an alternative purpose? Please provide reasons to support your view.*

Liquid Pacific understands the resistance within the public sector to the concept of highest and best use as it relates to the valuation of public sector assets. The costs associated with the provision of community service obligations are never more transparent than when a new public sector asset is valued at less than its cost of acquisition. And, when the continuing use of a community asset is deemed not to be that asset's highest and best use.

Nonetheless, it is assumed for most public sector entities obtaining and reporting asset fair values (market value) is more than just a policy requirement. That entities use the information provided to manage their assets and to allocate scarce public funds.

It is therefore difficult to imagine how management could competently assess the continuing delivery of a service provision if they are not able to assess the cost of that provision against the fair value (market value) of the asset employed to deliver it if that fair value does not reflect markets.

We understand in certain circumstances the public sector must create or hold assets contrary to what commercial management decisions might otherwise suggest. Regardless, users of financial statements should have the ability to identify the actual cost associated with a service delivery, not one that is artificially created.

6. *Do you agree with the example in paragraph F10 of steps that might, in some circumstances of a particular entity, need to be completed before the appropriate level of the entity's management is committed at the measurement date to a plan to sell the asset or use the asset for an alternative purpose, namely:*

   (a) *relevant field studies or a Ministerial briefing on whether there is a market for the asset (and, if so, its likely price) or for the alternative services that the asset could be used to provide;*
   (b) *initial due diligence processes to determine that a sale of the asset or an alternative use of the asset is possible within the current socio-economic environment and would maximise the asset's value; and*
   (c) *development of project milestones and expected timelines to complete the sale or the plan to use the asset for the alternative purpose?*

Regardless of the question of highest and best use, we assume a process similar to this is already best practice within Government.

7. *Do you agree with the proposal in paragraph F12 that an entity is only required to assess whether a use of the asset is physically possible, legally permissible and financially feasible in accordance with paragraph 28 when (per paragraph F9) the presumption in AASB 13 paragraph 29 that the asset's current use is its highest and best use is rebutted? Please provide reasons to support your view.*

No. Per above

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8. *Do you agree with the draft implementation guidance in paragraph F13 for applying the 'financially feasible use' concept described in AASB 13 paragraph 28(c), namely that, for a non-financial asset of an NFP public sector entity not held primarily for its ability to generate net cash inflows, a use is financially feasible if market participants (including NFP public sector entities) would be willing to invest in the asset's service capacity, considering both the asset's ability to be used to provide needed goods or services to beneficiaries and the resulting cost of those goods or services? Please provide reasons to support your view.*

No. By introducing non-financial influences into the concept of financial feasibility significantly distorts the meaning of financial feasibility. With regard to non-financial assets, financial feasibility is the possibility an asset might provide a commercial return on its construction and/or continuing use or in an alternative use, where the financial return is benchmarked in markets. The other legs of highest and best use, physically possible and legally permissible, are the necessary and adjustable variables to finding the highest financial return.

It is recognised the public sector does not necessarily make investment decisions based upon the concept of highest and best use. However, users of financial statements should be provided the opportunity to identify when this occurs.

Application of the cost approach

For the valuation profession the cost approach is the approach of last resort. The approach lacks economic relevance as it fails to address the economic relationship which exists between inter-dependent assets (i.e., land and buildings). It makes no allowance for project financing and risk, it has no investment horizon, it does not address maintenance and holding costs, and is typically an additive model, rather than one of deduction.

9. *Do you agree with the proposal in paragraph F14(a) that the entity should assume the asset will be replaced in its existing location, even if it would be feasible to replace the asset in a cheaper location? Please provide reasons to support your view.*

Yes. The concept of modern equivalent cost has for some time been take out of context and the issue of location is at the forefront of this distortion. Feeding into previous comments above regarding asset management and highest and best use, we struggle to recognise how the true cost of service delivery can be identified using values based upon hypothetical assets.

We have found the problem is not just restricted to the question of location but also extends to assets themselves. Under the umbrella of modern equivalent replacement cost we have encountered public sector entities valuing alternative assets, rather than valuing the assets they own. Several examples we have encountered saw entities basing their valuation of bitumen sealed roads on graded unsealed roads. In these instances, the entities believed the concept of modern equivalent replacement cost included redefining your asset base with what you might replace the asset with, rather than what is currently there.

10. *Do you agree with the proposal in paragraph F14(b) that the entity should assume that the asset subject to measurement (the subject asset) presently does not exist; and therefore, all necessary costs intrinsically linked to acquiring or constructing the subject asset at the measurement date should be included in the asset's current replacement cost? Please provide reasons to support your view.*

Yes, with qualifications. Land is not valued based upon the replacement cost approach to valuation. It is valued on the basis of direct comparison with market transactions, adjusted for dissimilarities. Therefore, the initial acquisition cost of land to establish infrastructure (i.e., railway) or a national park or reserve is highly unlikely to equate to its fair value (market value) after acquisition.

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And, upon subsequent revaluations, the land is assumed to be available for that purpose. (i.e., the costs of acquisition do not replicate themselves).

It is also noted some entities add professional fees (i.e., legal costs/conveyancing fees) back into land values at acquisition. The market value of land (based on comparable sales) already factors such costs into the value.

11. *Do you agree with the proposal in paragraphs F14(b) and F14(c) that, when estimating the current replacement cost of the subject asset, the entity should estimate the replacement cost of a reference asset (ie a modern equivalent asset or a replica asset) as input and adjust the estimated replacement cost of a reference asset for any differences between the current service capacity of the reference asset and the subject asset? Please provide reasons to support your view.*

Yes, again with qualifications. We consider the primary objective of the entity should be to reflect, to the best of their ability, the value of the asset they own which necessarily encapsulates all the value influencing characteristics of that asset.

However, we do not agree the replacement cost of an existing asset should be referenced to a modern equivalent asset if a cost for the replica of the asset being valued is available.

We agree, if a modern equivalent replacement cost must be used for the purpose of the cost approach to valuation, adjustments to that reference cost must be made to reflect the service capacity of the subject asset, when new. How those adjustments are made is likely to be based on an informed estimate.

12. *Do you agree with the proposal in paragraph F15(a) that once-only costs that would be expected to be necessarily incurred in a hypothetical acquisition or construction of the subject asset should be included in that asset's current replacement cost? Please provide reasons to support your view.*

With reference to our comments in 10 above; land values derived by reference to market transactions usually already reflect the costs of demolition as comparable land transactions have accounted for demolition in their sale values. There are however situations where the public sector will incur excessive demolition costs for projects such as the creation of inner metropolitan transport routes. When such costs are incurred, they should not be factored into either the value of the land or the costs of constructing the new infrastructure asset.

As an example, Transport Services acquires several significant land holdings comprising multi-storey office buildings (not at the end of their economic life) for the purpose of establishing a new public transport route. The cost of acquiring the land is $250m and the cost of demolishing the structures is $50m. The acquisition provides 2,500m2 of new land for the transport corridor. In this example, the value of the land is not the cost of acquisition $250m ($100,000m^2), nor, for the purpose of valuation, is the cost of building the transport route escalated by the cost of demolition ($X+$50m). For the purpose of valuation, these are sunk costs because the development of the transport corridor was not the highest and best use of the land at the time of acquisition (i.e., in these situations the market would rarely compensate the new asset's fair value for the costs incurred to construct it).

Whereas, if the construction of the transport route required a tunnel through a hill or another similar one-off infrastructure cost, then we consider that cost should form part of the gross replacement cost for the cost approach to valuation. The test being the component is a continuing use of the asset and exists in its highest and best use, for which a market participant may attribute some value against that initial cost.

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13. *Do you agree with the proposal in paragraph F15(b) that, when estimating the current replacement cost of the subject asset, an entity should determine, based on the circumstances of the subject asset, whether the following costs would (among other costs) need to be incurred upon the hypothetical acquisition or construction of that asset at the measurement date:*

    (a) unavoidable costs of removal and disposal of unwanted existing structures on land; and
    (b) any disruption costs that would hypothetically be incurred, when acquiring or constructing the subject asset at the measurement date, including costs of restoring an asset not controlled by the consolidated group (if any) to which the entity belongs?

    Please provide reasons to support your view.

Our comments in 12 above address this topic. However, we would clarify, in a commercial environment the fair value (market value) of an asset constructed for the purpose of selling for profit would factor into its sale price any costs associated with the development, including the mandatory costs of restoring an asset not controlled by the developer. And, a further resale of that commercial asset continues to embody those costs.

14. *Do you agree with the proposal in paragraph F15(c) that an NFP public sector entity includes in the subject asset's current replacement cost all necessary costs required to be incurred in the context of the entity's expected manner of replacement in the ordinary course of operations, rather than necessarily including only the cheapest legally permitted costs to the entity? Please provide reasons to support your view.*

No. Whilst valuations need to reflect the assets being valued, they also need to be realistic. If a market participant prices the cheapest legally permitted costs to construct an asset that delivers the same service potential, then they will likely take that path, assuming all other factors remain the same (i.e., future maintenance costs, asset lives, etc).

With regard to example 1 and 2 in the ED, the underlying assumption for these examples is that cost equates to value. Local Government tends not to depreciate road earthworks or formation under the assumption these components exist in perpetuity. It also effectively lowers depreciation expense.

Economic obsolescence

15. *Do you agree with the proposal in paragraph F16 that identifying economic obsolescence should not be limited to circumstances in which a formal decision has been made to reduce the asset's physical capacity? Please provide reasons to support your view.*

Yes. Valuation practice requires assets be valued based upon market evidence which necessarily includes supply and demand considerations. At the date of valuation, the demand for an asset's service potential should be measured against the demand for all similar assets and against the asset's own historical demand and future potential.

We note for the public sector's relevant valuation dates during a period of COVID (2019 – 2021), we could find no Government jurisdiction that amended asset values due to the changing economic climate brought on by the pandemic.

Further, we analysed the movement in asset values for 12 of Australia's largest universities for the period 31 Dec 2091 – 31 Dec 2020, a time when universities themselves were forecasting the loss of billions of dollars in revenue due to a reduction in international student numbers. Not one of these universities reported a decrease in the value of their non-financial assets, nor addressed potential value adjustments due to COVID.

When the subject was raised with a state audit department, we were advised there would have to be a crisis in Australia similar to that in the Ukraine, before their audit department would expect to see Government's non-financial asset values impacted by economic factors. In light of those comments, the topic of economic obsolescence is somewhat benign.

16. *Do you agree with the proposal in paragraph F17 and the example in paragraph F18 that economic obsolescence should not be identified for any 'surplus capacity' of an asset that is necessary for stand-by or safety purposes (eg to deal with contingencies), even if it seldom or never is actively utilised? Please provide reasons to support your view.*

    Yes. Many assets are initially over-engineered to ensure service delivery does not wane over time and many assets operate at industry accepted vacancy levels (i.e., have surplus capacity). The test for the valuer is whether the surplus capacity is necessary.

    In relation to the school example set out in F18, our immediate conclusion is an asset permanently operating at 20% of its capacity is not operating at its *highest and best use*.

    And, whilst we agree economic obsolescence should be recognised in the school example, we do not agree on the method that has been used to recognise that obsolescence. As with previous comments, the approach in the example is considered by many entities to be a factor of a modern equivalent replacement cost, when it is not. The objective of conducting a valuation for fair value is to value the asset having regard to its future economic benefits, which requires the existing asset to be valued, not a hypothetical replacement.

    The school example is obviously simplified and only intended to demonstrate a point. But, trying to account for obsolescence at the front end of the cost approach by adjusting the gross replacement cost requires significantly broad assumptions about the asset being valued (i.e. proportionality) and ignores what market participants might factor into their decision when considering the asset on as 'as is' basis (i.e. excessive maintenance and holding costs of surplus assets, continuing decline in student numbers, potential for sale of surplus land, co-location opportunities, etc).

Application of the proposed implementation guidance

In response to Para 17-21, Liquid Pacific does not support the implementation of an owner specific guidance if that guidance seeks to differentiate fair values only for that group.

General matters for comment

Whether, overall, the proposals would result in financial statements that would be useful to users?

As previously stated, Liquid Pacific considers supporting the use of artificial fair values by ignoring market influences and the highest and best us of assets only contributes to erroneous interpretations of an entity's financial health and management performance.

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