ED181 sub 6

New South Wales
TREASURY

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Dear Mr Stevenson

Exposure Draft 181 Fair Value Measurement

New South Wales Treasury welcomes the opportunity to provide comments on the above exposure draft.

NSW Treasury supports clarifying the meaning of fair value and whether or not it is an exit or entry price. In principle, we agree with the IASB's proposed definition of fair value, based on an exit price model.

However, our main general concern is that we do not believe the Exposure Draft adequately addresses non-financial assets, where commonly there is no active market. This is a particular issue for public sector entities, with specialised assets. We think the IASB needs to consider how in practice an entity is able to adjust its own data to reflect hypothetical market participants and whether this is appropriate or practical.

Our detailed views in relation to the matters raised in the exposure draft follow.

Yours sincerely

Robert Williams

Robert Williams
for Secretary

NSW Treasury Response to
AASB ED 181 / IASB ED 2009/5 Fair Value Measurement

General comments

NSW Treasury supports the IASB's attempts to clarify the meaning of fair value and whether or not it is an exit or entry price. In principle, we agree with the Board's proposed definition of fair value, based on an exit price model. However, we have the following general concerns, some of which are discussed in more detail in the response to the questions for comment below.

1. There is an inherent difficulty in finalising a Standard on fair value measurement, which deals with "how to" measure at fair value, without also determining "when to" measure at fair value. Therefore, we believe that as part of the Framework projects, the Board should re-consider whether the current requirements of "when to" measure at fair value continues to be appropriate, given that fair value is based on a current exit price model, based on a market participant's perspective.

2. We do not believe that the Exposure Draft adequately addresses non-financial assets, where commonly there is no active market. The Exposure Draft places greater emphasis on financial instruments rather than physical assets. There is insufficient guidance provided for property, plant and equipment and the difficulties associated with valuing specialised assets, where there is a lack of market evidence. This includes providing guidance about how in practice an entity is able to adjust its own data to reflect hypothetical market participants and re-considering whether this is appropriate.

3. The Exposure Draft does not adequately address the reliability of valuations based on level 3 inputs, other than as a disclosure issue. We believe that the Exposure Draft needs to explicitly deal with the recognition issue and the circumstances where the use of entity specific measures are preferred over hypothetical markets, assumptions and prices, on the basis of reliability and relevance. This, therefore, needs to address the question of "how to" measure at fair value any asset or liability when it cannot be reliably measured and whether or not there are circumstances where the costs exceed the benefits of providing such information.

4. The ramifications on the interrelationship with current Accounting Standards is not made clear. For example, although there has been an amendment to IAS 16 *Property Plant and Equipment*, the effect of the change has not been made clear. That is, under the current IAS 16, the income approach and the current replacement cost can only be used in the absence of market evidence. In contrast, the Exposure Draft includes all valuation techniques at the same level (i.e. there is no hierarchy for the valuation techniques). Further, it is unclear how this Exposure Draft interrelates with separate projects on financial instruments by the IASB, which addresses similar issues, including credit risk.

5. We agree in principle with the proposed definition of fair value. However, some view the definition as being inconsistent with the "in use" and "cost approach" (and therefore the other parts of the ED), given that the accounting literature has generally associated these approaches with the entry rather than exit value (i.e. not just 'some respondents'). The reasons for the change in view from the accounting literature should be explicitly acknowledged.

6. NSW Treasury has concerns with the proposed treatment of liabilities, in particular with:
   - The view that there is no difference between settlement and transfer value (para BC69-70). In our view, the settlement notion and transfer notion do not necessarily give the same result, as the lowest cost (and the most advantageous market) may be to settle the liability rather than transfer it.
   - The measurement of a liability at the counterparty's asset value, where there is no observable market price for the liability (para 26). This is inconsistent with other aspects of the ED, where the Board concludes that fair value of a liability, unlike an asset, is not a function of marketability, but performance (para BC75).

Definition of fair value and related guidance

Question 1

The exposure draft proposes defining fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs.

Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

Yes. NSW Treasury supports the IASB's attempts to clarify the meaning of fair value and whether or not it is an exit or entry price. In principle, we agree with the Board's conclusion that an exit price is a relevant definition, regardless of whether an entity intends to use or sell an asset (based on the reasoning in para BC23).

However, our main issues are:

- the *application* of the definition where there is a lack of market evidence (discussed separately).
- that some may view the current exit value definition of fair value (or core principle) as being inconsistent with the "in use" and "cost approach" (and therefore the other parts of the ED).

The application issues with the definition are discussed separately in the responses to questions 7, 8 and 10. In regard to the second dot point above, the Exposure Draft may be seen to be inconsistent with the accounting literature, as the use of an "in use" valuation premise and the "cost approach" has been associated with current entry rather than current exit prices. In effect, the ED seems to change long accepted concepts in the accounting literature, by incorporating the "in use" and "cost approach" within the concept of the current exit value. The reason for this change should be acknowledged and explained in the proposed Standard / Basis for Conclusions.

Similarly, we believe that the Board should acknowledge that it is adopting a different view to the accounting literature (not just 'some respondents'), which in the past has asserted that the current exit and entry price vary where assets are bought and sold in different markets. The discussion on scrap value (para BC 61-63) reinterprets accounting literature by concluding that the current exit price is not the scrap value for specialised assets, based on the principle of substitution and the impracticality of using a market approach with an in use valuation promise.

Scope

Question 2

In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts:

(a) In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 Share-based Payment and reacquired rights in IFRS 3 Business Combinations) (see paragraph BC29 of the Basis for Conclusions).

(b) The third context is the requirement in paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

NSW Treasury believes that fair value should have the same meaning across all Standards. Where the Board has found instances of where the term is used in a way that is inconsistent with the ED, then the respective Standard should be amended to use a term other than 'fair value'. As a result, we support the Board's approach in para (a) above regarding IFRS 2 and 3, but do not support the approach in para (b). This is because para (b) retains the use of the term 'fair value', but excludes it from the scope of the proposed standard on fair value measurement, without adequate explanation.

In addition, NSW Treasury believes that, in future, the treatment of these exceptions may need to be reviewed to determine whether the measurement basis is appropriate, given that it does not represent fair value. For financial liabilities with a demand feature, this should occur as part of the current project to replace IAS 39.

The transaction

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?

Yes. However, the Exposure Draft does not provide sufficient guidance on what to do where there is no market at all. Also, the subjectivity of hypothetical markets raises serious issues of relevance and reliability. This is further discussed in the response to question 10 below.

Question 4

The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions).

Is the description of market participants adequately described in the context of the definition? Why or why not?

Yes, in principle. However, NSW Treasury does not believe that sufficient guidance is provided regarding how to ascertain hypothetical market participants, where, given the nature of certain assets (e.g. for specialised "in use" assets), there may be no market. This would require the use of level 3 inputs, reflecting the entity's own assumptions about the assumptions that hypothetical market participants would use. It is unclear how in practice this can produce reliable and relevant information. This is further discussed in the response to question 10 below.

Further, we note that there may be a difference between the existing definition of fair value which refers to an "arm's length transaction" and the proposed definition of market participants which refers to participants as "independent of each other, ie they are not related parties". That is, in certain circumstances (e.g. in the public sector), an entity may transact with a "related party", but the transaction may be at "arm's length"'; i.e. on the same terms as those given to other external parties.

Application to assets: highest and best use and valuation premise

Question 5

The exposure draft proposes that:

(a) the fair value of an asset should consider a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).

(b) the highest and best use of an asset establishes the valuation premise, which may be either 'in use' or 'in exchange' (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).

(c) the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).
Are these proposals appropriate? Why or why not?

(a) and (b)

In principle, NSW Treasury agrees with the highest and best use concept and valuation premise, subject to the following comments.

1. The highest and best use concept needs to take account of the socio-political environment in which the entity operates, in addition to the physical, financial and legal feasibility. This is particularly an issue for public sector entities, where the highest and best use may be constrained by the political environment.

2. The concept of feasible use should also clarify that it is a use that is not remote (say the next five years). For example, it may be physically, legally and financially feasible to convert a botanical garden to land available for residential use, but in the current socio-political environment this change of use may be regarded as remote and therefore is not feasible (despite being physically, financially and legally feasible). We understand that the case law in Australia on valuations has also applied the concept of remoteness.

3. It is unclear how an entity incorporates the relative efficiencies of hypothetical market participants into the highest and best use valuation and the meaning of the resulting valuation. This may lead to potentially inflated asset values that are not reflective of the entity's financial performance. For example, an entity may argue that a hypothetical market participant may expect greater efficiencies than in reality the entity is providing and use this as a basis for increasing the entity's asset values (i.e. based on higher net cash inflows). However, it is questionable whether the hypothetical market participant's efficiency expectations are more reliable than the entity's.

The first two dot points are incorporated and further explained in NSW Treasury's policy *Valuation of Physical Non-Current Assets at Fair Value* (TPP 07.1, section 2.3.1) (see attached).

(c)

For liabilities, NSW Treasury believes that the equivalent concept of highest and best is the concept of lowest available market price, which in the absence of observable market prices, maybe the settlement value. We believe that this should be acknowledged in the ED. This is further discussed in the responses to questions 7 and 8 below.

Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions).

Is the proposed guidance sufficient and appropriate? If not, why?

NSW Treasury is concerned that in effect this requires disclosure on two bases; i.e. existing use and alternative highest and best use. This may be both confusing (i.e. as it implies that fair value comprises two components) and costly. Also, contrary to the Board's conclusion in para BC54, we believe that measuring the factory at nil (where the highest and best use is to demolish the factory) does provide decision useful information.

Application to liabilities: general principles

Question 7

The exposure draft proposes that:

(a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).

(b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).

(c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

NSW Treasury has concerns with the proposed treatment of liabilities, in particular:

- That there is no difference between settlement and transfer value (para BC69-70).
- With the measurement of a liability at the counterparty's asset value, where there is no observable market price for the liability (para 26).

We do not agree with the Exposure Draft's proposals on liability measurement for the following reasons:

1. Where there are no market participants, it may not be possible to determine reliably the risk or profit margin for hypothetical market participants (or the risk premium is so high that a transfer would not reasonably occur). But the Exposure Draft assumes that this is possible in concluding that the liability is the same regardless of whether it is settled or transferred (para BC 69).

2. The highest and best use of liabilities (i.e. lowest cost) may be to settle the liability rather than to transfer it. That is, the most advantageous market may be regarded as the 'settlement' market.

3. Market participants in the asset and liability market are likely to be different and to hold different views from one another. Measuring the liability based on the counterparty's asset value seems inconsistent with other aspects of the ED, where the Board concludes that the fair value of a liability, unlike an asset, is not a function of marketability, but performance (para BC75). This is an explicit reason why the liability value would not be the same as the counterparty's asset value.

As a result, we believe that either the fair value definition of a liability needs to be adjusted to incorporate the settlement notion as a distinct concept from the transfer value or a settlement value needs to be provided as an alternative or surrogate (or practical expedient) valuation methodology to fair value for liabilities.

In our view, the settlement value is appropriate where:

- settlement represents the least cost option or
- where it is not possible to reliably measure the transfer value because of a lack of market evidence.

Application to liabilities: non-performance risk and restrictions

Question 8

The exposure draft proposes that:

(a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfil the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).

(b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

(a)

In principle, NSW Treasury agrees that the fair value of a liability reflects non-performance risk, where fair value is based on a transfer value. However, as discussed in the response to question 7 above, we do not agree that the settlement notion and transfer notion of liability measurement are the same. We do not believe that it is appropriate to reflect credit risk where a settlement notion is adopted. This is because, where a settlement notion is applied, unlike the transfer value, there is no reference made to market variables, such as credit risk.

We also note that the issue of credit risk (or non-performance risk) was separately canvassed as part of the Board's Discussion Paper on *Credit Risk in Liability Measurement*. We are unclear how the comments on that Discussion Paper interrelate with the Exposure Draft on *Fair Value Measurement*. We assume, however, that the Board will consider the responses to that Discussion Paper before finalising any Standard on fair value measurement.

(b)

Yes, NSW Treasury agrees, that a liability is not affected by a restriction per se, for the reasons given in the Basis for Conclusions. However, a restriction may mean that there are no observable market prices for the transfer of the liability and as in the response to question 7 above, may mean that a settlement notion is appropriate, using present value techniques.

Fair value at initial recognition

Question 9

The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions).

Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

In principle, NSW Treasury supports the proposal. However, we note that recognition of day one gains or losses is determined on a standard by standard basis. While we accept that this may be regarded as an interim approach, we believe that the Board should consider in future whether this is appropriate. That is, Standard setters should consider whether any differential treatment for the recognition of day one gains or losses between different types of assets and liabilities is justified. For example, at face value, we can see no reason why the principle in IAS 39 should not be extended to other types of assets and liabilities.

Valuation techniques

Question 10

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples).

Is this proposed guidance appropriate and sufficient? Why or why not?

NSW Treasury has significant concerns about the application of the fair value definition in valuing specialised physical assets, where there is a lack of market evidence. In this regard, we do not believe that the guidance in the Exposure Draft is sufficient, in the following respects.

1. There is insufficient guidance about how the entity's own inputs can be adjusted to reflect hypothetical market participants. The Exposure Draft only provides 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. It is unclear how in practice this could ever be done in situations where there are only hypothetical market participants and no market evidence.

We believe that, in many circumstances where specialised physical assets are measured based on the "cost approach" or an "income approach" using level 3 inputs and the "in use" valuation premise, the measure will be "entity specific". As a result, the Board should acknowledge the use of an entity specific measure as a pragmatic and acceptable surrogate for fair value, in certain situations. Any alternative proposition (of adjusting entity data for hypothetical market participants) seems to provide less relevant and reliable information than the entity's own data. For example, currently IAS 39 (with regard to equity instruments) and IAS 40 (with regard to investment property) allow the use of the cost model when fair value is not reliably determinable.

The issue of reliability is only addressed in terms of disclosure and not in terms of recognition. We believe that the Board needs to explicitly address how to measure at fair value any asset or liability when it cannot be reliably measured. This also needs to consider the question of cost versus benefit; i.e. whether there are circumstances where the costs of providing 'fair value' information (as proposed by the ED) exceed the benefits.

2. There is no hierarchy of the valuation techniques. We are concerned that while the hierarchy prioritises the inputs, it does not rank or sufficiently explain the relationship with the valuation techniques or valuation premise. In principle, this means that the 'cost' approach is available at the same level as the other valuation techniques, using either the 'in use' or 'in exchange' valuation premise.

   However, we believe that the cost approach is generally appropriate at the lower level in the hierarchy, based on the 'in use' valuation premise, in the absence of market evidence. This seems to be implicitly accepted in the Basis for Conclusions where the Board acknowledges that a market approach is unlikely to be used to value tangible assets using the 'in use' valuation premise (para BC 63). Therefore, we believe that this needs to be made more explicit and could be illustrated by using a matrix showing the different combinations of inputs and valuation techniques and premises.

3. The practicality of determining the "point within that range that is most representative of fair value", when using multiple valuation techniques is disputed. We believe that the meaning of this phrase (in paras 39 and B8 and the Illustrative Examples) is unclear and believe that further guidance is required. Using mid-point, weighted average or 'most likely' approaches may result in very different outcomes and it is unclear what is the most appropriate or representative of fair value. This is particularly difficult where a market is not active or where there are no market participants.

4. There is insufficient guidance on when it would be appropriate to use multiple valuation techniques. We believe that the Exposure Draft should *require* that multiple valuation techniques should at least be considered where there is an absence of market evidence (i.e. level 3 inputs only available). In contrast, the ED only gives examples of situations where a multiple valuation technique "may be appropriate", including where a market is not active (para 39 and B8). We are concerned that unless this is made explicit, the current two step approach to fair value measurement of specialised assets may be lost.

   Currently, specialised assets are generally measured at depreciated replacement cost under IAS 16, and then, as a second step, subject to 'value in use' impairment testing. However, in the absence of market evidence, the use of level 3 inputs in conjunction with an 'income approach' may mean that depreciated replacement cost information is not prepared. Effectively, any impairment would be very limited as there would seem to be little difference between the entity specific 'value in use' assumptions under IAS 36 and the hypothetical (level 3 inputs) market participant assumptions, or as stated in point 1 above, it would be impractical to determine the hypothetical market participants' assumptions.

   In our view, for specialised assets, depreciated replacement cost information provides valuable information to users. As such, we would be concerned by any proposal that permits, in the first instance, an income approach based on level 3 inputs (which will result in an amount very similar to a 'value in use' calculation). This issue also depends on the unit of account used (refer to the response to question 13 below).

Disclosures

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements, using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

Yes, in principle, we do not object to the proposed disclosure requirements, subject to cost benefit considerations. However, we would prefer that, instead of concentrating on disclosures, a greater focus is placed on how reliability should be addressed in terms of recognition (refer response to question 10 above). As discussed in response to question 10, it may be that the Board needs to clarify that, in certain situations, a measure is not market based and that, for pragmatic reasons, an entity specific measure is adopted, as a surrogate for fair value.

Also, refer response to question 6.

Convergence with US GAAP

Question 12

The exposure draft differs from Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157.

Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

Yes, in principle NSW Treasury supports the approach proposed by the IASB on those issues rather than the SFAS 157 approach. The exception, however, relates to the disclosure of highest and best use, where it differs from the current use (refer response to question 6). Notwithstanding this, we strongly support the IASB and FASB continuing to work together to achieve a converged outcome.

Other comments

Question 13

Do you have any other comments on the proposals in the exposure draft?

Impairment under IAS 36

NSW Treasury believes that the interrelationship between fair value and IAS 16 and IAS 36 needs to be further considered by the Board.

In particular, we are concerned that the consequential amendments to IAS 36, which link 'fair value' in IAS 36 to the Exposure Draft, means that an entity that applies the IAS 16 revaluation model could not be impaired, unless disposal costs are material. This is because the 'recoverable amount' is based on the *higher* of 'fair value less costs to sell' and 'value in use'. However, IAS 36, para 5(b), clearly envisages that impairment may arise in relation to fair value measurement, determined on a basis other than market value, in circumstances other than where disposal costs are material. Para 5(b) of IAS 36 is based on the current more limited concept of fair value (compared to the Exposure Draft), where there is market based evidence available (i.e. level 1 or level 2 inputs) (previously referred to as 'net selling price').

Further, as discussed in response to question 10 (point 4), application of the proposed Standard may mean that for specialised assets, fair value under IAS 16, based on an income approach, may be identical to 'value in use' under IAS 36. That is, although the Basis for Conclusions asserts that 'value in use' (based on the entity's assumptions) is different to an 'in use' fair value valuation (based on the market participants' assumptions) (para BC 64), the practicality is that where there is a lack of market evidence it may not be possible to reliably measure fair value, other than by using the entity's assumptions. This is contrary to the two step approach, whereby the IAS 16 fair value is tested for impairment.

Unit of account

The Exposure Draft refers to the unit of account prescribed by IFRSs applicable to the asset or liability. However, the unit of account is not prescribed in IAS 16 (para 9). This is a significant issue that is largely unaddressed and raises conceptual issues, which are only being considered as part of Phase B of the *Conceptual Framework* project. Depending on the unit of account, a very different 'fair value' could be recognised. We believe that the ramifications of different units of account need to also be more fully considered as part of the fair value measurement project.

2.3 Step one - Guidance to apply AASB 116 valuation principles

The following additional guidance is provided to apply the three valuation principles in AASB 116 to the unique circumstances of the public sector.

2.3.1 Fair value of assets is to be measured at highest and best use

AASB 116 merely states that fair value "is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction" (AASB 116, para 6). This Policy clarifies that the fair value of an asset[1]:

- Is the most advantageous price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer.
- Presumes the entity is a going concern, without any intention to liquidate or materially change the scale of operations.
- Presumes that there is an adequate period of marketing.
- Excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale.

Further, this Policy clarifies that fair value is determined by reference to its 'highest and best use' taking into account the existing physical, legal, financial and socio-political environment in which the entity operates and which results in the highest value[2].

The concept of the highest and best use is also consistent with the approach adopted by economists and valuers. In applying the willing buyer and seller principle, valuers generally measure fair value or "market value based on its highest and best use, which will not necessarily be the existing use". The argument is that "the prudent and well informed vendor would not willingly part with his land for a price less than that appropriate to its highest and best use; and the prudent buyer would not expect to be able to purchase it for less. Each party would take into account not only the present purpose to which the land is applied, but also any more beneficial purpose to which, in the course of events at no remote period, it may be applied" (quote of Isaacs J in the High Court decision of Spencer V the Commonwealth of Australia (1907) 5 CLR 148 quoted in R.O. Rost and H.G. Collins *Land Valuation and Compensation in Australia*).

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[1] This guidance is also consistent with the principles outlined in:

- AASB 101 *Presentation of Financial Statements* (AASB 101, para 23)
- AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139, paras AG69 and AG71);
- AASB 140 *Investment Property* (AASB 140, paras 36 and 43).

[2] This is consistent with the principles in the IASB Discussion Paper on *Fair Value Measurements*, based on the equivalent FASB Standard No. 157 (SFAS 157, para 12).

Although this quote applies to land, it is equally applicable to any asset. Therefore, the term 'highest and best use' is clarified (and qualified) by "any more beneficial purpose to which, in the course of events at no remote period, it may be applied".

Given the above, guidance is needed to apply 'highest and best use' consistent to the unique circumstances in the public sector.

In the public sector, there can be natural, legal, financial and socio-political restrictions on the use and disposal of assets. In fact, most assets in the general government sector are held as community, cultural or heritage assets. Further, most entities are mandated by government/ministerial directives or legal/administrative requirements to continue to provide the services that the assets assist them in providing. Therefore, the natural, legal, financial and socio-political environments are relevant because they impact on the opportunities available to the entity. These restrictions may mean that certain opportunities or alternative uses are not available and therefore should not be taken into account.

From the above, the following three general policy guidelines can be drawn in applying the principle that fair value is to be measured having regard to the 'highest and best use' of the asset:

- 'Highest and best use' means a feasible alternative use. It therefore must take account of (or is qualified by) the existing natural (or physical), legal, financial and socio-political environment in which the entity operates (as well as the general zoning and statutory restrictions in respect of land).

- 'Highest and best use' means a feasible alternative use that is not remote. A practical guide to this is that an alternative use should only be considered to be feasible where it can be demonstrated that it can be achieved in the relatively near future (say the next five years) rather than at some remote future time.

- 'Highest and best use' must take account of the costs of achieving the feasible highest and best use alternative. These costs include holding costs, the costs required to provide utilities, the costs for any rezoning of the land and the costs of restoration or removal of existing improvements and/or reparation work to restore the land to useable condition for that alternative use.

Based on the above, the following policies apply in valuing assets having regard to 'highest and best use':

- Fair value of assets should be measured having regard to 'highest and best use' (net of costs to achieve that use) when and only when there exist feasible alternative uses in the existing natural, legal, financial and socio-political environment and the alternative uses are feasible within the near future. Such assets include much land and general use buildings.

- Conversely, where there are natural, legal, financial or socio-political restrictions on use and disposal of an asset, such that there is no feasible alternative use in the relatively near future, such an asset should be valued at fair value for its existing use. This is because fair value determined by reference to its highest and best use means "existing use" where there is no feasible alternative use.

Assets with no feasible alternative use include botanic gardens, national parks, most community assets such as schools and hospitals, some heritage properties, library and museum collections and most specialised assets (e.g. water and sewerage systems).

Valuing assets at "Fair (or Market) Value for Existing Value" (or "Existing Use") contemplates the continued use of an asset in contributing to the objectives and outcomes of the entity. This is not the value to the specific existing owner, but the value to a class of owners that would continue the existing use.

The above clarification acknowledges that the concept of 'highest and best use' is not a black and white distinction; but allows possibilities within a spectrum. There are cases where there are few or restricted feasible alternative uses. For example, land under heritage buildings and the heritage buildings may have few or limited restricted potential for development for feasible alternative uses.

Further guidance is given in Section 3 in applying the above to land and buildings.

2.3.2 Fair value is determined by the best available market evidence

AASB 116 states that "...the fair value of land and buildings is usually determined from market-based evidence..." (AASB 116, para 32). The withdrawn Australian Guidance to AASB 116 clarified this as follows:

> "Where a quoted market price in an active and liquid market is available for an asset, that price represents the best evidence of the asset's fair value. When a quoted market price for the asset in an active and liquid market is not available, the fair value is estimated by reference to the best available market evidence of the price for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. This evidence includes current market prices for assets that are similar in use, type and condition ('similar assets') and the price of the most recent transaction for the same or a similar asset (provided there has not been a significant change in economic circumstances between the transaction date and the reporting date). Current market prices for the same or similar assets can usually be observed for land, non-specialised buildings, used motor vehicles, and some forms of plant and equipment. For land and buildings, these prices can also be derived from observable market evidence (e.g. observable current market rentals) using discounted cash flow analysis" (AASB 116, withdrawn Australian Guidance, para G3).

This above withdrawn Guidance is incorporated as part of this Policy[3].

[3] This is also consistent with the concept of fair value discussed in:

- AASB 136 *Impairment of Assets* (AASB 136, paras 25-27);
- AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139, paras AG71 and AG74); and
- AASB 140 *Investment Property* (AASB 140, paras 45-46).