Australian Government

Department of Defence
Chief Finance Officer Group

R1-2-C001
Russell Offices
CANBERRA ACT 2600

CFO/OUT/2012/491

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA

Dear Mr Stevenson

ED 227 PROPOSED AMENDMENTS TO AASB 1049 – EXTENSION OF TRANSITIONAL RELIEF FOR THE ADOPTION OF AMENDMENTS TO THE ABS GFS MANUAL RELATING TO DEFENCE WEAPONS PLATFORMS

The Department of Defence welcomes the opportunity to comment on Exposure Draft 227 'Proposed Amendments to AASB 1049 – Extension of Transitional Relief for the Adoption of Amendments to the ABS GFS Manual relating to Defence Weapons Platforms'.

The exposure draft details two specific matters for comment. Our comments are as follows:

Whether you agree with the proposal to extend the transitional relief for a further 2-year period.

We welcome the Australian Accounting Standards Board's (AASB) extension of transitional relief for a further two years from the requirement to adopt amendments to the Australian Bureau of Statistics (ABS) Government Finance Statistics (GFS) Manual requiring Defence Weapons Platforms to be measured at fair value where reliably measurable.

We support the two year extension of transition relief for the reasons included in our previous correspondence with the AASB on 10 January 2012 (refer Attachment A) and 3 February 2012 (refer Attachment B).

Whether there are any regulatory issues or other issues arising in the Australian environment the may affect the proposal.

The Department of Defence is not aware of any regulatory issues or other issues in the Australian environment that may affect the proposal.

If you have any questions concerning our comments, please contact me on (02) 6265 6790.

Yours sincerely

Phillip Prior
Chief Finance Officer

7 November 2012

Attachment

A. Letter: Fair Value Measurement of Defence Weapons Platforms of 10 Jan 12

B. Letter: Supplementary Submission: Fair Value Measurement of Defence Weapons Platforms of 3 Feb 12

ATTACHMENT A

Australian Government

Department of Defence
Chief Finance Officer Group

R1-2-C001
Russell Offices
CANBERRA ACT 2600

CFO/OUT/2011/613

Kevin Stevenson
Chairman
Australian Accounting Standards Board
Level 7
600 Bourke Street
Melbourne Vic 3000

Dear Chairman,

Fair Value Measurement of Defence Weapons Platforms

I am writing to you in relation to the conceptual and practical difficulties in relation to the requirement to fair value Defence Weapons Platforms (DWPs) in the financial reports of the Commonwealth Whole of Government (WoG) and General Government Sector ('GGS') which are driven by the 2009 amendments to the Australian Bureau of Statistic's Government Finance Statistics Manual ('ABS GFS').

While the Department of Defence ('Defence') will carry DWPs in its own financial reports at cost, it will be required by the Department of Finance and Deregulation ('Finance') to provide fair value information for its DWPs to enable Finance to comply with Accounting Standard AASB 1049 *Whole of Government and General Government Sector Financial Reporting* ('AASB 1049') in the preparation of the Commonwealth WoG and GGS financial reports for the reporting periods ending on or after 30 June 2013.

We are strongly of the view that DWPs will qualify for the exemption under paragraph 14(a) of AASB 1049 on the basis that the fair value of such assets cannot be reliably measured. Further, we are strongly of the view that the requirement to measure DWP assets at their fair value will not meet the conceptual measurement characteristics of relevance, understand ability and comparability.

Accordingly, I am writing to request that action be taken by the Board in relation to matters addressed above. Specifically, the purpose of this letter is to:

(i) notify the AASB of the AASB 1049 implementation issues relating to DWPs; and

(ii) formally request that the AASB confirm, prior to the beginning of the 2013 reporting season, that the exemption in paragraph 14(a) of AASB 1049 applies to DWPs on the basis that such assets cannot be reliably measured and request that certain amendments be made to that Standard.

1. Current accounting requirements for DWPs

Consistent with the Finance Minister's Orders ('FMOs'), Defence reports in its financial statements Specialist Military Equipment (SME) as a single class of assets comprising DWPs and Non Defence Weapons Platform assets. All SME assets are measured at cost less accumulated depreciation and accumulated impairment losses in accordance with AASB 116 *Property, Plant and Equipment* and the FMOs.

AASB 1049 does not apply to the financial statements of Defence but applies to Commonwealth WoG and GGS financial statements. In preparing the WoG and GGS financial statements, AASB 1049 specifically states that the rules in the ABS GFS Manual are to be applied unless they conflict with Australian Accounting Standards (AASs) in which case a reconciliation of the differences must be disclosed.

DWPs are defined in the ABS GFS Manual as 'the structural systems from which destructive weapons such as missiles, bombs and torpedoes are launched or fired. They include submarines, warships, fighter planes and tanks.'[1]

Prior to the 2009 amendment, the 2003 version of the ABS GFS Manual (which is applicable to financial statements ending on or before 30 June 2012) required DWPs to be expensed at the time of acquisition. As this is not a basis of accounting permitted under AASB 116, DWPs are carried using the cost basis in the Commonwealth WoG and GGS financial statements.

2. Changes to the ABS GFS Manual

The ABS GFS Manual was revised in September 2009 to align with the International System of National Accounts and now requires DWPs to be capitalised and carried at market value. This has resulted in a change in the existing GFS treatment of DWPs.

3. Implications for Defence

The 2009 amendments to the ABS GFS manual will require DWPs to be recorded at fair value when preparing the Commonwealth WoG and GGS financial Statements for the reporting periods ending or after 30 June 2013.

While the changes to the ABS GFS manual do not impact financial reporting by Defence, Finance will require Defence to obtain fair values for its DWPs as at 30 June 2012 and onwards for the purposes of the preparation of the Commonwealth WoG and GGS financial reports.

3.1 What is fair value for DWPs?

Fair value is currently defined as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.[2]

If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing

[1] ABS Information Paper 5310.0.55.002 Chapter 7 Military Expenditure
[2] AASB 116.6

business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.[3]

The newly published accounting standard, AASB 13 *'Fair Value Measurement'* which applies for reporting periods beginning on or after 1 January 2013 provides further guidance on the definition of fair value.

Fair value is defined[4] 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 (i.e. an exit price). This is not an entity-specific measurement, but rather focuses on market participation assumptions for a particular asset or liability.

Under AASB 13, it is assumed that the 'orderly transaction' takes place in either the 'principal' market; i.e. the market with the greatest volume and level of activity for the asset, or in the absence of a principal market, the 'most advantageous' market; i.e. the market that maximises the amount that would be received to sell the asset, after considering transaction costs[5].

Furthermore, AASB 13 groups valuation techniques into three different approaches that may be used to measure fair value:

- Market approach[6]: This uses prices and other relevant information from market transactions involving identical or similar assets or liabilities;
- Income approach[7] : This converts future amounts (e.g. cash flows or income and expenses) to a single, discounted amount; and
- Cost approach[8] : This reflects the amount required currently to replace the service capacity of an asset (frequently referred to as the current replacement cost, which differs from the cost incurred).

Management is required to use valuation techniques that are appropriate in the circumstances and for which sufficient data is available. Regardless of the technique used, entities are required to maximise the use of observable inputs and minimise the use of unobservable inputs[9] .

While Defence acknowledges that a market price will exist for a small number of DWPs, this will not be the case for the majority of its DWPs on the basis that these are specialised assets for which an active market does not exist. As Defence is a not-for-profit entity and such assets are used by Defence to meet its public defence objectives rather than to generate income, application of the hierarchy of fair valuations approaches would require Defence to determine fair value based on the current replacement cost of these assets.

Defence is firmly of the view that there are significant barriers to the reliable measurement of the fair value of DWPs.

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[3] AASB 116.33
[4] AASB 13.9
[5] AASB 13.16
[6] AASB 13.B5
[7] AASB 13.B10
[8] AASB 13.B8
[9] AASB 13.61

4. The fair value of DWPs cannot be reliably measured

The Framework states that 'Information is reliable if it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.'[10]

Importantly, the Framework highlights the trade-off between reliability and relevance, stating that 'information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading.'[11]

Having performed an analysis of our SME, we acknowledge that for a limited number of non-specialised DWP assets it can be demonstrated that an active market with willing buyers does exist and that there are observable market prices. The fair value of such DWPs can therefore be determined reliably.

However, the majority of our DWP asset base is specialised and fundamental issues exist with the reliability of a fair value measure using a depreciated current replacement approach for the following reasons:

- For many assets and asset components, there is either no market, or too few observable transactions in the market to determine the replacement cost with any degree of accuracy or reliability;
- The lack of depth and liquidity in the market means that often a transaction is negotiated according to the relative bargaining strengths of the participants and is not indicative of a price that would be achieved in an active market between willing buyers and willing sellers;
- The presence of observable 'one-off' transactions can skew the fair value from one year to the next, introducing meaningless volatility to asset values when the intention of Defence is to hold an asset for the whole of its useful life;
- Many of the DWP assets are so specialised in nature and at various stages of economic useful life that it would not be possible to replace them with an asset of similar utility and service potential. In such situations, different fair values may be derived depending on the valuations approach applied. Consider the example of a 20 year old submarine: One approach could be to determine depreciated replacement cost by referring to the current purchase price for a 20 year old submarine however each submarine is unique and determining the differences in capability would involve a considerable level of judgement and subjectivity. Another approach could be to determine depreciated replacement cost based on an aggregation of the current prices for each component that the submarine is comprised of, including internally generated software and intellectual property, and adjusting for depreciation, obsolescence and technical capabilities, again requiring a significant level of judgement and subjectivity. In each scenario, the complexity of the valuations and the significant reliance on subjective judgements will significantly limit the verifiability of the financial information; and
- The exercise requires input of a highly specialist nature for which the availability of an external independent advisor is limited and therefore it would be so heavily reliant on internal assessment or information.

We note that the ABS has been determining the fair value of DWPs for the preparation of statistical information since the amendment in 2009. In its Information Paper 5310.0.55.002: *Implementation of New International Statistics Standards in ABS National and International Accounts September 2009* which discusses and provides guidance on the 2009 amendment to

[10] Framework 31
[11] Framework 32

the treatment of DWPs under GFS, the ABS however acknowledges the difficulties in obtaining a reliable measure of fair value for DWPs. It states as follows:

'Estimates of the value of DWPs will be included in the national balance sheet. These estimates have proved to be challenging: observable market values are not available; similarly replacement cost values are not observable due to rapidly changing technology and caveats on weapons trading in secondary markets. Therefore the ABS is relying on asset life assumptions to model balance sheet values.'

The ABS itself has acknowledged that there are difficulties in obtaining a reliable fair value measure for such assets and while it has developed its own fair value methodology as noted above, this methodology would not be sufficiently robust or acceptable for financial reporting purposes.

In our view, while it may be possible that a depreciated replacement cost for specialised DWPs could be determined with great difficulty, such measure of depreciated replacement cost will be so unreliable so as to make its recognition potentially misleading. On this basis, it is our view that the current measurement of depreciated historical cost, reduced to recoverable amount where impairment to service potential is identified, provides more reliable information to financial statement users.

5. Further conceptual and practical challenges in measuring DWP assets at fair value

In any event, even if it were to be held that a reliable measure of fair value can be determined, we are strongly of the view that the requirement to measure DWP assets at fair value will not provide information which is useful to users on the basis that such information does not meet the qualitative characteristics set forth in the Conceptual Framework such as relevance, understandability and comparability.

a) Relevance

The Framework asserts that 'Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.'[12]

Defence is firmly of the view that the requirement to measure DWP assets at fair value does not satisfy the characteristic of relevance.

Users of the Whole of Government financial statements are most interested in whether the Department has managed to maintain or enhance the physical service potential of its asset base in order to maintain or enhance its operational capability. Users are not interested in whether Defence has been able to maintain or enhance a financial notion of capital asset values for DWPs are affected by many variables and are often determined in markets which are not active and in which one major market participant can cause volatile movements in prices. Such movements however do not reflect any changes in the service utility of the assets on hand and therefore should not be reflected in asset values. For users, the most relevant measure of the service potential of its DWPs is cost less any depreciation less any impairment due to diminution in service potential.

Defence has limited history of asset sales and for the majority of DWPs, the intention of Defence is to hold DWPs to the end of their respective useful lives. In such a case, the short-term changes in value that would be reported where a fair value basis is used would not be

[12] Framework 26

relevant to the Commonwealth Government's financial position and performance. A rise or fall in prices is of no relevance especially where expectations as to future service potential remain unchanged. Valuations based on observable sale prices or any other measure of fair value will not provide relevant information to users of the financial statements of the utility of the assets and their service potential.

Current market prices and replacement costs are affected by inflationary impacts and changes in exchange rates. For example, while the price for a new helicopter to be purchased from the US may not have changed in US dollars today compared to a helicopter purchased two years ago, the appreciation of the Australian dollar will mean that it is cheaper to purchase a helicopter to day. This would result in a devaluation of existing Defence helicopters below cost without any diminution in the service potential of the asset if fair value was to be adopted.

Technological advancements mean that comparisons with modern DWP assets to source a fair value measure based on replacement cost are not relevant, on the basis that any such exercise would not be comparing like with like. As noted above, a twenty year old submarine cannot be replaced with a new one, as the capability and utility of the assets would not be comparable therefore the replacement cost measurement basis determined by reference to the current market price of a new submarine is not a relevant fair value basis for such specialised assets.

b) Understandability

The Framework provides that 'An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.'[13]

In our view, requiring DWP assets to be carried at fair value will diminish the understandability of the WOG and GGS financial statements.

To the extent that it is accepted that a fair value can be reliably determined for certain DWPs while it cannot be determined reliably for other DWPs, this would result in a 'mixed measurement approach' for assets within the one class of assets resulting in a meaningless total figure when presented on the Balance Sheet and a confusing approach for users trying to understand the application of inconsistent accounting policies across the one asset class. As at 30 June 2011, the SMEs balance which will continue to be held at cost contained 37.4% of DWP assets. On the other hand, if assets were to be divided into further asset classes, i.e. DWP assets measured at fair value and residual SMEs measured at cost, this would detract from the users' overall understandability of the assets.

Understandability will also be diminished by the requirement to use complex and subjective valuation models to determine depreciated replacement cost because the user of the financial statements may not appreciate the limitations of the models used to derive estimated values and the assumptions on which they rely on. For example, while the fair value of a submarine may be adjusted to take into account the lack of liquidity of the asset in the market, a user cannot assume that it can be readily liquidated at that value.

c) Comparability

The Framework provides that 'An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation

[13] Framework 25

of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises.'[14] .

It is Defence's firm view that comparability will not be impaired by measuring DWP assets at cost rather than fair value for the following reasons:

- The ABS GFS is intended to provide statistical information on Governments in Australia in a systematic and uniform way to enable policy makers and other users to analyse the financial operations and financial position of the various levels of government. The preparation of financial statements at the WoG and GGS level using the principles in AASB 1049 provides for uniformity in accounting policies and hence allows for comparisons between different levels of government and between States and Territories for the same level of government.

- Our research has indicated that fair value, as defined in this paper, is not a valuation basis adopted by Defence organisations in other jurisdictions. In particular it is only the United Kingdom and New Zealand which claim to apply the fair value basis while other jurisdictions apply the cost method where the either accruals basis of accounting or the cash basis of accounting is applied. Moreover even though the UK and New Zealand purport to utilise the fair value basis, on closer inspection it is apparent that the methods used are either a mixture of fair value and a surrogate approach as in the case of New Zealand or are a surrogate method as in the case of the UK. It should be noted that the UK describes fair value as a Modified Historical Cost using market indices - an approach which is considered by some in the valuation profession and by Defence not to be an acceptable fair valuation approach. Hence, maintaining the cost basis for DWPs will not result in a lack of comparability at the global level, but would actually provide a more comparable basis as between Defence jurisdictions.

5.1 Practical challenges

There are also significant practical challenges in determining the fair value of Defence's DWPs. The time, consumption of resources and cost required to undertake a fair value exercise would exceed any benefits that may arise and place an undue burden on Defence. Defence has a significant amount of DWP assets which represents a total net book value of $14.45 billion on its asset register. Due to the specialised and unique nature of the equipment, calculating a replacement cost for each asset would require granting physical access to a valuations expert to a very large number of assets currently deployed in multiple locations around the world. It is unlikely that the entire asset base would be available for inspection at any point in time as a number of the assets may be deployed in combat zones which are inaccessible, and as such unlikely that a valuation exercise could be completed for such assets.

Considering the practical difficulties inherent in applying a fair value methodology, Defence is of the view that the time, cost and use of resources that would be required to perform such an exercise is an inefficient use of resources and a pervasive constraint on any perceived benefit that may arise from the perspective of the users of the financial statements.

[14] Framework para 40

6. Proposed solution to resolve the conceptual and practical issues of applying fair value measurement to DWPs

We propose that the AASB formally addresses the issues identified in relation to the fair value measurement of DWPs by confirming that the exemption in paragraph 14(a) of AASB 1049 applies to DWPs on the basis that fair value for such assets cannot be reliably measured and request that the following amendment be made to the Standard as underlined:

> 14. Examples of particular optional treatments in Australian Accounting Standards that paragraph 13 of this Standard has the effect of limiting, include:
> (a) assets within the scope of AASB 116 *Property, Plant and Equipment*, AASB 138 *Intangible Assets* or AASB 140 *Investment Property* that may be measured at cost or at fair value. Those assets that are assets under the ABS GFS Manual that are within the scope of those Standards are required to be measured at fair value because the ABS GFS Manual requires those assets to be measured at market value.
> However, the fair value options allowed under AASB 116, AASB 138 and AASB 140 are not amended by paragraph 13 of this Standard. If the fair value of an asset cannot be reliably measured in accordance with an Australian Accounting Standard that allows a choice between fair value and cost, then that asset is to be measured at cost. <u>For example, the fair value of Defence Weapon Platforms cannot be measured reliably as neither observable market values nor replacement cost values are observable</u> Where historical cost is adopted because fair value cannot be measured reliably, historical cost is not characterised as fair value. Also, for example, the requirement for the fair value of an intangible asset to be determined by reference to an active market under AASB 138 continues to apply.

We are of the view that the issues relating to the fair value measurement of DWP require immediate attention and clarification prior to the 2013 reporting season. We look forward to receiving the Board's response to these matters as set out above.

Please do not hesitate to contact me should you wish to discuss further any matters raised in this letter.

Yours sincerely

Phillip Prior
Chief Finance Officer

10 January 2012

ATTACHMENT B

Australian Government

Department of Defence
Chief Finance Officer Group

R1-2-C001
Russell Offices
CANBERRA ACT 2600

CFO/OUT/2012/35

Kevin Stevenson
Chairman
Australian Accounting Standards Board
Level 7
600 Bourke Street
Melbourne Vic 3000

Dear Chairman,

Supplementary Submission: Fair Value Measurement of Defence Weapons Platforms

Further to my letter of 10 January 2012, there has been additional interest and discussion amongst key stakeholders in Defence and other Commonwealth agencies. In the interest of assisting the Board to appreciate our position, I thought it sensible to provide some further clarifying information on some key aspects.

We have performed a detailed review of the Amendments to Australian System of Government Finance Statistics: Concepts, Sources and Methods 5514.0.55.001, issued 13 July 2010 ('Amendments Paper'), to the existing ABS GFS Manual 2005 version 5514.0 ('ABS GFS Manual') and the System of National Accounts 2008 ('SNA 2008') to determine the impact of the proposed amendments on Defence.

The purpose of this supplementary submission is to highlight two additional concerns as follows:

(i) the application of the Standard in relation to the definition and scope of military equipment contained within the ABS GFS Manual and the Amendments Paper; and

(ii) the level of resource and cost that would be necessarily incurred in the valuation of military equipment, which would be disproportionate to the perceived level of benefit that would arise.

1. The application of the ABS GFS Manual and the Amendments Paper

AASB 1049 is clear in the requirement to refer to the ABS GFS Manual when applying the Standard. We have found some difficulties in applying the ABS GFS Manual and it appears there is a need for more work to be done to the ABS GFS Manual before AASB 1049 can be adopted.

In essence our concerns with the ABS GFS Manual, as amended, relate to the definition of defence weapon and the varying treatment of these assets. By way of example we refer to the following ABS GFS Manual issues:

- There appears to be an internal inconsistency in the manner that Defence Weapons Platforms (DWPs) are classified by the ABS, which has an impact on the applicable basis of measurement. DWPs are referred to as "capital formation" (fixed assets) in the Amendments Paper and as "non-financial produced assets: inventories" in the unamended ABS GFS Manual. This is significant, as Australian Accounting Standards prescribe that inventory shall be measured at the lower of cost or net realisable value [AASB 2 para 9], therefore a fair value based approach to the measurement of inventory is not permitted [Refer to Appendix 1, section A];

- Despite the amendments in the Amendments Paper representing ABS's response to the changes in SNA 2008, the ABS's amended classification of weapons as "capital formation" appears inconsistent with the SNA 2008 classification of such assets as "military inventories [Refer to Appendix 1, section B]"; and

- The ABS GFS 2005 also explains that 'Inventories of weapons and weapons platforms includes stocks of and parts for DWPs'. This unamended paragraph suggests that weapons are inventory, which contradicts the Amendments Paper classification of weapons as "capital formation". Further, the classification of Repairable Items (spares and component parts relating to Specialist Military Equipment) has not been addressed in the Amendments Paper. Having consideration for the inconsistencies with the classification of weapons and weapons platforms above, it is conceptually unclear whether Repairable Items should be classified as "capital formation" or inventories [Refer to Appendix 1, section C].

- Prior to the release of the Amendments Paper, the ABS GFS Manual required all Specialist Military Equipment to be expensed, apart from light weapons and armoured vehicles. The Specialist Military Equipment comprised of weapons platforms, weapons and Repairable Items. The Amendments Paper capitalises DWPs which by definition includes all Specialist Military Equipment. Prima facie, Repairable Items which prior to the Amendments Paper under the previous practice had been expensed by this change are now being capitalised.

- Interestingly, Repairable Items are classified as inventory in the ABS GFS Manual (Appendix 3, Item 8167, page 188), but Defence's policy is they should be classified as a fixed asset as per AASB 116, paragraph 8. It is not clear how to deal with a conflict of asset definition between the ABS GFS Manual and the Accounting Standard. In the event that Repairable Items are measured at fair value, we would encounter the same difficulty as with DWPs.

Without resolution to the above issues, it would be difficult to apply AASB 1049 as currently constructed.

2. Resources and Costs to Defence

Notwithstanding the challenges in applying the requirements of ABS GFS Manual as described above, we believe the requirement in the Amendments Paper to potentially measure DWP and Repairable Item assets at fair value would place a considerable burden on Defence. It is incumbent on us to present our concerns, from the perspectives of cost and the efficient use of Commonwealth resources and also to assess the benefits to our stakeholders of compliance.

It is important to note that Defence places the utmost importance on the rigour and governance of its financial reporting policies and processes and would not attempt to avoid compliance with a new requirement on the basis of the difficulty of the task alone. Indeed, Defence already applies due process and allocates resource to the measurement of certain non-current assets at fair value where appropriate.

We believe that the requirement in the Amendments Paper to potentially measure weapons, DWPs and Repairable Items at fair value, represents a significant burden in terms of people effected and dollars. Our concerns are as follows:

- The burden on the Australian tax payer could run into millions of dollars, given the complexity of the exercise. The asset register contains 88,000 types of military assets (including DWP assets) and has some 1.8 million individual items with differing useful lives, totalling $58.3 billion in gross book value terms. Noting Repairable Items account for 80,087 types of military assets and 1.7 million items, totalling $12.9 billion in gross book value terms. If they were bought to book as a military asset, then a sample of 95% of the gross book value or $55.4 billion was subject to valuation procedures, this sample would represent 32,000 types of assets and in excess of 150,000 individual items. We have conservatively estimated that the level of internal resource that would be required to perform the initial valuation would be 1,200,000 hours and would cost in the region of $100 million. This estimate is based on the assumption that each individual asset would take 1 day to value;

- We also bring to your attention that obtaining independent expertise for valuing these assets in Australia would be problematic. In the main, the expertise for valuing our unique assets lays within Defence. Not only would this compromise the independence of the exercise, but would also mean that key resources, such as specialist Defence personnel with knowledge of defence strategic and capability requirements, who are engaged in critical tasks in Defence would be diverted from important duties to focus on an accounting exercise; and

- We are not entirely sure if stakeholders will be better informed by applying valuation policies that may apply arbitrary and highly subjective measurement bases to our Defence assets. Our assessment of stakeholder needs is further reinforced by the knowledge that since Defence adopted the cost approach in 2002, we are not aware of any stakeholders requesting fair value information, with respect to weapons or DWPs.

Whilst Defence has had to apply valuation techniques to defence assets in the past, by our own admission the policy (as described in Appendix 2) was not able to be followed rigorously and the exercise evolved into a 'minimum compliance' approach over each three year cycle, given the scarce resources that Defence had to allocate to the exercise. The exercise performed would not be likely to stand up to the level of scrutiny in today's financial reporting environment and in our view was simply not comparable with current requirements.

3. Conclusion

We are firmly of the view that the issues identified above require the Boards attention and clarification and the cost of applying the requirements detailed in the Amendment Paper significantly exceeds the benefits of that compliance. This is not a new issue to Defence, a paper was prepared in April 2002 and provided to other Government agencies on this topic, a copy of the paper is at Appendix 2.

We look forward to your comments to these matters as set out above. Please do not hesitate to contact me should you wish to discuss further any matters raised in this letter.

Yours sincerely

Phillip Prior
Chief Finance Officer

3 February 2012

Appendix 1 – Extracts from the Amendments Paper, ABS GFS Manual 2005, and SNA 2008

Section A

In the Amendments Paper, weapons and weapons platforms are classified as "capital formation" as follows:

"The ABS's GFS system records expenditures on weapons and weapons platforms as capital formation and so follows the same conceptual and valuation basis applied to other non-financial assets." [Chapter 2, Para 7.109, page 2]

"In keeping with the treatment of purchases of defence weapon platforms as capital formation, depreciation of such platforms is recorded as an expense." [Chapter 2, Para 2.157, page 2]

In the unamended ABS GFS Manual 2005, DWPs are classified as "non-financial produced assets: inventories" as follows:

"Non-financial assets, which are all assets other than financial assets, are classified in the following categories: *Non-financial produced assets* - refers to assets created by a production process and held by producers mainly for the purposes of production; includes produced assets, such ...... inventories (including materials, supplies, defence weapon platforms, work in progress, finished goods and goods for resale)..." [Para 2.186, page 46 & 47]

Section B

In the Amendments Paper, weapons are classified as "capital formation" as follows:

"The ABS's GFS system records expenditures on weapons and weapons platforms as capital formation and so follows the same conceptual and valuation basis applied to other non-financial assets." [Chapter 2, Para 7.109, page 2]

In SNA 2008, weapons are classified as "military inventories" as follows:

"Weapons systems include vehicles and other equipment such as warships, submarines, military aircraft, tanks, missile carriers and launchers, etc. Most single-use weapons they deliver, such as ammunition, missiles, rockets, bombs, etc., are treated as military inventories." [Para 10.87, page 204]

"Military inventories consist of single-use items, such as ammunition, missiles, rockets, bombs, etc., delivered by weapons or weapons systems." [Para 10.144, page 210]

Section C

In the Amendments Paper, weapons and weapons platforms are classified as "capital formation" as follows:

"The ABS's GFS system records expenditures on weapons and weapons platforms as capital formation and so follows the same conceptual and valuation basis applied to other non-financial assets." [Chapter 2, Para 7.109, page 2]

"In keeping with the treatment of purchases of defence weapon platforms as capital formation, depreciation of such platforms is recorded as an expense." [Chapter 2, Para 2.157, page 2]

The unamended part of the ABS GFS manual 2005 which suggests that weapons are inventory, which contradicts the Information Paper, states:

"Inventories of weapons and weapons platforms includes stocks of and parts for defence weapons platforms." [Appendix 3 Item 8167, page 188]

DEFENCE
MATERIEL

Using a Cost Basis Valuation for Specialist Military Equipment

A Discussion Paper

April 2002

Using a Cost Basis Valuation for Specialist Military Equipment

1. Introduction

The Department of Defence uses the deprival method of valuation to measure its non-current assets. The new Australian Accounting Standard 38 (AAS 38) "Revaluation of Non-Current Assets" released in December 1999 requires public sector entities to commence using either the fair value or cost basis for valuing non-current assets, subsequent to initial recognition, for reporting periods beginning 1 July 2002. In view of AAS38, Defence believes that it is opportune to revisit the appropriateness of using a deprival-type valuation methodology for its Specialist Military Equipment (SME) assets.

SME is currently a separate class of non-current assets on the Department of Defence's statement of financial position. It is defined in the Financial Statements as "items that are of a specific military nature and not available through the normal market in their current form to other than government military purchasers". This includes prime military equipment plus the direct support items associated with that equipment. It does not include standard commercial items or commercial items with only minor modifications.

2. Defence's Current Policy on Asset Valuation

The methodology and policies used by Defence are summarised below:

- Assets are revalued in accordance with the Deprival method of valuation. The deprival method differentiates between assets that would be replaced if lost and those that are surplus to requirements and would not be replaced. Replaceable assets are valued at depreciated replacement cost while surplus assets are measured at their net realisable value.
- Prime military equipment has a revaluation threshold of $1 million, support and ancillary equipment has a threshold of $150,000. Revaluation thresholds are reassessed annually.
- Assets are revalued over a 3-year revaluation cycle so that values are no greater than 3 years old. The current cycle is 1 July 1999 – 30 June 2002.
- At the commencement of the 3-year revaluation period, Groups prepare a plan outlining the proposed asset types to be valued in each year of the cycle. Plans also should specify for major Specialist Military Equipment types that values should be updated each year by index or adjustment for changes in relevant exchange rates.
- Assets acquired after the valuation of that particular asset type are reported at cost for the duration of the cycle unless there are significant changes in the value of the asset, in which case it will be subject to revaluation.
- Any revaluation increment or decrement in an asset class is put in that particular class's asset revaluation reserve. When the reserve has a nil balance, a revaluation decrement is to be expensed.

Defence derives depreciated replacement costs by:

- The functions of the existing assets are identified in terms of defence strategic requirements.
- A proportion is assessed for each function (eg. the importance of that function to the asset).
- A suitable replacement or reference asset is identified which could perform these functions and any other required defence strategic functions.
- The reference asset is compared to the existing asset in terms of its capability to perform the identified functions.
- The relative capabilities in functions, and time and importance allocated to these functions are then assessed. These are combined to give an overall assessment of the existing asset against the reference asset in performing the required functions.
- This relative assessment is applied to the new cost of the reference asset to determine a gross value for the existing asset.
- Then the total and remaining useful life of existing asset is assessed to determine appropriate accumulated depreciation.

The valuers for SME are either Defence personnel with knowledge of capital procurement activities or personnel with specialist knowledge of defence strategic and capability requirements in general and for the equipment being valued. In view of the specialised and unique nature of the 'assets', the use of independent, professional valuers from the AVO or industry is not possible.

3. Rationale for Moving to Cost Based Valuation for SMEs

Classes of Assets Valuation

AAS 38 – Revaluation of Non-Current Assets allows entities to elect between a cost basis or the fair value basis to measure a class of non-current assets from 1 July 2002. The standard permits some classes of non-current assets to be measured on the cost basis and other classes to be measured on the fair value basis.

Accordingly, the accounting standards would not be an impediment to treating SMEs as a separate class for valuation purposes.

Administrative Cost Savings: Ernst & Young Survey

There are significant overhead costs associated with a fair value based valuation methodology for non-current assets. In view of the very tight funding arrangements facing Defence, the benefit of this overhead needs to be weighed against the cost.

It is interesting to note that when, Ernst & Young conducted a survey on the impact of AASB 1041 "Revaluation of Non-Current Assets" in January 2002, they found that:

- Of the 129 private companies surveyed, none chose to revert to the fair value basis for valuing non-current assets on commencement of AASB 1041. Overall, 40% of the entities (52 entities) changed from the fair value basis to the cost basis.
- Ernst & Young believed that cost effectiveness and future reporting flexibility were the two main factors influencing management's decision in implementing the standard and deciding the appropriate measurement basis.

This report suggests that companies have considered that the cost savings of using the cost basis, rather than fair value which can require frequent independent valuations, is more important than recognising up to date fair value information. This is reflected in the notes to a number of financial reports.

Although this survey only applied to private companies and there are many differences between the public and private sectors, nevertheless it provides added weight to Defence's argument to value SMEs on a cost basis.

Definition of a Non-Current Asset vs SME 'Asset'

An asset is defined in terms of containing 'future economic benefit'. The intent of recognising an asset in the statement of financial position is to enable users to be informed of the amount and types of future economic benefits deployed by the government department to meet its service delivery objectives. Such information is also useful for assessing the government department's ability to continue to provide goods and services at a particular level.

Defence is in the business of 'defending Australia'. Its SME assets do not fall neatly into the more traditional 'asset' model.

Unlike Plant & Equipment or Land & Buildings, an SME's 'economic benefit' is hopefully never realised – ie they are killing machines to fight a war. They are not contributors to an on-going service provision and their future economic benefit, if they are actually used, is impossible to measure. Their benefit does not derive from the SME alone, but rather from their contribution to a capability – and their value is driven by the value of the capability to the 'defence of Australia' and not simply the cost or fair value of the SME. An assessment of Defence's ability to provide the services required by Government is more to do with an assessment of the value of the capability rather than the value of the SME. The value to Government of the Collins submarine is not reflected in either its historic cost or its replacement value (if that were possible to estimate) but rather in its contribution to the defence of Australia.

A case could be mounted that SMEs do not neatly fit into the 'asset' concept of accrual accounting. The 'asset' that needs to be captured is the capability and not simply the SME. However, in view of the complexity of such an approach and the lack of sophistication in the current accounting skills and systems in Defence, Defence is in no position to develop such a concept at this stage. Nevertheless, if SMEs are to be treated as assets, then a valuation methodology needs to be adopted which best meets the intent of reporting them as assets, both in terms of usefulness for the user of this information and in terms of accountability to Government, its owner, but which balances this against cost.

Objectivity of Measures

As most of the SMEs owned by Defence are Australia unique, there is a considerable subjective assessment component in the present deprival based valuation methodology. As indicated above, it is not possible to use independent valuers. This will continue to be the case if a fair value basis is now adopted.

At least with a cost based valuation, the element of subjectivity is largely removed, so the user of the information can have some reasonable confidence in the information provided and there is greater transparency of the assumptions underpinning the valuations.

Users Information Needs

Users of SME valuation information are essentially:

- Government, the owner
- Government, the customer
- Decision makers within Defence
- The public/taxpayer.

As discussed above, the value of SMEs contributes little to an understanding of Defence's capabilities, their future economic benefits or their ability to deliver a service. The key drivers for such information are an understanding of the 'readiness' of these assets and of their capability compared to that of the potential 'enemy'. The valuation method chosen will not contribute to this assessment. Moreover, there is a risk that a fair or deprival value could actually be misleading to the extent that the subjective elements result in an overstatement of the current worth of these platforms and weapons and create an ill-founded sense of well being.

From a decision-maker's perspective, it is not the current value of the SME, however it is calculated, which will drive either its usage or replacement, but rather its availability and its contribution to capability. Replacement of most SMEs is not with like assets but with either a totally new generation of that asset type or even a totally different asset type, which can meet the capability requirement. Using fair or deprival value assumes that it will be replaced by something similar. In the case of Defence SMEs, this is rarely the case.

Valuations are a significant driver for Defence's capital use charge and funding levels. At least by basing these on a transparent and objective valuation basis, there will be greater accountability to a process which bears little relationship to either Defence's true asset worth or its future capital replacement requirements.

The public/taxpayer are also more interested in SMEs being adequate to defend them in the event of war and not how Defence values its SMEs. Cost based valuation will provide as good an indication as a fair value based one, with considerably less cost to the department.

SMEs Productivity

SMEs generally have exceptionally long lives – eg F111. However, unlike infrastructure assets which also have long lives, as stated above, SMEs are not generally replaced with a similar type of asset. For example, there will be very little similarity between the eventual replacement of the F111 and the current F111, other than its replacement will probably also be some form of aircraft – but even that may not be the case. Achieving the desired capability is the driver to replacement decisions and not simply replacing like with like – unlike roads for example. Accordingly whether fair value or a cost based value is used, neither will better inform decision makers.

Also, the productivity of an SME is not comparable to that of a traditional asset. SMEs may never be actually used for the purpose for which they have been acquired. They are also bought with a view that part of their 'productivity' may require them to be sacrificed in the event of war. Accordingly the valuation method or ' future economic benefits' are irrelevant to decisions on Defence capability.

Life of SMEs not a function of economic life but rather capability / useful life

As already raised above, the life of an SME is not driven by normal economic considerations. Their reason for being is to support capability and once that becomes 'at risk', an analysis is undertaken on the best options to remedy the situation. Their life is very much driven by their usefulness, and this is reviewed annually by senior Defence capability managers. Again, the value of the asset (or its remaining future economic benefits), and hence the valuation method, is irrelevant to the assessment. Usefulness is assessed in terms of the level of capability attained by retaining the SME and the cost of maintenance of the SME, and this is compared to the cost of new capability options.

Practicality

There is considerable work involved for Defence to currently revalue its SME based on deprival value each three years. The discussion above raises the cost/benefit argument, in terms of:

- how much better informed will the user of the information be if Defence was to continue valuing SMEs on the deprival/fair value basis rather than move to a simple cost based valuation; and
- how much greater accountability does it offer.

At least with the cost basis, there is little overhead costs compared to a fair value base, with the intent for treating these platforms as assets largely in tact. A cost based approach also significantly reduces the risk of error, given the necessary subjectivity of much of the fair value assessment.

4. Conclusion

Given that SMEs do not fall neatly into the accounting definition for 'assets' and their value to users is driven essentially by non-financial considerations, the financial value of an SME is not the prime concern of users of the accounting information or of Government in terms of accountability. Accordingly, in view of the cost of applying fair value to SMEs, and the associated risks of misinformation in view of the subjective process which must be used, as compared to using a cost based valuation, Defence is seeking the establishment of a special class of assets which is based on cost for valuation rather than fair value. It would like this revised valuation policy to commence 1 July 02.