NSW GOVERNMENT | Treasury

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Dear Dr Kendall

ITC 45 *Request for Comment on IPSASB Exposure Drafts ED 76 Conceptual Framework Update: Chapter 7, Measurement of Assets and Liabilities in Financial Statements and ED 77 Measurement*

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to respond to ITC 45 *Request for Comment on IPSASB Exposure Drafts ED 76 Conceptual Framework Update: Chapter 7, Measurement of Assets and Liabilities in Financial Statements and ED 77 Measurement*. HoTARAC is an intergovernmental committee that advises Australian Heads of Treasuries on accounting and reporting issues. The Committee comprises senior accounting policy representatives from all Australian states and territories and the Australian Government.

HoTARAC acknowledges the efforts of AASB and IPSASB in reviewing the application of fair value in the public sector. The valuation of physical non-current assets is particularly important in the Australian public sector. The attachment to this letter sets out HoTARAC's responses to the specific and general matters for comment.

Overall, HOTARAC:

- Does not support the IPSASB's proposals regarding the measurement of assets;
- Supports the AASB's view that fair value is an appropriate measurement basis for physical non-current assets in the public sector; and
- Does not support the AASB's views on how fair value should be determined, including the AASB's views on financially feasible use, reinvestment potential and that the current value of restricted operational assets should not be lower than the current value of an equivalent unrestricted asset.

In HOTARAC's view, the IPSAB proposals take an approach that is too rules-based in mandating valuation methodologies in certain circumstances. A more principles-based approach would be to define an overarching valuation objective. In HoTARAC's view, aspects of the AASB's views will lead to inconsistencies with the overriding fair value concept in AASB 13.

HoTARAC is concerned the IPSASB proposals and AASB views would lead to assets being measured at values that are not meaningful to the users of public sector financial statements. In particular:

- Assets in many instances, would effectively be ‘overvalued’ with reference to the specific asset in question;
- Similar assets would have different values; and
- There are potential inconsistencies with how professional valuers would determine the value of assets with restrictions.

Current practice across Australia is widely supported by preparers, valuers and auditors. Information from HoTARAC members indicates the draft proposals would lead to significant financial reporting impacts at considerable cost. In HoTARAC’s view, these changes will not provide better information to users of financial statements.

If you have any queries regarding HoTARAC’s comments, please contact Sean Osborn from New South Wales Treasury on (02) 9228 5932 or by email to sean.osborn@treasury.nsw.gov.au.

Yours sincerely

Stewart Walters
CHAIR
Heads of Treasuries Accounting and Reporting Advisory Committee
3 August 2021

ENCLOSED:

HoTARAC Comments to the AASB on ITC 45 *Request for Comment on IPSASB Exposure Drafts ED 76 Conceptual Framework Update: Chapter 7, Measurement of Assets and Liabilities in Financial Statements and ED 77 Measurement*

AASB ITC 45 – Request for Comment on IPSASB Exposure Drafts ED 76 *Conceptual Framework Update: Chapter 7*, Measurement of Assets and Liabilities in Financial Statements and ED 77 *Measurement*

HoTARAC Response

AASB Specific Matters for Comments (AASB SMC)

Topic A: The measurement basis to apply when measuring the current value of an operational asset

AASB SMC 1: In respect of the measurement basis to apply when measuring the current value of an operational asset, do you agree with: (a) the IPSASB's proposal that fair value is inappropriate; or (b) the AASB's view that fair value is still appropriate (whether or not current practice in Australia in applying fair value is maintained)? Please provide your reasons. See also AASB SMC 2 and SMC 3, which relate to this SMC.

Subject to the comments throughout the remainder of this response, HoTARAC agrees with the AASB's view that fair value is still appropriate and current practice in Australia in applying fair value should be maintained. This does not mean that AASB 13 would not benefit from minor improvements and additional guidance to make it more useful for the public sector and possibly for all not-for-profits.

Any change from measuring assets at fair value to current operational value would effectively be a departure from IFRS for the Australian public sector. In HoTARAC's view, this would be inconsistent with the concept of sector neutrality contained in the strategic direction from the Financial Reporting Council (FRC) in 2002, whereby the AASB adopts International Financial Reporting Standards (IFRSs)) into Australian Accounting Standards.

There is no evidence that using measures other than fair value would benefit users of public sector financial statements. Such a fundamental departure would undermine the existing framework applied in Australia, effectively creating a 'hybrid' where assets held primarily to generate cash flows are valued at fair value and other assets are valued at current operational value. Sector neutrality through the adoption of IFRS is a major benefit for public sector financial reporting and HoTARAC would not support departing from this position.

IFRS/AASB 13 provides a conceptually sound hierarchy for measurement. It uses a single, easy to understand definition of fair value, based on exit price. It then requires preparers to use a valuation technique that is appropriate and maximises observable (i.e. unbiased) inputs. The standard allows different valuation approaches, but the choice of approach is subordinate to the concept of exit price. In HoTARAC's view, fair value derived from each of the three approaches anticipated in IFRS 13, should be the same in most instances. For example, the cost approach and market approach for a specific land parcel should derive the same fair value. In HoTARAC's view, fair value in IFRS 13, provides a consistent measurement basis for all assets in the public sector.

In IFRS 13, the valuation objective of exit price is an overriding constant that applies, regardless of the valuation approach selected and the inputs and assumptions to that valuation approach. In HoTARAC's view, ITC 45 lacks a similar conceptual hierarchy, because the proposals require the adoption of particular valuation approaches in particular circumstances, rather than adopting an overriding measurement concept. There is a risk this bottom-up approach is too rules-based and will result in inappropriate values.

AASB SMC 2: In respect of fair value, do you agree with the AASB's tentative view that hypothetical market participant buyers would include another NFP entity with similar service delivery objectives? Please provide your reasons.

In HoTARAC's view, a hypothetical market participant <u>could</u> include another NFP entity. Sometimes, there is another public sector entity or another not-for-profit entity with similar service delivery objectives that could be a potential buyer of the asset despite of any restrictions on the asset's use. In other instances, there could for-profit entities, that could be considered potential market participant buyers, for example, if an NFP entity values its non-specialised assets such as motor vehicles.

However, there will be instances where another NFP entity with similar service objectives does not exist. For example, with highly specialised assets and/or where the service provided is unique to government. In this case, when there is no observable market, consistent with AASB 13 para 21, the fair value measurement must assume a transaction takes place at that date, considered from the perspective of a market participant that holds the asset, i.e. based on a hypothetical market.

One HoTARAC member dissents from this view and believes that a hypothetical market participant should not include another NFP entity when valuing public sector assets as most public sector assets are very unique and there are generally no other NFP buyers.

AASB SMC 3: In respect of <u>current value measurement of operational assets</u>, do you agree with:

(a) the IPSASB's views that fair value is inappropriate because:
   (i) the 'highest and best use' concept is generally inappropriate for NFP public sector entities; and
   (ii) the 'maximise the use of market participant data' concept is generally inappropriate for NFP public sector entities; or
(b) the AASB's tentative views to date that fair value is appropriate because the 'highest and best use' and 'maximise the use of market participant data' concepts should be retained for NFP entities?

Please provide your reasons.

HoTARAC disagrees with the IPSASB's views that fair value is inappropriate for the NFP public sector.

HoTARAC agrees with the AASB's tentative views to date that fair value is appropriate and the 'highest and best use' and 'maximise the use of market participant data' concepts should be retained for NFP entities.

ED 77 adopts the premise that 'highest and best use' is generally inappropriate when valuing public sector operational assets not held primarily for their ability to generate economic benefits or with a view to sale. In HoTARAC's view, ED 77 and the Basis for Conclusion has not adequately explained why this is always the case.

ED 77 also does not explain why ‘maximising the use of market participant data’ is generally inappropriate in the public sector. IFRS 13 does not use the term ‘market participant data’, instead referring to ‘observable inputs’. HoTARAC supports the principle of using observable inputs to the maximum extent possible.

In respect of ‘highest and best use’ and maximising observable inputs, HoTARAC notes:

- ED 97, paragraph 7.39 acknowledges that purchases can provide evidence an asset’s value is at least as much as the purchase price, but that the value could be higher. However, it is not clear why a market participant would pay more than the cost to purchase. In any case, adopting a type of purchase price (current operational value) instead of the asset’s value in these circumstances, seems to contradict the point being made.
- Public sector assets are routinely valued at fair value using observable data. For example:
    - Residential properties used for social housing, using market data on sales and leases of similar residential properties.
    - Non-specialised office buildings, using available market data on similar commercial properties.

Refer to HoTARAC’s response to SMC 7 on appropriateness of alternative uses.

HoTARAC acknowledges that applying highest and best use in the public sector has additional difficulties not present for the for-profit private sector, because many public sector’s assets do not have any alternative uses.

AASB SMC 4: In respect of fair value, do you agree with the AASB’s tentative view that the ‘financially feasible use’ aspect of the asset’s highest and best use should not be applicable to measuring restricted operational assets of NFP entities when an equivalent restricted asset is not obtainable in the marketplace for a price supported by observable market evidence? Please provide your reasons.

HoTARAC disagrees that the ‘financially feasible use’ aspect of the asset’s highest and best use should not be applicable to measuring restricted operational assets of NFP entities. While most restricted operational assets do not generate a full financial return, any use of restricted operational assets should be financially feasible, i.e. should make economic sense in terms of comparing resources expended with service delivery objectives achieved. In the context of the public sector, HoTARAC does not believe financially feasible means profit-making, and financial feasibility is a necessary criterion when logically considering the highest and best use. In HoTARAC’s view, AASB 13 should include guidance clarifying application of the ‘financially feasible use’ concept in the public sector.

Topic B: Definition of ‘current operational value’

[AASB SMC 5 corresponds to IPSASB SMC 3 of ED 76 and SMC 5–6 of ED 77]

AASB SMC 5: Do you agree with the IPSASB's proposed definition of 'current operational value' or the alternative definition stated in paragraph AV3 of ED 76 (quoted above)? If you disagree with both definitions, do you have suggestions for another definition of 'current operational value'? In answering this question, please indicate whether you consider that the definition of 'current operational value' should:

(a) clearly reflect the service potential of operational assets; and
(b) focus on the cost of replacing the asset's service potential?

Please provide reasons for your views.

Proposed definition: Current Operational Value is the value of an asset used to achieve the entity's service delivery objectives at the measurement date.

Alternative definition: Current Operational Value is the cost to replace the service potential embodied in an asset at the measurement date.

HoTARAC does not support either the proposed or alternative definitions of current operational value. In HoTARAC's view, the application of fair value in accordance with AASB 13 Fair value measurement should be retained.

Although, in HoTARAC view, fair value should be retained, HoTARAC prefers the proposed definition over the alternative definition. The proposed definition is focused on the value of service potential, rather than solely replacement cost. Value should be based on the principles of service potential, for the specific asset, by using the appropriate method and maximising observable inputs. It follows therefore, that the cost approach should not be the only approach to value.

In HoTARAC's view, the proposed definition should be further clarified as 'the value of an asset' could mean a number of different things resulting in different valuation outcomes. For example, as commented on in para AV4 of ED76, value could be the cost to replace the asset or its service potential or the opportunity cost of using an asset to generate services, measured by reference to net cash inflows forgone.

Topic C: Measurement techniques for estimating the current operational value of an operational asset: relevance of using the income approach (AASB SMC 6)

[AASB SMC 6 corresponds to IPSASB SMC 8 of ED 77]

AASB SMC 6: Do you agree with:

(a) the IPSASB's proposal in ED 77 that the income approach can be an appropriate measurement technique in certain circumstances to estimate the current operational value of an operational asset (paragraphs B24 and B38); or
(b) the alternative view documented in ED 77 that the income approach would be inappropriate for estimating an operational asset's current operational value because current operational value should focus on the cost to replace the service potential embodied in the asset (paragraphs AV5–AV12)?

Please provide reasons for your view.

In HoTARAC's view, it is unlikely the income approach would be an appropriate measurement technique for valuation of assets held primarily for operational purposes. However, general principles of valuation (e.g. those in AASB 13) should apply when determining the most appropriate valuation technique, i.e. the valuation technique that is appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

In HoTARAC's view, a variety of valuation techniques can be used to value an asset. In some circumstances, it is appropriate to use a mix of valuation techniques. However, this means the definition of value needs to be clear and unequivocal, so that preparers use the technique(s) best aligned to the value being derived. In AASB 13, the overriding concept of exit price provides a level of top-down clarity.

Topic D: Measuring the current value of an operational asset based on its current use

[AASB SMC 7 corresponds to IPSASB SMC 5–6 of ED 77]

AASB SMC 7: In respect of measuring the current value of an operational asset, do you agree with: (a) the IPSASB's proposal that the asset's current operational value should be measured based on its current use, disregarding potential alternative uses and any other characteristics of the asset that could maximise its market value; or (b) extending application of the AASB's tentative view (that the fair value of an operational asset should take into account its reinvestment potential), to apply to the measurement of either the asset's fair value or current operational value? Please provide your reasons.

Refer to HoTARAC answer to SMC 3.

HoTARAC disagrees with IPSASB's proposal that the asset's current operational value should be measured based only on its current use. Some limited alternative uses should be considered, even when valuing public sector assets not primarily used to generate cash flows, as long as those alternative uses are legally, economically and physically feasible. In HoTARAC's view, there is possible benefit in considering other feasibility criteria, or sub-criteria of existing criteria. For example, social (community reaction), environmental, and political restrictions.

HoTARAC disagrees with AASB's tentative view that the fair value of an operational asset should take into account its reinvestment potential.

The rationale for the AASB's tentative view is not adequately explained. In HoTARAC's view, if reinvestment potential is considered, this should be based on the legal, financial, physical and other restrictions that are a characteristic of that specific asset.

HoTARAC notes that in the public sector, governments mandate that specific services be provided to the public. This imposes restrictions on the sale or use of most government assets because the entity is not able to sell or change the use of the asset, unless approved by government. As a result, restrictions imposed by a government regarding the use and disposal of assets are characteristics of the asset, that a market participant would take into account when pricing the asset.

Without this context there is a risk the AASB's proposal would effectively mean taking into account alternative uses of an asset that are not feasible. In HoTARAC's view, this would contradict AASB 13 paragraph 11, that requires taking into account the characteristics of the asset such as restrictions on the sale or use of the asset when measuring fair value of the asset. For example, the reinvestment potential of land set aside for national parks based on its alternative use as residential housing, would be vastly higher than its existing value, In

HoTARAC's view, that reinvestment value would not provide meaningful information to users of financial statements.

While reinvestment potential is relevant for surplus assets as they are normally intended to be sold, it is not relevant for operational assets as they are not intended to be sold.

Topic E: Measuring the current value of restricted operational assets

[AASB SMC 8–10 correspond to IPSASB SMC 5–6 of ED 77]

AASB SMC 8: In respect of restricted operational assets, if an equivalent restricted asset is obtainable in the marketplace, do you agree with the IPSASB's proposal in ED 77 (and the AASB's tentative view) that the current value of such restricted operational assets should be measured based on the available market evidence for the equivalent restricted asset? If you disagree, do you have suggestions for an alternative way to measure the current value of such restricted operational assets? Please provide your reasons.

HoTARAC agrees, where the market evidence reflects the fair value of that particular asset.

AASB SMC 9: In respect of restricted operational assets, if an equivalent restricted asset is not obtainable in the marketplace, do you agree with the IPSASB's proposal in ED 77 (and the AASB's tentative view) that the current value of such restricted operational assets should not be lower than the current value of an equivalent unrestricted asset? If you disagree, do you have suggestions for an alternative way to measure the current value of such restricted operational assets? Please provide your reasons.

HoTARAC disagrees that the current value of restricted operational assets should not be lower than the current value of an equivalent unrestricted asset, when an equivalent restricted asset is not obtainable in the marketplace. HoTARAC's reasons are both conceptual and practical. Further HoTARAC does not believe that such an approach has wide acceptance in the valuation community.

HoTARAC's key reasons are that this proposal:

(a) Is a departure from the hierarchy in AASB 13 and in these circumstances, replaces a principles-based valuation concept, with a rules-based approach.
(b) Reflects a concept of economic opportunity cost, rather than accounting concepts of historical cost or fair value.
(c) Imposes on valuers a 'hard' valuation rule.
(d) Could in practice lead to similar (identical) assets being measured at significantly different values.
(e) Will lead to significant uplifts in value for many types of public sector assets, where those reported values will not reflect the use of those assets in the foreseeable future.
(f) Would be costly, because the impact will be material and many valuations will need to be fundamentally rescoped.
(g) Would mean the carrying value of assets would not reflect government decisions regarding their use and would not change when government decisions change.
(h) Appears to limit the valuation of assets with legal restrictions to the market approach.

(i) Will in practice be difficult to apply, because the definition of an ‘equivalent asset’ in paragraphs B15 and B16 of ED 77, means identifying an unrestricted equivalent asset in the market will often not be possible, and valuers may have different interpretations of an ‘equivalent asset’ definition.

Detailed discussion of SMC 9

(a) AASB 13/IFRS 13 provides a principles-based hierarchy, in that it:

1. Sets a single definition of fair value based on an exit price – for that specific asset.
2. Requires maximising the use of observable inputs over unobservable inputs.
3. Anticipates several techniques can be used to estimate fair value, including a combination of techniques.

This means a range of available information and valuation techniques must be considered. However, preparers (and valuers) must apply a principles-based exit price.

In HoTARAC’s view, any measurement basis, including fair value, should be principles based and be able to be applied in all circumstances. The proposals would effectively mandate a rule that would override a principle. i.e. that fair value must $x in one circumstance, but $y in another.

In HoTARAC’s view, the service potential of a restricted asset is lower than the service potential of an equivalent unrestricted asset. For example, a school zoning restriction imposed on a parcel of land, limits the use of the land to be a school site. As a result, an entity would not be able to use this land for other purposes, such as residential development, unless the land is rezoned accordingly.

Similarly, in HoTARAC’s view, replacement cost can be used where appropriate, as an estimate of an asset’s fair value. However, it should be the cost to replace that specific asset, including all relevant restrictions, and not the cost of replacing a similar unrestricted asset.

(b) In the public sector, where market supply and demand forces are normally limited by restrictions, valuing restricted assets at the same value as equivalent unrestricted assets would effectively reflect an economic opportunity cost approach. This is not aligned with the existing measurement bases in the Conceptual Framework. While an economic opportunity cost is useful, it will not necessarily reflect the existing characteristics of the asset.

(c) The rule in the proposals applies when an equivalent asset is available in the marketplace. In practice, HoTARAC understands valuers estimate fair value using information from a variety of sources, as well applying as professional judgement in how that information is used. Mandating this type of valuation rule risks overriding the concept of fair value.

Example A – School land

There are occasional, but infrequent sales of parcels of land with restricted zoning for schools. An individual valuer's approach could be:

(i) Identify there is historical sales information available and use this information to directly to estimate the land value;
(ii) Determine there is no historical sales information available, and use adjacent land, with an adjustment to reflect zoning restrictions, current restricted use and location.
(iii) Identify there is historical sales information available, but decide it is not relevant, and use adjacent land, with an adjustment to reflect zoning restrictions, current restricted use and location.
(iv) Identify there is historical sales information available in several other areas, and use that information, together with adjacent land, with an adjustment to reflect zoning restrictions, current restricted use and location.

HoTARAC understand valuers often use a mix of approaches when valuing restricted assets. It is HoTARAC's understanding, the premise that valuers would simply remove a percentage discount factor to comply with the new proposals, is an oversimplification.

The current practice in most Australian jurisdictions is to reflect restrictions in the measurement of fair value. HoTARAC notes this approach is well understood by valuers and has been subject to audit by Auditors-General. This indicates the approach is well supported and there is sufficient audit evidence for discounts applied.

(d) The proposal_will in practice result in significantly different valuations, depending on the availability of recent market information for identical assets.

Example B – School Land

Two identical schools in two identical regional towns.

In Town A the valuer determines there is equivalent restricted land obtainable in the marketplace, based on a sale in recent years. The valuer uses market information to value the land at $200,000.

In Town B the valuer determines there is no equivalent restricted land obtainable in the marketplace. The valuer uses market information on nearby residential land to value the land at $3,000,000. Alternatively, the valuer uses market information on nearby commercial land to value the land at $2,000,000.

(e) The proposed approach would result in uplifts in asset values in Australia. While it is not possible to estimate reliably, the uplifts could be billions of dollars. The resulting asset values would reflect potential future uses of those assets, that in most cases are unlikely to happen. For example:

- National parks
- Zoo in a central metropolitan CBD with unique views
- Land under roads in a metropolitan CBD
- Parliament House and Governor House

Additional examples can be provided if requested.

Illustrative Example: City Zoo
A Zoo occupies land in a major international city. The location has unrivalled views across the city's harbour. The Zoo is adjacent an expensive residential suburb. Currently the land zoning restricts use to zoological gardens and the fair value of land reflects those restrictions. If the land was valued using market evidence of nearby residential land, the land value would likely increase by hundreds of millions or billions of dollars.

(f) The impact of the proposal on Australian jurisdictions would be onerous and costly. HoTARAC estimates that hundreds of thousands of valuations currently apply discounts for restrictions. We understand that in determining these discounts, the sources of information are often varied and the methodologies are not always straightforward. Therefore, the proposals will generally not simply result only in the removal of a discount/adjustment factor.

(g) In HoTARAC's view, the proposal would mean that certain government decisions on the use of assets would not be reflected in changes in their carrying amount. The value changes can provide useful information to users of financial statements. For example, if a government changes the use of land zoned for a national park in an urban area, to residential zoning, the impact of that decision should be reflected in changes to its fair value.

(h) Paragraphs B13 to B17 of ED 77 indicate that assets with legal restrictions should always be valued using the market approach, rather than the cost approach or income approach. This would be inconsistent with paragraph 36, that requires the use of '…measurement techniques that are appropriate in the circumstances…'. HoTARAC does not support limiting the selection of valuation techniques in this way and recommends this requirement is clarified.

This also raises the question of how to value assets that are constructed or located on another restricted asset. For example, a school building constructed on restricted land. Given paragraphs B13 to B17 of ED 77 limit the valuation of restricted land to the market approach, we understand there are some views the building must also use the same approach. HoTARAC notes that due to the unique features of specialised assets (i.e. design and facilities in schools and hospitals), it is highly unlikely there are equivalent comparable assets for sale in the market.

In HoTARAC's view, it should not be necessary to value both restricted land and buildings on that land, using the same valuation techniques. AASB 13 paragraph 63, specifically allows a mix of valuation techniques. HoTARAC supports the use of multiple valuation techniques, where there is an overriding single definition of fair value.

In the example of a school above, HoTARAC notes that the market value of land should be the same as the replacement cost of land, if the valuation objective is an exit price based on fair value. It could be possible to value the building and the land using different valuation techniques because the building was constructed specifically to provide its service potential as a school building while the land does not have any inherent service potential limited to a school site.

(i) In HoTARAC's view, the definition in ED 77 paragraph B16(b) of an 'equivalent unrestricted asset' will often in practice be self-contradictory. On one hand, the asset is unrestricted. However, it is defined as 'an asset that provides services of the same nature as those the entity's asset provides in its current use but is not subject to all the restrictions imposed on the entity's asset'. In HoTARAC's view, in many instances equivalent assets will often have the same restrictions as the assets being used to provide services. For example, for a cemetery, an equivalent asset must be providing services of the same nature. This appears to be limited to other cemeteries. HoTARAC is unclear how it is proposed to value restricted assets if there are no equivalent restricted and unrestricted assets obtainable in the marketplace.

HoTARAC notes that many assets have some type of legal restrictions attached. For example, land adjacent to a school could be zoned residential, commercial or industrial. It is not clear, therefore which type of land would be considered 'unrestricted' in accordance with the proposals. In HoTARAC's view, this supports our view that a more reliable and meaningful value is obtained when restrictions are adjusted for in valuing assets. In this example, the valuation discount/adjustment would vary, depending on the type of adjacent land, but the outcome would always be fair value based on an exit price.

HoTARAC notes that the requirement in ED 77 paragraph B26 to apply the market approach using '…market transactions involving identical or comparable assets…', appears to be inconsistent with the requirement to use '…an equivalent restricted asset…' and '…an equivalent unrestricted asset…' in para B14.

Other Comments

- The proposals do not distinguish between restrictions the entity can unilaterally remove and those that require the approval or agreement of other parties. While HoTARAC does not agree with the proposal, if retained this point would need to be considered and clarified, including restrictions imposed by community views.

  Land rezoning in Australia requires support of local councils, consultation with the community, approval of the state governments. Rezoning is sometimes imposed by law (e.g. rezoning of land under cemeteries). This means governments do not always have full discretion over rezoning. In HoTARAC's view, this is consistent with the concept that the zoning restriction is an intrinsic characteristic of the land and a market participant would value the land based on its current restricted use.

- HoTARAC is aware that discussions about the fair value of restricted assets has introduced two additional arguments to support use of undiscounted values:
  - Some stakeholders are concerned with apparently inconsistent approaches to determining the amount of discount/adjustment. HoTARAC considers this to be a valuation issue, and not an issue to be dealt with in accounting standards; and

- Some stakeholders argue it is important that an entity's management should be accountable for the purchase of assets made on the "open market", based on their undiscounted values instead of their discounted values. When assets are devalued to their discounted values after the purchase, the magnitude of the capital expenses may not be as visible to stakeholders as when the assets are accounted at their undiscounted value. HoTARAC agrees that information on undiscounted values may be useful to users, but is of the view that:
    - As it relates to transactions, it is primarily of interest in the period of the transaction – or soon after – and is not of ongoing valuation usefulness; and
    - If the information is considered important to users, the issue can be addressed by disclosures, rather than ongoing accounting valuations.

AASB SMC 10: Would your answer to AASB SMC 9 (for restricted operational assets generally) be different in respect of measuring the current value of <u>restricted land for which equivalent restricted land is not obtainable in the marketplace</u>? Please provide your reasons.

HoTARAC's answer to AASB SMC 9 would not be different.

Topic F: Assumed location of an operational asset used to measure its current value

[AASB SMC 11 corresponds to IPSASB SMC 7 of ED 77]

AASB SMC 11: Do you agree with the IPSASB's proposals in ED 77 (and the AASB's tentative view in the context of fair value) that an asset's current value assumes that the entity will continue to meet its service delivery objectives from the same location in which the existing asset is situated or used? Please provide your reasons.

HoTARAC agrees.

HoTARAC supports measuring operational assets at fair value. Paragraph 11 of AASB 13 requires the location of the asset to be taken into account when determining its fair value, if location impacts pricing of the asset by market participants.

In HoTARAC's view, entities should measure existing assets rather than hypothetical assets that, for example, correspond to existing service potential. Valuations that reflect the location of the asset help inform government decisions and users about possible relocations.

Topic G: Nature of the component costs to include when considering the cost of a modern equivalent asset

[AASB SMC 12 corresponds to IPSASB SMC 5–6 of ED 77]

AASB SMC 12: When estimating the cost of a modern equivalent asset to measure the current value of an operational asset, do you agree with: (a) the IPSASB's proposals in ED 77 that the cost of a modern equivalent asset may in some circumstances exclude certain costs (paragraph B35); or (b) the AASB's tentative view that all necessary costs intrinsically linked to acquiring or replacing an asset at the measurement date should be included?

Please provide your reasons, including explaining how your preferred treatment relates to the objective of the measurement basis adopted.

In HoTARAC's view, the principles of including 'all necessary costs' and 'in some circumstances excluding certain costs' are not necessarily mutually exclusive. However, additional consideration and guidance is recommended on the concept of the cost of a 'modern equivalent' asset.

HoTARAC does not agree with the rules-based approach in paragraph B35 of ED 77 to exclude certain costs based purely on their nature or function. Rather, costs should be included where they relate to the fair value of a modern equivalent asset. Guidance should focus on when there is a nexus between the cost and that fair value.

In particular, it is not clear why ED 77 excludes the following costs:

- Costs of extending an asset. It is not clear what costs IPSASB is referring to. However, if a modern equivalent asset would include an extension, the associated cost should be included, as long as it is not included in the value of another asset.
- Contract variations. Where variations relate to design features that are an intrinsic component of the modern equivalent asset, these costs should be included.

Topic H: Whether borrowing costs should be included when considering the cost of a modern equivalent asset

[AASB SMC 13 corresponds to IPSASB SMC 5–6 of ED 77]

AASB SMC 13: In respect of measuring the modern equivalent asset as part of the estimation of an operational asset's current value, do you agree with: (a) the IPSASB's proposal in ED 77 that if an entity does not capitalise borrowing costs in accordance with its accounting policy, the entity should disregard any financing costs (paragraph B35(a)); or (b) the AASB's tentative view that the accounting policy choice regarding whether to capitalise borrowing costs into an asset's cost on initial recognition is irrelevant to how those costs should be treated when measuring the current value of the asset? Please provide your reasons.

HoTARAC disagrees with the IPSASB's proposal.

IPSASB's proposal would mean that not-for-profit and for-profit entities would have different fair values. This would impact the AASB's policy of sector neutrality.

HoTARAC agrees with the AASB's tentative view that measuring fair value is different to measuring the historical cost of assets at initial recognition. Therefore, when deciding whether to include borrowing costs in the current replacement cost of an asset, an entity should consider whether a market participant buyer of the asset would include borrowing costs in its pricing decisions about the asset.

Two HoTARAC members dissent from this view and agree with the IPSASB proposal that fair value should exclude borrowing costs.

Topic I: Consideration of surplus capacity and economic obsolescence

[AASB SMC 14–16 correspond to IPSASB SMC 5–6 of ED 77]

AASB SMC 14: Do you agree with the IPSASB's proposal in ED 77 that the current operational value of an operational asset should assume the asset is used to its full capacity, subject to any tests for impairment (paragraph B11)? Please provide your reasons.

HoTARAC notes that SMC's 14 and 15 are closely linked.

HoTARAC disagrees with the IPSASB's proposal that surplus capacity should always be ignored in all circumstances.

In the public sector, assets are often constructed in anticipation of future demand for services considerably higher than current demand. In these circumstances, revaluation decrements resulting from under-capacity, would not provide useful information and would result in fluctuations due to subsequent revaluation increments, as the assets planned capacity is taken up.

HoTARAC notes that in the for-profit sector, the use of the income approach to value assets is more common. This means anticipated future cash flows, resulting from the uptake of under-capacity, will be included in the estimate of fair value.

Therefore, in HoTARAC's view, in the above circumstances, a temporary and planned surplus capacity, should not reduce the fair value of the asset, as it has been designed.

In HoTARAC's view, where the entity plans to utilise the surplus capacity in future, the over-capacity should be ignored in estimating fair value. However, unplanned or long-term over-capacity should be considered.

HoTARAC agrees with the AASB's tentative views in AASB Agenda item 11.2 M174 of March 2020 *Working draft of Exposure Draft (ED 29X) Amendments to Australian Accounting Standards – Fair Value Measurement of Non-Financial Assets of Not-for-Profit Entities Held Primarily for their Service Capacity*. Appendix F, para F25 of ED 29X states that if an asset has apparent overcapacity in view of current demand for its services, economic obsolescence shall not be identified for that asset if there is more than an insignificant chance that future increases in the demand for its services will largely eliminate that overcapacity within the foreseeable future.

In HoTARAC's view, there is some merit in the alternative view in SMC 16, that if the surplus capacity is severable from the asset and the entity intends to dispose of the surplus capacity, it should be accounted as a separate asset and its value should be measured under the rules applicable to assets held for their financial capacity.

AASB SMC 15: Do you consider the guidance in ED 77 to be sufficiently clear in distinguishing whether a loss of utility of an asset should be treated as: (a) surplus capacity, as described in paragraphs B10 and B11 (which is not adjusted for when measuring the asset's current operational value); or (b) an indication of economic obsolescence, as described in paragraph B36(c) (which is deducted when measuring the asset's current operational value); or (c) an indication of impairment? Please provide your reasons.

In HoTARAC's view, the guidance on how surplus capacity is distinguished from economic obsolescence is not sufficient. Guidance and illustrative examples explaining differences between surplus capacity, economic obsolescence and impairment should be provided.

Specifically, paragraph B10 of ED 77 states that surplus capacity exists when an asset is not used to its maximum capacity. For example, an entity owns a building, but only utilises 80% of the space available and the remaining 20% is left vacant. In HoTARAC's view, it is not sufficiently clear why this would not constitute economic obsolescence, in accordance with paragraph 36(c).

AASB SMC 16: Do you agree with the Alternative View in paragraph AV17 of ED 77 that, when an asset includes surplus capacity that is severable from the asset and surplus to operating requirements: (a) the unit of account for the asset's measurement should be bifurcated; and (b) the severable part of the asset should be classified and measured as an asset held for its financial capacity (i.e. with its current value consequently measured at fair value instead of current operational value under the proposals in ED 76 and ED 77)? Please provide your reasons.

Refer to HoTARAC's response to SMC 14.

Topic J: Value in use as a measurement basis identified in the IPSASB's Conceptual Framework

[AASB SMC 17 corresponds to IPSASB SMC 4 of ED 76]

AASB SMC 17: Do you agree with the IPSASB's proposal to remove 'value in use' from the list of measurement bases in the IPSASB Conceptual Framework? Please provide your reasons. In answering this question, please have regard to the potential implications of the issue addressed by AASB Specific Matter for Comment SMC 15.

HoTARAC agrees. However, value in use should be retained in the IPSAS's standards relating specifically to impairment of assets.

Topic K: Overall comments on the IPSASB's proposed current operational value measurement basis

[AASB SMC 18–22 correspond to IPSASB SMC 5–6 of ED 77]

AASB SMC 18: For NFP entities in Australia, do you support measuring the current value of <u>restricted</u> operational assets using: (a) the IPSASB's proposed current operational value measurement basis; or (b) fair value as currently applied under AASB 13; or (c) fair value incorporating the AASB's tentative views; or (d) another measurement basis (please provide details)? Please provide your reasons.

HoTARAC supports measuring the current value of restricted operational assets using fair value as currently applied under AASB 13. However, HoTARAC recommends the AASB considers further guidance and examples relevant to the public and not-for-profit sectors. As stated in AASB SMC 1-4 above, HoTARAC's the view is that a single exit price for a specified asset is appropriate.

ED 76 states that fair value is appropriate if the asset is being held primarily for its ability to generate economic benefits or with a view to sale. It is not sufficiently clear when current operational value might be appropriate and when fair value might be appropriate for valuation of assets. There may be assets held to generate income that are also used for service delivery.

AASB SMC 19: For NFP entities in Australia, do you support measuring the current value of <u>unrestricted</u> operational assets using: (a) the IPSASB's proposed current operational value measurement basis; or (b) fair value as currently applied under AASB 13; or (c) fair value incorporating the AASB's tentative views; or (d) another measurement basis (please provide details)? Please provide your reasons.

As above, HoTARAC supports measuring the current value of unrestricted operational assets using fair value as currently applied under AASB 13.

AASB SMC 20: Unless already provided in response to the above AASB SMCs, please provide an indication of the likely costs and benefits (quantitative and qualitative) of the IPSASB's proposed current operational value measurement basis relative to: (a) fair value as currently applied under AASB 13; and (b) fair value incorporating the AASB's tentative views. In relation to quantitative financial costs, the AASB is particularly seeking to know the nature(s) and estimated amount(s) of any expected incremental costs, or cost savings, of the IPSASB's proposed current operational value measurement basis relative to fair value (under current practice and/or incorporating the AASB's tentative views).

Under the IPSASB proposals and the AASB's tentative views, costs are not expected to be much lower as valuers would still have to assess the market evidence to determine if there were any relevant sales of equivalent restricted assets, and if not, then – equivalent unrestricted assets. Also, there are expected extra costs and time required from valuers and agencies in assurance and complying with auditing requirements. Finally, there would likely be a significant one-off cost on initial adoption. HoTARAC notes, both proposals may increase the need for professional judgement by valuers and therefore cost savings are questionable.

In HoTARAC's view, eventual cost savings, if any, would not justify the reduced benefits to users of financial statements.

HoTARAC notes that if ED 77 is adopted without appropriate transition provisions, a substantial proportion of public sector assets would need to be revalued in Year 1, compared to current valuation cycles of 3-5 years. This would result in a significant transition cost.

AASB SMC 21: Unless already provided in response to the above AASB SMCs, please provide an explanation of whether you consider, overall, that the IPSASB's proposed current operational value measurement basis would: (a) create any auditing or assurance challenges;

(b) result in financial statements that would be useful to users; and
(c) be in the best interests of the Australian economy

In HoTARAC's, the IPSASB's proposed current operational value measurement basis would:

(a) Potentially create an audit challenge because the definition of 'equivalent unrestricted asset' is highly subjective. As stated above (SMC 9), in HoTARAC's view, assets are rarely completely unrestricted.
(b) Not result in financial statements that are more useful to users.
(c) Not be in the interests of the Australian economy.

The proposal to value assets by effectively ignoring legal restrictions on their use, would result in an increase in the value of Australian governments' balance sheets. The number of assets impacted and the estimated dollar impact cannot be reliably estimated. However, HoTARAC understands in Australia, the public sector potentially holds hundreds of thousands of parcels of restricted land and increases in asset values would likely be billions of dollars.

In HoTARAC's view, this would not provide better information to users about a government's accountability or management of assets such as schools, Crown land, national parks, hospital land, cemeteries etc., because:

- If an asset is valued at its theoretical unrestricted value, any government decision to remove the restriction, would not result a corresponding change in value of the asset;
- The restricted value provides information about the characteristics of that specific asset. The proposals would provide information about another asset or the existing asset with different characteristics;
- Users would assume assets are measured based on their existing characteristics. The proposals would necessitate significant disclosures, so users can understand assets are in fact, valued based on an alternative premise;
- It will result in public sector assets being valued under two different principles: exit price and entry price. Using a single principle still allows for different valuation techniques, subject to the overriding principle;
- The concept of an 'unrestricted asset' is not clear. For example, most land has some legal restrictions on its use.

HoTARAC also understands there may be land assets that are currently not recognised, because their restricted values are immaterial. These may need to be recognised if the unrestricted replacement cost is material. Examples include some national parks, marine parks, the exclusive economic zone, land under water. The potential impact could be many billions of dollars. In HoTARAC's view, these unrestricted values would not necessarily provide useful information about the underlying assets.

AASB SMC 22: Are there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the IPSASB's proposed current operational value measurement basis, including Government Finance Statistics (GFS) implications? Please include an explanation in your response.

In HoTARAC's view, the IPSASB's proposed current operational value measurement basis is inconsistent with Government Finance Statistics (GFS). The ABS – Australian System of

Government Finance Statistics: Concepts, Sources and Methods – 5514.0 – 2015 (the GFS Manual) paragraph 3.74 states that in the GFS system, all flows and stock positions are measured at the current market price. Fair value is generally accepted as an approximation of current market price.

In Australia, the application of AASB 1049 *Whole of Government and General Government Sector Financial Reporting*, means Australian governments' financial statements must apply the measurement bases in GAAP, that are consistent with GFS. Even without AASB 1049, governments would need to determine the market price of their assets for GFS reporting purposes, if materially different to current operational value.

HoTARAC recommends consideration of whether recording assets at values that exceed their current restricted value could be inconsistent with the legal obligations on office holders of certain types of entities.

AASB General Matters for Comment (AASB GMC)

AASB GMC 1: Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the IPSASB's proposals, including Government Finance Statistics (GFS) implications.

In HoTARAC's view, the AASB's tentative views will result in the measurement of non-physical assets and amounts inconsistent with GFS. Refer to HoTARAC response to SMC 22.

In HoTARAC's view, the cost of fulfillment as a measurement basis for liabilities is not applicable to Australia, as the measurement of liabilities is adequately addressed in AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 9 *Financial Instruments*.

On an international basis, the cost of fulfilment is potentially different from fair value, and many of the same issues considered for assets in this response will also apply to liabilities.

AASB GMC 2: Whether the proposals would create any auditing or assurance challenges?

Refer to HoTARAC responses above.

AASB GMC 3: Whether, overall, the IPSASB's proposals would result in financial statements that would be useful to users?

Refer to HoTARAC responses above.

AASB GMC 4: Whether the IPSASB's proposals would be in the best interests of the Australian economy?

Refer to HoTARAC responses above.

AASB GMC 5: Unless already provided in response to the AASB Specific Matters for Comment 1–22 and/or general matters for comment 1–4 above, the costs and benefits of the IPSASB’s proposals relative to the current Australian measurement requirements for NFP entities, whether quantitative (financial or non-financial) or qualitative. In relation to quantitative financial costs, the AASB is particularly seeking to know the nature(s) and estimated amount(s) of any expected incremental costs, or cost savings, of the IPSASB’s proposals relative to the existing Australian requirements.

Refer to HoTARAC responses above.