Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	Fair Value Measurement for Not-for-Profit Public Sector Entities	**Meeting**	AASB December 2022 (M192)
Topic:	Analysis of stakeholder's comments on certain proposed fair value principles	**Agenda Item:**	3.2
		Date of this agenda paper:	30 November 2022
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Objectives of this paper

1 For the purposes of finalising the proposed Standard AASB 2022-X *Amendments to Australian Accounting Standards – Fair Value Measurement of Non-Financial Assets of Not-for-Profit Public Sector Entities,* the objectives of this paper are for the Board to:

(a) **consider** comments received from a stakeholder, Liquid Pacific, expressing disagreement with the 'financially feasible use' and 'market participant assumptions' principles explained in the Board's proposals;

(b) **consider** staff's analysis of those comments; and

(c) **decide** whether any of the stakeholder's concerns represent a fatal flaw in the draft Standard or otherwise warrant redeliberation of any of the Board's proposed principles for fair value measurement.

The stakeholder's comments on the Illustrative Examples related to the application of the cost approach are analysed in Agenda Paper 3.3.

Introduction

2 During 2022, the stakeholder provided written comments expressing concerns regarding most of the Board's proposed modifications to AASB 13 *Fair Value Measurement* via their:

(a) submission on ED 320 *Fair Value Measurement of Non-Financial Assets of Not-for-Profit Public Sector Entities*;

(b) letter to the Board dated 21 September 2022; and

(c) submission on the Fatal-Flaw Review (FFR) draft version of AASB 2022-X.

3 At its September 2022 meeting, the Board considered all submissions on ED 320 before deciding to issue an FFR draft Standard. In that process, the Board noted that the views in stakeholder's submission were in the minority.

4 The stakeholder's letter dated 21 September 2022 was provided to:

(a) the Board subcommittee as part of the subcommittee's final review of the FFR draft Standard; and

(b) the Board together with a staff analysis, as part of the November 2022 meeting agenda papers (Agenda Papers 8.2 and 8.3 for that meeting). At the request of the stakeholder, those papers were provided to the Board as Board-only papers. The Board did not discuss the content of the letter and decided to consider the issues raised together with other comments it receives on the FFR draft at its December 2022 meeting.

5 Accordingly, the focus of this paper is on both the stakeholder's comments raised in the 21 September 2022 paper and in its submission on the FFR draft regarding its proposed fair value principles. The stakeholder's comments on Illustrative Examples related to the application of the cost approach are discussed in Agenda Paper 3.3.

6 For ease of reference, unless otherwise stated, each 'asset' referred to in this paper refers to a non-financial asset of a not-for-profit (NFP) public sector entity not held primarily for its ability to generate net cash inflows.

Overview of the stakeholder's comments and staff view

7 Consistent with the stakeholder's submission on ED 320, they expressed disagreement with most aspects of the proposed AASB 13 modifications in the FFR draft. Staff consider that the main reasons for their disagreement with the proposals stem from their disagreement with the following fundamental principles and the application of the Board's Standard-setting process.

Stakeholder's view	Board's view/Standard-setting process
Sector-specific fair value Standards would be inappropriate. The purpose of accounting Standards is to create a framework for consistent financial reporting across all entities. Making changes to AASB 13 for the benefit of public sector entities appears to contradict the objectives of standard setting.	When justified under the *AASB Not-for-Profit Entity Standard-Setting Framework*, the Board modifies IFRS Standards to address NFP-specific or public-sector-specific issues. As discussed in the Appendix to this paper, staff consider that the Fair Value Measurement for Not-for-Profit Public Sector Entities project (the FVM project), including all decisions made by the Board leading to the proposals in the FFR draft, complied with that Framework.
Fair value measurements of some assets would be affected by an entity's subjective assessment of whether the asset is held primarily for its ability to generate net cash inflows (which therefore would determine whether the asset's fair value measurement is subject to the proposed modifications to AASB 13). If reporting entities are at liberty to make such assessments to suit their reporting needs, it would lead to different fair values for certain assets between the private and public sectors and within the public sector. A user of financial statements would not be able to form judgements and make decisions based upon the fair values of assets presented in financial statements if the interpretation of fair value changes depending on: • the sector the asset's holder operates in; and	Allowing an entity to self-assess whether its non-financial assets are held primarily for their ability to generate net cash inflows is consistent with how AASB 136 *Impairment of Assets* is applied. AASB 136 paragraph Aus5.1 states that AASB 136 does not apply to specialised assets of NFP entities that are held for continuing use of their service capacity and not held primarily for their ability to generate net cash inflows if those assets are regularly revalued to fair value.

Stakeholder's view	Board's view/Standard-setting process
• whether the entity's management decides to retain or dispose of the asset.	
The notion that hypothetical NFP public sector market participant buyers exist for public sector entity assets is ethereal and unrealistic. The hypothetical transaction underpinning the fair value concept in AASB 13 should be supported by actual market activity, or the generation of actual cash flows that support assumptions about what that market activity might be.	Other NFP public sector entities should be considered market participants for a non-financial asset of an NFP public sector entity held primarily for its service potential rather than to generate net cash inflows. Paragraphs 26–33 of this paper provide detailed analysis of this topic.
Proposed paragraph Aus28.1 to AASB 13 would introduce non-financial influences into the concept of financial feasibility and significantly distort the meaning of that concept.	In principle, the 'investment return' on an asset held primarily for its service potential rather than to generate net cash inflows should not be limited to the direct cash inflows the asset can generate but, rather, an equivalent test of financial feasibility should consider both: (a) the capability of the asset to be used to provide needed goods or services to beneficiaries; and (b) the resulting cost of those goods or services. As reflected in draft paragraph Aus28.1 of the FFR draft, the factors in (a) and (b) are key factors affecting the amount that market participant buyers would be willing to pay for such an asset. Therefore, that draft paragraph does not introduce non-financial influences into the concept of financial feasibility.

8 The overall view expressed in the stakeholder's letter to the Board and in its submission on the FFR draft is that the proposals would be likely to result in departures from the principles of IFRS 13 *Fair Value Measurement*. Staff observe that when developing ED 320 and the FFR draft the Board noted the possibility of non-conformity with IFRS 13 in some fair value measurements. The Board concluded that the particular features of the public sector — together with cost/benefit considerations — warrant that risk (this was highlighted in the FFR draft paragraphs BC39–BC43 and paragraphs BC228 and BC229 of the Basis for Conclusions).

9 Staff consider that the Board's views noted above are technically sound. Other stakeholders, including the Australian Property Institute (in their ED 320 submission), the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC), the Australasian Council of Auditors-General (ACAG) expressed agreement with the above Board views.

10 The staff view is that the letter and the stakeholder's submission on the FFR draft do not provide new information that has not yet been considered by the Board in making its decisions on the FFR draft Standard or would require the Board to redeliberate the fair value measurement principles in the project.

11 The stakeholder's comments requesting the Board to clarify its proposal on the 'financially feasible use' and 'market participant assumptions' principles are discussed below.

Stakeholder's comment regarding financially feasible use

12 Regarding the meaning of 'financially feasible use', the FFR draft proposed the following modification of AASB 13 paragraph 28(c):

> "Notwithstanding paragraph 28(c), for a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, an asset's use is financially feasible if market participants (including not-for-profit public sector entities) would be willing to invest in the asset's service capacity, considering both the capability of the asset to be used to provide needed goods or services to beneficiaries and the resulting cost of those goods or services." (Paragraph Aus28.1 proposed in the FFR draft)

Stakeholder comment

13 The stakeholder commented that paragraph Aus28.1 seems to convey that "because assets of this nature are not held to generate net cash inflows, then net income should not be a pricing consideration in determining fair value. If this is indeed the intention of this paragraph, then we must conclude the income approach to valuation is not a suitable valuation methodology for these types of assets because market participants do not consider net income as a value determinant."

14 They requested the Board to clarify the following in the Standard:

(a) Indicate whether non-financial assets of a not-for-profit public sector entity not held primarily for their ability to generate net cash inflows can be valued using the income approach;

(b) If fair value is a measure of an asset's future economic benefits, what benefits are to be measured under paragraph Aus28.1;

(c) If net income is the benchmark, then what costs (valuation inputs) are to be ignored in the valuation process; and

(d) provide working examples to illustrate the application of paragraph Aus28.1 including where the asset does, or does not, have the potential to derive income.

Staff analysis – The use of the income approach

15 In respect of the comment noted in paragraphs 13 and 14(a), when developing ED 320 and the FFR draft, the Board decided not to mandate the use of particular valuation techniques (market, cost or income approach), as noted in paragraphs BC174–BC181 of the FFR draft. Therefore, the proposed paragraph Aus28.1 is not intended to direct or constrain the application of a particular valuation technique.

Staff recommendation – The use of the income approach

16 Staff recommend adding a paragraph in the Basis for Conclusion stating that "the modifications to AASB 13 set out in this Standard (eg the modification of the guidance on 'financially feasible use' in paragraph Aus28.1) do not indicate that the income approach cannot be applied when measuring the fair value of a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows. The entity uses judgement in determining which valuation technique (or combination of techniques) to apply, considering all facts and circumstances and the availability of observable inputs relevant to the subject asset."

Staff analysis – Future economic benefits

17 In its submission on ED 320, the stakeholder indicated that financial feasibility is the possibility of generating a commercial return, where that return is benchmarked in markets. In the context of their question in paragraph 14(b), the stakeholder appears to regard future

economic benefits as the ability to sell an asset (measured by reference to market inputs) and/or generate a commercial return in the form of net cash inflows.

18 In a context that is not specific to asset measurement, the *Framework for the Preparation and Presentation of Financial Statements* provides explanation of the concept of 'future economic benefits' in respect of NFP entities' assets. The relevant paragraphs are reproduced below:

> "… Future economic benefits is synonymous with the notion of service potential ... Future economic benefits can be described as the scarce capacity to provide benefits to the entities that use them, and is common to all assets irrespective of their physical or other form." (paragraph Aus49.1)
>
> In respect of future economic benefits embodied in an asset, "future economic benefits are also used to provide goods and services in accordance with the entities' objectives. However, since the entities do not have the generation of profit as a principal objective, the provision of goods and services may not result in net cash inflows to the entities as the recipients of the goods and services may not transfer cash or other benefits to the entities in exchange." (paragraph Aus54.1)
>
> "In respect of not-for-profit entities, the fact that they do not charge, or do not charge fully, their beneficiaries or customers for the goods and services they provide does not deprive those outputs of utility or value; nor does it preclude the entities from benefiting from the assets used to provide the goods and services. For example, assets such as monuments, museums, cathedrals and historical treasures provide needed or desired services to beneficiaries, typically at little or no direct cost to the beneficiaries. These assets benefit the entities by enabling them to meet their objectives of providing needed services to beneficiaries." (paragraph Aus54.2)

19 Consistent with those paragraphs of the Framework, and as noted in paragraphs BC75 and BC76 of the Basis for Conclusions for the FFR draft, the Board proposed adding paragraph Aus28.1 to AASB 13 because it considered that an NFP public sector entity should not be precluded from measuring the fair value of an asset at an amount exceeding the present value of cash inflows generated directly by the asset. This is because the amount of cash inflows generated by an asset that is not held primarily to generate net cash inflows may not reflect faithfully the service potential embodied in the assets for which market participant buyers would be prepared to pay.

20 In the context of fair value measurement, for any entity, the concept of future economic benefits or service potential must reflect benefits for which market participant buyers would be prepared to pay for the subject asset. Therefore, a NFP market participant buyer would be:

(a) unwilling to pay more for the subject asset than the amount reflecting the net cash inflows the asset could generate, if the subject can be bought from another entity pricing it for its cash-generating ability (e.g. a generic motor vehicle); and

(b) willing to pay more for an asset, *if necessary*, than the amount reflecting the net cash inflows the asset could generate, if the subject asset is not available in the market for a price reflecting its cash-generating ability (e.g. many specialised assets).

21 In summary, then, it would seem that the stakeholder has a narrower view than the Board's of the nature of future economic benefits/service potential for which market participant buyers would be prepared to pay when a non-financial asset is held by a NFP public sector entity primarily for its service potential. This is linked to differing perspectives on the characteristics of market participant buyers for such assets, which are discussed in paragraphs 26–33.

22 If the Board reaffirms its previous decision (consistent with paragraph 20), the stakeholder's question in paragraph 14(c) about the implications for assessing an asset's financially feasible use if net income is the benchmark would be inapplicable, i.e. net income would not be the benchmark.

Staff recommendation – Future economic benefits

23 Staff consider that the Basis for Conclusions for the FFR draft provides sufficient explanation of the Board's proposal in paragraph Aus28.1. Therefore, staff recommend taking no action in response to the stakeholder comment noted in paragraph 14(b).

Staff analysis – No illustrative example proposed regarding financially feasible use

24 Liquid Pacific expressed concern that the concepts in proposed paragraph Aus28.1 (regarding 'financially feasible use') have not been demonstrated in the illustrative examples. Staff consider that it would be inappropriate to add illustrative examples on proposed paragraph Aus28.1 because:

(a) it proposes a simple amendment to replace:

(i) assessing whether an asset's use would generate an investment return on an investment in that asset, with

(ii) assessing whether market participants would be willing to invest in the asset's service capacity. This would be largely dependent on whether the asset provides essential (or other important) goods or services to beneficiaries of either the entity or a similar NFP public sector market participant buyer hypothetically bidding for the asset, which would typically be the case for assets within the scope of this Amending Standard;

(b) the illustrative examples on IFRS 13 do not include illustrative examples on 'financially feasible use'; and

(c) neither (i) nor (ii) above involves estimating fair values (instead, 'financially feasible use' is a factor in developing fair value estimates).

Staff recommendation – No illustrative example proposed regarding financially feasible use

25 Staff recommend adding to the Basis for Conclusions the explanation in paragraph 24 and the following paragraphs:

(a) where an asset is measured using the cost approach based on acquisition for its highest and best use (including deductions for any obsolescence), its fair value measurement would reflect a use that is financially feasible because current replacement cost is calculated, in accordance with paragraph B9, as not exceeding the amount for which a market participant buyer could replace the asset's service capacity; and

(b) where the market or income approach is used, there should be no change to how financially feasible use would be assessed in light of paragraph Aus28.1.

Question for Board members

Q1: In respect of the stakeholder's comment about financially feasible use, do Board members agree with the staff recommended approach in:

(a) paragraph 16 regarding clarifying in the Basis for Conclusion that paragraph Aus28.1 does not indicate that the income approach cannot be applied when measuring the fair value of a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows;

(b) paragraph 23 to take no further action regarding the comment about measuring future economic benefits;

(c) paragraph 24 to decline to add any illustrative examples of applying proposed paragraph Aus28.1; and

(d) paragraph 25 to add to the Basis for Conclusion explanations and observations about financially feasible use?

If not, which approach do you suggest?

Stakeholder's comment regarding market participants for an NFP public sector asset

Stakeholder comment	
26	The stakeholder made the following comments:

> "Another concern is Aus 28.1 creates imaginary markets for public sector assets and for which public sector entities are the only relevant participants. It also implies the holding entity is a market participant and there are sufficient numbers of the same entity to constitute a market. All these assumptions conflict with the real-world acceptance of land economics and with the concept of fair value. Willing buyer, willing seller, arm's length transactions, full knowledge of markets and so on."
>
> "The obvious question then becomes what happens to these imaginary markets and market participants when the entity decides to sell the asset? If these assumptions disappear then the Aus 28.1 is most likely to lead to an entity's fair value 'in use' being significantly different to its fair value 'on disposal'."

Staff analysis – Imaginary markets and market participants

27 Fair value under AASB 13 uses the notion of hypothetical sale transactions. AASB 13 paragraph 23 states that:

> "an entity **need not identify specific market participants**. Rather, the entity shall **identify characteristics that distinguish market participants generally**, considering factors specific to all the following:
>
> (a) the asset or liability;
>
> (b) the principal (or most advantageous) market for the asset or liability; and
>
> (c) market participants with whom the entity would enter into a transaction in that market." [**emphasis added**]

28 In addition, the IASB noted in paragraph BC78 of the Basis for Conclusions for IFRS 13, in respect of measuring the fair value of an asset (the subject asset) that contributes value to an entity by using the subject asset in combination with other assets, the fair value (the exit price) reflects the sale of the asset to a market participant that has, or can obtain, the complementary assets needed to use the subject asset **in its own operations**". In effect, "the market participants buyer **steps into the shoes of the entity**" that holds the subject asset. [**emphasis added**]

29 The IASB also noted in paragraph BC79 of the Basis for Conclusions for IFRS 13 that sometimes an observed market sales price — one for sale on a stand-alone basis — will not reflect the fair value of a subject asset that is used in combination with other assets. In such situation, the entity would need to measure the fair value of the subject asset using another valuation technique, such as an income approach or the cost approach depending on the circumstances and the information available.

30 The IASB's rationale seems to provide arguments for:

(a) other NFP public sector entities being considered market participants for a non-financial asset of an NFP public sector entity held primarily for its service potential rather than to generate net cash inflows (because those assets are likely to contribute value to its holder when used in combination with other assets and "the market participant steps into the shoes of" the holder of the subject asset); and

(b) concluding that, sometimes, the market selling price of an asset (for sale on a stand-alone basis) will not reflect the fair value of the subject asset and the entity will need to use another valuation technique to measure the fair value of the asset.

31 As noted in paragraph 26, the stakeholder commented that the asset's fair value 'in use' would be likely to differ significantly from its fair value 'on disposal'. Staff agree that the fair value assumptions used when the asset is assumed to remain in its current use might differ from the assumptions used when the asset is held for disposal. This is because the hypothetical market when the asset is in use might differ from the market in which the entity plans to sell the asset.

32 In other words, if the demand for the services that an NFP public sector asset provides diminished to such an extent that neither the current holder of the asset nor other NFP public sector market participants would be willing to pay a premium over the asset's commercial value (i.e. the amount reflecting the net cash inflows the asset could generate), then investing in the asset for its previous use would cease to be financially feasible. In short, the market conditions affecting the pricing of the asset would have changed.[1] Therefore, staff consider it may be appropriate for the assessment of an asset's financially feasible use (and, consequently, the measurement of the asset's fair value) to change upon a decision to sell the asset.

33 **Staff recommendation:** Staff recommend clarifying in the Basis for Conclusions that the assumptions of market participants for the subject asset shall include the assumptions of other NFP public sector entities hypothetically acquiring the subject asset would help remind readers of AASB 13 of this principle.

Question for Board members

Q2: Do Board members agree with the staff recommendation to clarify in the Basis for Conclusions that the assumptions of market participants for the subject asset shall include the assumptions of other NFP public sector entities hypothetically acquiring the subject asset?

1 Note that the mere fact that the asset's holder intends to sell the asset would not of itself indicate a change in the asset's 'financially feasible use'; other NFP public sector market participants would need to cease to be willing to pay a premium for the asset over its commercial value. This would be evaluated primarily by considering whether the asset provides an essential or highly demanded service.

Appendix: Application of the Standard-Setting Framework

A1. Staff consider that the FVM project and all decisions made by the Board leading to the proposals in the FFR draft Standard complied with the *AASB Not-for-Profit Entity Standard-Setting Framework* (the Standard-Setting Framework).

A2. Paragraph 24 (a) of the Standard-Setting Framework states that the Board's objectives are to use IFRS Standards and transaction neutrality as a starting point, however, when justified, make modifications to IFRS Standards or develop Australian-specific guidance to address:

(a) issues specific to the NFP sector of such prevalence and magnitude that the objectives and qualitative characteristics of financial reporting as set out in the *Framework for the Preparation and Presentation of Financial Statements* (Conceptual Framework) would not be met; and/or

(b) undue cost or effort considerations.

A3. Paragraph 25 of the Standard-Setting Framework specifies the triggers that would cause the Board to consider whether NFP-specific amendments are needed, including when:

(a) Australian constituents raise the need with the AASB (via agenda consultation, outreach activities, or written or verbal submissions) (paragraph 25(d)); and

(b) evidence of undue widespread and significant diversity in accounting practices exists (paragraph 25(g)).

A4. Paragraph 30 of the Framework specifies the justifiable circumstances for NFP-specific (or public-sector-specific) modifications to a pronouncement or guidance, including:

(a) issues specific to the NFP (or public) sector are of such prevalence and magnitude that the entities' financial statements do not reflect economic reality (paragraph 30(e)); and

(b) an assessment indicates that the costs of preparing and disclosing information outweigh the benefits to users (paragraph 30(h)).

A5. The Board undertook the FVM project because some respondents to ITC 34 *AASB Agenda Consultation 2017–2019* requested the Board to provide guidance clarifying how to apply the requirements in AASB 13 to the fair value measurement of public sector entity assets.

A6. Throughout the project, many stakeholders in the public sector commented that applying AASB 13 had been challenging and costly. Accordingly, the Board undertook the FVM project to provide guidance that:

(a) assists the NFP public sector to apply the principles of AASB 13 more consistently; and

(b) enables application of AASB 13 in a more cost-effective manner by clarifying its application, including clarifying the extent to which preparers of financial statements need to search for information in the absence of observable market inputs.

A7. Additionally, the proposal regarding an asset's highest and best use is designed to reduce the cost and effort of an NFP public sector entity resulting from searching unnecessarily for possible alternative uses of an asset not held primarily for its ability to generate net cash inflows. The Board made this decision after considering stakeholders' comments that the cost incurred to search for possible alternative uses of such an asset is not justified when the asset is very unlikely to be used for an alternative purpose for the many cases in which the asset is:

(a) specialised, especially if the costs to convert the asset to an alternative use are high; and

(b) being used to provide necessary services to the public and, therefore, the public sector entity holding the asset is highly likely to continue using the asset to provide those services.