NSW GOVERNMENT | The Treasury

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Our Reference:
Your Reference:

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Dear Ms Fox

IPSASB Consultation Paper: Conceptual Framework: Measurement of Assets and Liabilities in Financial Statements

New South Wales Treasury welcomes the opportunity to provide comments to the International Public Sector Accounting Standards Board (IPSASB) in relation to the abovementioned Consultation paper. Detailed comments are attached.

While NSW Treasury supports development of the Conceptual Framework by both the IPSASB and International Accounting Standards Board (IASB), we strongly recommend that the IPSASB does not progress the IPSASB Measurement Consultation Paper (CP) until the IASB / Financial Accounting Standards Board (FASB) Conceptual Framework Phase C Measurement is complete. We strongly believe that a CP on the measurement of assets and liabilities is best first undertaken by the IASB. The IPSASB should then determine whether there are any not-for-profit specific reasons as to why these conclusions are not appropriate for the public sector.

We note that "the development of the IPSASB Conceptual Framework is not an IFRS convergence project", but that the IPSASB is "closely monitoring the development of the IASB's Conceptual Framework". However, the reason for not treating this as an IFRS convergence project is not explained or supported. Therefore, we encourage the IPSASB to proceed consistent with its document *'Process for Reviewing and Modifying IASB Documents'* (October 2008).

NSW Treasury believes that the IPSASB should work closely with the IASB with the objective of maximising convergence between the two Frameworks and the Accounting Standards. To do otherwise will invariably increase the risk of creating a wedge between the two Frameworks and resulting accounting standards, that will become increasingly difficult to reduce and even more difficult to eliminate.

Further, we believe that maximum convergence between the IPSASB and IASB is in the interests of the integrity of the accounting profession and the usefulness of its accounting standards in the global economy. Any action that increases the risk of unnecessary divergence should be avoided.

NSW Treasury is also concerned that the CP Executive Summary envisages "that the IPSASB Framework will identify factors that should be considered in choosing the measurement basis to be required for *particular* assets and liabilities in specific circumstances" (italics added) (para 1.5). The CP does not adequately explain or demonstrate why the IPSASB reached this conclusion rather than trying to identify a single measurement basis that is appropriate in all circumstances. Instead, the CP signals to a reader that the conclusion will be argued for, instead of rigorously evaluating the alternatives. It also presumes that a mixed measurement will continue.

We believe that the objective of a Framework document should be to conclude on a single measurement basis, even if this is only as an ideal that can only be achieved in certain circumstances, for example, where there is an active market. This can be attempted by critically evaluating each alternative measurement basis against the objectives of financial reporting and the qualitative criteria for information to be useful for decision-making. In this regard, NSW Treasury is concerned that even if the limited scope of the CP is accepted (i.e. based on measurement for particular assets / liabilities), the CP does not critically evaluate each measurement basis, in a structured and rigorous manner. Therefore, we do not believe that the CP is sufficient to satisfy its stated objective.

In addition, we note that the concept of capital is mentioned and linked to measurement bases. However, the concept of capital is not fully explained as being a driver of measurement bases, which therefore undermines the likelihood of reaching a valid conclusion on a desirable measurement basis.

Finally, in NSW Treasury's view, we believe that the CP is difficult to follow, as it mixes terminologies and confuses features, measurement bases, valuation techniques and proxies (e.g. market value versus fair value; replacement cost vs market value). Given this, we do not believe that the CP can reach valid conclusions.

These overarching comments are repeated in the following responses to the specific matters for comment as relevant to each question asked.

If you have any queries regarding the above and the attached comments, please contact me on +612 9228 3019.

Yours faithfully

R Williams

Robert Williams
for Acting Secretary

IPSASB Consultation Paper: Conceptual Framework: Measurement of Assets and Liabilities in Financial Statements NSW Treasury comments

Specific Matter for Comment 1

Should the role of the Framework be to identify factors that are relevant in selecting a measurement basis for particular assets and liabilities in specific circumstances, rather than specify a single measurement basis or combination of bases?

As discussed in the covering letter, NSW Treasury has serious concerns that the CP Executive Summary envisages "that the IPSASB Framework will identify factors that should be considered in choosing the measurement basis to be required for particular assets and liabilities in specific circumstances" (para 1.5). This therefore presumes that mixed measurement will continue. However, no reasoned argument for this vision is demonstrated or explained. Instead, it signals to the reader a conclusion has been made (i.e. to identify factors in choosing the measurement bases for *particular* assets and liabilities), that will be argued for, instead of rigorously evaluating the merits of alternative views.

Conversely, we believe that the objective of a Framework document should be to conclude on a single ideal measurement basis, even if this is an ideal that can only be fully achieved in certain circumstances, for example, in an active market. This can be attempted by critically evaluating each alternative measurement basis against the objectives of financial reporting and the qualitative criteria for information to be useful for decision-making.

The CP very briefly refers to the objective of financial reporting for accountability and decision-making and the qualitative characteristics of information (refer paras 1.15 to 1.18). It then very briefly discusses historical cost, market value and replacement cost. This is followed by a lengthy discussion of deprival value in a separate chapter. We are therefore concerned that the CP does not critically evaluate each measurement basis against the relevant qualitative criteria (which are noted at para 1.18) in a rigorous and structured manner. Therefore, even if the limited scope of the CP is accepted, we do not believe that the draft is sufficient to choose a preferred model.

The fact that, in practice, substitutes or proxies may need to be obtained for a measurement basis (and in individual accounting standards) does not deny that the ideal can be articulated. To simply state that "there is no single measurement basis that is appropriate in all circumstances" (para 1.5) misses the point of a Framework document, which should be conceptual in nature and which should attempt to outline an ideal.

Further, articulating an ideal measurement model in the Framework should not preclude also including guidance that may assist in choosing between measurement bases in specific circumstances, in the absence of being able to apply a single measurement basis. This would at least allow for the development of an improved mixed measurement model, as a precursor to applying an ideal model in all circumstances.

In selecting the ideal measurement basis, we also believe that the IPSASB should start with, or at least include, a rigorous evaluation of the various concepts of capital, which can be seen as the driver of the different measurement bases.

However, as discussed in the covering letter, we nevertheless believe that this analysis is best first undertaken by the IASB. The IPSASB's role should be to determine whether there are any not-for-profit specific reasons as to why these conclusions are not appropriate for the public sector.

NSW Treasury also notes that the CP states that "...it is desirable for the measurement bases used in financial statements to be consistent with those used for statistical purposes" (para 1.2). Further, the IPSASB's 'At a Glance' publication of December 2010, more strongly states that "the IPSASB is committed to minimising divergence from the statistical financial reporting models." We are concerned that the IPSASB makes such statements, without any justification and without similarly stating that it is desirable for the IPSASB measurement bases to be consistent, to the maximum extent possible, with those used by the IASB.

Similarly, we find it concerning that the CP refers to the IVSC definition of market value (refer para 3.2 of the CP), but does not include reference to the definition of fair value in the academic literature and IASB framework and accounting standards.

Specific Matter for Comment 2

If in your view the Framework should specify a measurement basis or combination of bases (or approach in the case of deprival value), which should that be?

Single measurement bases

- *(a) Historical cost*
- *(b) Market value*
- *(c) Replacement cost*

Combinations of Bases/Approach

- *(d) Deprival value*
- *(e) Historical cost and market value*
- *(f) Replacement cost and market value*
- *(g) Historical cost, replacement cost and market value*

Others

- *(h) Another measurement basis or combination of bases / approach*

Please explain why you support a particular measurement basis or combination of measurement bases/ approach and your reasons for rejecting alternatives.

As stated under Specific Matter for Comment 1, we believe that the objective of a Framework document should be to conclude on a single ideal measurement base, even if this is an ideal that can only be fully achieved in certain circumstances, for example, an active market.

In broad terms, we believe there are two main measurement bases: current value and other than current value. We believe that, ideally, the single measurement base should be based on a current value, because current values are more relevant to evaluating and making economic decisions. Within these two measurement bases, there are a number of different measurement approaches, which may or may not be separate measurement bases in their own right. For example:

- Current value includes current market exit price and current market entry price (referred to as 'fair value' in IFRS 13).
- Other than current value includes adjusted past entry prices (sometimes referred to as historic cost).

From the current value bases, we believe that the ideal should be fair value. Market value or fair value is the most widely discussed / used current value model in the existing Accounting Standards, academic literature and the valuation profession. In this regard, we believe that the CP needs to discuss IFRS 13 *Fair Value Measurement*, which defines 'fair value' as an exit price. IFRS 13 is based on the view that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market (IFRS13, BC44).

In contrast, however, NSW Treasury is concerned at the disproportionate focus given in the CP to deprival value. We particularly note the assertions in the CP that:

- deprival value "provides a rationale by which a specific basis may be selected as the most relevant in specific circumstances" (para 5.2) and
- deprival value "ensures that appropriate consideration is given to all the qualitative characteristics and the need to obtain an appropriate balance between them" (para 5.3).

In response, we believe that fair value, as articulated in accounting standards, does exactly the same as deprival value.

NSW Treasury believes that, in practice, there is no material difference between deprival value and fair value (or market value), as demonstrated in NSW Treasury's Policy Paper TPP 07-1 (refer extract attached as an Appendix to this submission). Therefore, we strongly question the benefit of the deprival value concept, which we view as merely an additional concept that over-complicates the measurement basis.

Finally, we note that IFRS 13 adopts a different solution to the problem of an ideal versus what is the most relevant basis in specific circumstances. Instead of alternative bases of measurement, it outlines a fair value hierarchy of alternative inputs. We strongly believe that a CP on measurement should acknowledge and rigorously evaluate the IFRS 13 approach to measuring assets and liabilities.

Specific Matter for Comment 3

The Consultation Paper discusses the following measurement bases: historical cost, market value and replacement cost. It also discusses the deprival value concept which does not describe a single measurement basis, but rather a means by which a basis may be selected that is relevant to the circumstances. Value in use and net selling price are discussed in the context of the deprival value model.

In your view, is this discussion complete, balanced and fair? If not, please indicate what in your view is missing or in what respects you consider the discussion does not draw out the strengths and weaknesses of the various bases (or approach in the case of deprival value).

In NSW Treasury's view, the discussion in the CP on the measurement bases is not complete, balanced or fair, for the following reasons.

The discussion is not complete in many respects

First, as discussed in Specific Matter for Comment 1, the CP does not rigorously and critically evaluate each measurement basis against the objectives of financial reporting and qualitative characteristics and cost constraints, in a structured, rigorous and consistent manner. The consequence is that the discussion is not complete.

The incomplete nature of the discussion is illustrated by the IPSASB's rejection of a single measurement basis. The fact that, in practice, substitutes or proxies may need to be obtained for a measurement basis (and in individual accounting standards) does not deny that the ideal can be articulated. To simply state that "there is no single measurement basis that is appropriate in all circumstances" (para 1.5) misses the purpose of a Framework document.

Further, articulating the ideal measurement model in the Framework should not preclude including guidance that may assist in choosing between measurement bases in specific circumstances, in the absence of being able to apply a single measurement basis. However, even if the limited scope of the CP is accepted, we do not believe that the CP is sufficiently complete to choose a preferred basis for measurement (or approach).

Second, the CP does not sufficiently discuss the measurement of liabilities, except as part of deprival value which is not a separate measurement basis. The CP asserts merely that liabilities are unlikely to be measured at market value without adequate justification or explanation (para 3.14).

Third, the CP is not complete, because, although the concept of capital is mentioned and linked to measurement bases, the concept of capital is not fully explained as being both a driver of alternative measurements bases, and as a concept that can be seen as a criterion for choosing between alternative measurement bases.

The CP is also incomplete, as it does not discuss the following:

- The unit of account to be measured; i.e. it does not define what is the asset or liability to be measured, which will affect measurement.
- The valuation premise; i.e. whether the valuation is on a stand alone basis or through use in combination with other assets and liabilities.
- What is the appropriate market; i.e.:
  - Principal market
  - Most advantageous market
  - Wholesale vs Retail market.
- Fair value hierarchy, based on inputs.

The discussion is not balanced or fair

First, we believe that the discussion in the CP is not balanced or fair as deprival value is overemphasised. Conversely, the discussion of market value / fair value is very brief, even though it is the more widely accepted valuation methodology, and is materially no different from deprival value (refer Specific Matter for Comment 2). We do not accept that the discussion on deprival value needs more emphasis simply because it is not so well known.

Second, the discussion of deprival value is more an argument of why deprival value is better that the other approaches. It argues and concludes in the first three paragraphs that:

- deprival value is well established in the academic literature (para 5.1)
- deprival value "provides a rationale by which a specific basis may be selected as the most relevant in specific circumstances" (para 5.2) and
- deprival value "ensures that appropriate consideration is given to all the qualitative characteristics and the need to obtain an appropriate balance between them" (para 5.3).

Although the same benefits could equally be argued for fair value, in contrast, the discussion of market value / fair value briefly states that "in an ideal context, market value possesses all of the qualitative characteristics" (para 3.5). The majority of the balance of the brief three pages then questions the usefulness of market value in other than the ideal situation, including more than one page explicitly articulating its limitations. Conversely, the 10 page discussion of deprival value did not address or contemplate any of its limitations.

Instead, we believe that the CP should provide a balanced and fair comparison, including an equivalent evaluation of fair value / market value and other bases.

For illustration, the following approach to determining the appropriate financial reporting valuation method was proposed by Chambers in *'Accounting, Evaluation and Economic Behaviour'* (1966)). He asked the following questions:

- What property is to be measured; e.g. monetary measures based on present selling (exit) prices.
- What is the concept of capital, which he termed 'capital maintenance'
- What should be allowed in real world circumstances where the desired measurement basis cannot be reliably applied?

Chambers then argued that all measurements are only approximations; i.e. which, although suggesting an ideal, then accepts surrogates.

Third, we are concerned that the terminology used in the CP is confusing, as it uses concepts that are not mutually exclusive and mixes measurement bases, features and valuation techniques. The resulting conclusions make the CP neither fair nor balanced. For example:

- Market value (as used in Valuation Standards) is confused with fair value (as used in Accounting Standards).
- Valuation techniques (e.g. replacement cost) are confused with measurement bases (e.g. market value).
- Replacement cost is not necessarily an entity specific measure; i.e. DRC is a measure of fair value under Accounting Standards.
- Replacement cost is a subset of market value / fair value; i.e. replacement cost and market value are not mutually exclusive.
- Deprival value is not a measurement base; rather it is an approach to choose the measurement base.
- The CP refers to the IVSC definition of 'market value' but does not refer to the IFRS 13 definition of 'fair value'.

Fourth, the line of argument in the CP is not balanced as it refers to consistency with Government Finance Statistics (GFS), but does not consider consistency with IASB. No rationale is given as to why GFS is an important consideration in the Framework; nor why the IASB Framework is not. The IPSASB Framework presumably will apply at the whole of government level, sector level, and individual entity level. However, as a macro-economic concept, GFS does not apply at the microeconomic level i.e. the entity level.

Specific matter for Comment 4

In your view, should:

(a) The effect of an entity's own credit risk be reflected in the measurement of liabilities at initial recognition; and
(b) The effect of changes in own credit risk be reflected when liabilities are subsequently remeasured.

NSW Treasury believes in principle that, where measurement is based on current values, it is appropriate to include own credit risk, both initially and subsequently. However, where the measurement is not based on current values then it is not appropriate to adjust for own credit risk.

However, this requires clarification as to what is regarded as a current value for a liability and when is it appropriate for it to be used. For example, it may not be possible or appropriate to measure the current value (or 'assumption price') of a liability where:

- the highest and best use is to settle rather than transfer the liability or
- there are no market participants.

In such cases, the settlement or cost of fulfilment may be appropriate; i.e. an entity specific measure which makes no reference to market variables such as profit margins or credit risk.

Specific matter for comment 5

In your view, where assets are not restricted in use and therefore may be sold for an alternative use, should the measurement reported in the statement of financial position reflect:

(a) Only the service potential relating to the existing use; or
(b) Include the incremental value relating to its possible sale for an alternative use?

NSW Treasury supports the approach adopted in IFRS 13 based on the concept of 'highest and best use'. That is, current value or fair value is based on the highest and best use; i.e. the use of the asset that is physically possible, legally permissible and financially feasible. This principle is established in accounting standard literature, valuation profession literature and academic literature.

Highest and best use is more consistent with para (b) above (i.e. incremental value relating to possible sale for an alternative use), except that we believe it is more appropriate to reflect the value for the highest and best use as one value, rather than, as para (b) implies, based on two measures, the existing use value plus the incremental for an alternative use. We also note that, the IASB, in issuing IFRS 13, has moved away from the concept of an incremental value, which was originally proposed in their fair value Exposure Draft (ED, para 20 and 21).

APPENDIX 1

EXTRACT OF NSW TREASURY POLICY PAPER TPP 07-1
VALUATION OF PHYSICAL NON-CURRENT ASSETS AT FAIR VALUE

Comparison of fair value and deprival value

This Appendix compares fair value and deprival value. In the past, deprival value has been adopted by some Public Trading Enterprises, following the *Guidelines on Accounting Policy for Valuation of Assets of Government Trading Enterprises* (October 1994). That document adopted the guidance provided in Statement of Accounting Practice SAP 1 *Current Cost Accounting* regarding measuring replacement cost. This Policy and its pre- AEIFRS predecessor (TPP03-02) require entities to value certain physical non-current assets at replacement cost, effectively also using the guidance provided in SAP 1 *Current Cost Accounting*.

This Appendix notes the major differences between fair value in AASB 116, subject to AASB 136 and deprival value and assesses the practical implications of moving to fair value under this Policy.

Two major differences exist between fair value and deprival value:

- Theoretical difference between fair value and deprival value concepts.
- The use of market value in AASB 116 compared to the use of both market value and net market value in certain circumstances under deprival value.

These two differences are briefly discussed below.

1. Theoretical difference between fair value and deprival value

Fair value is based on market evidence - a willing buyer and seller. In effect, this is the 'exit' or selling price. The best available market evidence is used, but where current market prices cannot be observed, fair value in AASB 116 is measured at depreciated replacement cost, which is a market buying or entry price.

Deprival value is measured by reference to the loss suffered by an entity on being deprived of an asset (an entry price). The valuation is then determined depending on whether the entity would or would not replace the asset. In this sense, it is based on rational management intentions.

The difference between fair value and deprival value is the difference between selling price and buying price. However, where current market prices can be observed for the same or similar asset, market selling price and buying price will be approximately equal.

Conversely, where current market prices cannot be observed, market selling price and market buying price may differ significantly. Most proponents of exit market price allow market buying price to be used as a surrogate for market selling price. In this circumstance, AASB 116 and this Policy require fair value to be measured at depreciated replacement cost, which is a market buying price. AASB 116 does not acknowledge that market buying price is being used as a surrogate for selling price. It acknowledges, however, that this is the best available evidence of fair value where market (selling) prices cannot be observed (AASB 116, para 33).

2. Market value versus net market value

Deprival value requires surplus assets (i.e. assets held for sale without replacement) to be valued at net market value. In these circumstances, fair value (per AASB 116) and deprival value would differ by the incremental costs directly attributable to selling the asset.

This difference is largely eliminated by the operation of either AASB 5 *Non-current Assets Held for Sale and Discontinued Operations* or AASB 136 *Impairment of Assets*, as follows.

- "Surplus assets" that meet the definition of "held for sale" in AASB 5 must be valued at the lower of its carrying amount and fair value *less costs to sell.*

- "Surplus assets" that do not meet the AASB 5 "held for sale" definition are subject to the recoverable amount test in AASB 136. The *recoverable amount* is defined as the higher of *net* fair value (i.e. fair value *less costs to sell*) and value in use.

3. Conclusion

NSW Treasury's conclusion from the above brief analysis is that there are no material practical differences between fair value and deprival value.