APV Valuers & Asset Management

Comments on

IPSASB Conceptual Framework Exposure Draft 3

"Measurement of Assets and Liabilities in Financial Statements"

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INTRODUCTORY COMMENTS

It is with great concern that I provide the following feedback on the IPSASB Exposure Draft 3 covering the measurement of assets and liabilities.

I have over 25 years experience specialising in the valuation and depreciation of public sector assets using current replacement techniques. This included both as an auditor and as a valuer. In my early career this included implementation of the Deprival Value method across 125 local governments and numerous state government agencies.

While the Deprival method was useful in assisting agencies identify and place some initial values on their portfolios it quickly became evident that it had a number of major flaws. As a result the method was withdrawn and replaced with Fair Value and is consistent with Fair Value currently defined under the IFRS. Since that time it has been successfully employed and well understood.

My deep concern is sourced from the IPSASB view to effectively discount Fair Value as an appropriate method to value operational assets (despite a range of international jurisdictions successfully achieving this for many years and previous commentators recommending it) with a predisposition to push the UK version of Deprival Value which attempts to provide a value for a hypothetical asset and therefore is open to extreme manipulation.

I believe the IPSASB has a responsibility to purse a path of harmonisation with the IFRS. Given that jurisdictions such as Australia have proven the robustness and objectivity of the Fair Value method for specialised public sector assets the IPSASB should be pursuing consistence with the IFRS.

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SPECIFIC MATTERS FOR COMMENT

Do you think that the selection of a measurement basis should be based on the extent to which a particular measurement basis meets the objective of financial reporting?

Yes

The objectives should be the same as for all users of general purpose financial statements, irrespective of whether the entity is a public sector entity or private sector entity. The following extracts are taken from Statement of Accounting Concept SAC2 and should be applied to the IPSAS just as they are applied to IFRS.

The objective is to provide information to users that is useful for making and evaluating decisions about the allocation of scarce resources.

When general purpose financial reports meet this objective they will also be the means by which managements and governing bodies discharge their accountability to the users of the reports.

The provision of information for accountability purposes is an important function of the process of general purpose financial reporting, particularly in relation to public sector entities and non-business entities in the private sector. However, the rendering of accountability by reporting entities through general purpose financial reporting is encompassed by the broader objective of providing information useful for making and evaluating decisions about the allocation of scarce resources, since users will ultimately require the information for resource allocation decisions.

General purpose financial reporting focuses on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs. These users must rely on the information communicated to them by the reporting entity.

Financial reports, comprising financial statements, notes, supplementary schedules and explanatory material intended to be read with the financial statements, are the principal means of communicating financial information about a reporting entity to users.

General purpose financial reporting also provides a mechanism to enable managements and governing bodies to discharge their accountability. Managements and governing bodies are accountable to those who provide resources to the entity for planning and controlling the operations of the entity. In a broader sense, because of the influence reporting entities exert on members of the community at both the microeconomic and macroeconomic levels, they are accountable to the public at large. General purpose financial reporting provides a means by which this responsibility can be discharged.

While business entities seek to earn profits or desired rates of return and non-business entities pursue primarily non-financial objectives, both types of entities provide goods and services to the community and use scarce resources in the process; both obtain these resources from external sources and are accountable to the providers of the resources or their

representatives; both control stocks of resources; both incur obligations; and both must be financially viable to meet their operating objectives.

Do you agree with the current value measurement bases for assets that have been identified in Section 3?

No

The Fair Value basis as defined in IFRS13 Fair Value Measurement should be specifically included. Currently it is partly included under the Market Value approaches and noted in section 4 as being an appropriate basis.

Inclusion would ensure consistency and harmonisation across the IFRS and IPSASB.
The Deprival Value method (Replacement Cost, Net Selling Price and Value in Use) as applied under this ED should be removed. They are inconsistent with much of the wording with the ED as well as the IFRS and International Valuation Standards.

It should also be noted that the explanation and definition of Replacement Cost is inconsistent with Replacement Cost under the IFRS and International Valuation Standards.

The concepts embodied within Net Selling Price and Value in Use are appropriately covered in IFRS standards (such as IAS36 and IAS16) and therefore for consistency and harmonisation the measurement basis should be identical to the IFRS).

Do you agree with the approaches proposed in section 4 for application of the Fair Value measurement model to estimate the price at which a transaction to sell an asset would take place in an active, open and orderly market at the measurement date under current market conditions

Yes.

However this basis should also extended to all assets.

Do you agree with the approaches proposed in section 4 for application of the deprival value model to select or confirm the use of a current measurement basis for operational assets.

No.

This document provides a range of reasons why the deprival method as explained (UK version of Deprival) should not be used. These are disccsed in the major issues section of this paper and include –

- Difference between UK and other versions of Deprival Value
- Inability to reliably measure Depreciation Expense under Deprival Method
- Complexity and Inefficiency of Proposed Approach
- Inconsistency of Results and open to manipulation

DETAILED COMMENTS

Para	Comments
1.1	The ED notes that it does not consider application to GPFS. This is of particular concern. The approach recommended by the ED is contrary to the IFRS and as a result it raises serious concerns over the motivation of the IPSASB to pursue a path contrary to that which the accounting profession has been trying to achieve for many years through the international harmonisation process. The reality is that many public sector entities are required to have their financial results consolidated into Whole of Government accounts which are required to be prepared under the IFRS. Some of these entities are commercial or for-profit entities and due to various jurisdictional legislation are compelled to prepare their financial statements in accordance with the IFRS. The existing measurement basis under the IPSASB are consistent with the IFRS and in some jurisdictions (such as Australia) the IFRS standards have been successfully enhanced to take into account the special circumstances of the public sector. This has ensured consistency with the IFRS and the existing IPSAS. Any attempt to require entities value assets and liabilities using methods which are contradictory with the IFRS will only result in significant additional duplication of effort, inefficiency and ultimately confusion by those who use the financial statement prepared by the public sector entity. As the impact of this ED is far reaching it is essential that the valuation basis be retained to ensure consistency with the IFRS.
1.2	This paragraph notes that the measurement basis is also important due to its impact in other financial statements. This of course includes depreciation expense which is charged as an expense in the Statement of Financial Performance. However the ED deals solely with the valuation measurement basis and does not appropriately analyse the resulting impact (or practicalities associated with a change in measurement basis) on the other statements. The ED only deals at a theoretical level without any discussion given to how depreciation expense would be measured or calculated. In practice the Deprival Value is open to manipulation and the results cannot be supported by sufficient and appropriate audit evidence. Given the risks and practicalities the ED should recommend the use of Fair Value only. Further discussion on this is covered later in this document under “Major Issues”.

1.3	This paragraph notes a range of aspects important to decision makers using the financial statements. One of these is the "cost of services provided in the period". However the he recommendation to adopt the UK version of Deprival Value however does not result in the calculation of an accurate measure of depreciation expense and as a result will not satisfy this need. By definition the deprival method measures a theoretical scenario which would only exist if the entity was completely efficient rather than measuring the actual assets it controls and actual value of service potential consumed during the year. Further discussion on this is covered later in this document under "Major Issues".
1.4	This paragraph notes a range of qualitative characteristics which are important. However the proposal to adopt the UK version of Deprival Version does not provide faithful representation, understandability, comparability or verifiability. The primary reason for this is that he UK version of Deprival Value does not measure the service potential embodied in the existing asset but instead measures what it would be given a theoretical scenario. For example I may have an asset at replacement cost of $1 million, costs $50,000 to maintain annually and its depreciation expense is estimated at $25,000. However under the proposed UK version of Deprival Value it could be argued that the asset is much larger than needed or would be built in a different location or even design. As a consequence the theoretical asset is valued at $200,000 with a resulting depreciation expense of $5,000. In reality both the value and depreciation expense figures are purely theoretical and do not reflect reality. As a consequence they do not satisfy the qualitative characteristics as stated. Further discussion on this is covered later in this document under "Major Issues".
1.5	This paragraph is under the heading of entry and exit values but simply concludes that many public sector assets are specialised. It does not make any real point. The issue of the appropriateness of exit values has recently been covered in IFRS13 Fair Value Measurement where the statement is quite clearly made that in any efficient market the purchase price (entry price) by definition will always equal the sales price (exit value). IFRS13 further states that for specialised public sector asset the replacement cost is the appropriate method to determine the exit price. To ensure consistency and harmonisation of the accounting standards as well as efficiency in consolidation the adoption of the 'exit price' should be adopted as per IFRS13.

1.7	The paragraph states that it does not prescribe a single or combination of measurement basis. This is a misrepresentation. In reality the ED proposes the adoption Fair Value (where there is an active market) of the UK version of Deprival Value (which is quite complex and requires the determination of three different values) for operational assets while ignoring Fair Value. The UK version of Deprival is also significantly different in approach to other versions of Deprival Value. While section 4 proposes two approaches (Fair Value or UK version of Deprival) the associated discussion in section 3 (and table 1) indicate that Fair Value should only be used to determine Market Value. This is inconsistent. Fair Value has been successfully used in a range of international public sector jurisdictions for any years and the public comments provided in the development of this ED were very supportive of Fair Value. Deprival Value was also used initially in some of these jurisdictions but was quickly dropped in favour of Fair Value because it had inherent problems. The non-inclusion of Fair Value suggests a bias by the IPSASB towards a particular approach and raises concerns regarding the over-riding motivation to adopt the UK version of deprival. For example – • Is it to maintain the status of IPSASB and the need to continually create their own unique accounting standards rather than simply enhance the existing IFRS standards which has been successfully dome in a range of jurisdictions? • Is it to ensure asset values are kept artificially low to minimise the amount of tax paid by local government entities to central government?
2.5	I agree that the financial statements should reflect the current cost of both the asset value and its associated depreciation expense and as a result for material public sector assets the use of current cost is preferred. However the paragraph can be interpreted as confusing the concept of depreciation and the *future cost of providing services*. Depreciation expense is recorded in the Statement of Financial Performance to record an estimate of the loss of service potential or reduction on the value of the asset due to consumption. Assuming an asset's service potential is consumed in a constant pattern over a 50 year period the rate of depreciation should be 2% per annum. However his is very different from the *future cost of providing services.* These are the asset lifecycle costs which include the cost of acquisition, operation, maintenance, renewal and disposal. None of these figures are repeoted in the financial statements and depreciation expense is not a defacto measure of the future funding needs. The *future cost of providing services* should be determined from the entity's asset management plan.

2.7	This paragraph argues that historical cost does not provide any useful information on the financial capacity of an organisation. I would agree. However this paragraph focusses on the value of assets in order to be used as collateral in obtaining borrowings. This context is inappropriate for the public sector and is based on a traditional commercial scenario of needing assets that can be sold to pay back loans. In the public sector the nature of the assets held are not of a type that can be sold and entities usually are either funded by appropriation or grants or have the legislative ability to raise revenue through rates, taxes or fees and charges. The financial capacity of public sector entities is more about the ability of the entity to continue to operate and maintain its asset base so as to continue to provide the appropriate level of services to the community. Commonly this is referred to as Financial Sustainability and is often assessed using a range of KPIs. While historical cost does not provide any useful information neither does the Deprival Value proposed by the ED. This is because the UK version of Deprival Value is based on a theoretical scenario rather than what actual exists. The most appropriate basis to provide reliable estimates of the value of remaining service potential and the rate of consumption of that service potential is the Fair Value basis.

3.1 & 3.2	This section deals with different basis and categorises them into whether they are an entry/exit price and whether or not they are supported by observable market evidence. As previously noted the table and discussion only focusses on Fair Value where the valuation approach is the market approach and the UK version of Deprival for all operational assets. The table should be enhanced to include a heading for Fair Value methods (including market, income and cost approach per IFRS13) and UK Deprival method (for replacement cost, net selling price and value in use). (Assuming of course that the UK version of Deprival remains a valid alternative) However no differentiation is provided between Replacement Cost (per UK Deprival method) and Replacement Cost (per Fair Value). These are fundamentally different and when calculated result in materially different results. The table should be updated to reflect the difference in approaches between UK version of Deprival and Fair Value. This is covered in more detail in the "Major Issues" section. IFRS13 clearly determines that the Cost Approach (based on the Replacement Cost) used to determine Fair Value is an 'exit price'. This is contradictory to Table 1. Under the UK version of Deprival Value the Replacement Cost represents what the specific entity would need to pay to acquire an asset that delivers the same service (different form same level of service potential) in the most efficient location or based on better design. This represents an 'entry' price for the specific entity. However under IFRS13 the Replacement Cost is based on the highest and best use that market participants would be prepared to pay and takes into account the entire service potential embodied within the asset. As a consequence it represents an 'exit' price and is a market price.
3.3	To ensure international harmonisation of the accounting standards and to ensure the general purpose users are not confused with different definitions the definition of Market Value should be updated to be consistent with the IFRS13 definition of Fair Value. The definition used is the same as the old definition of Fair Value (under both IFRS and IPSAS). The Market Value as defined should result in the same value as the market approach under IFRS13.

3.5	This paragraph states that "in practice few, if any, markets fully exhibit all of these characteristics, but some may approach this description". This is incorrect and I would suggest deliberately used as an argument against valuing specialised assets using market evidence. The public sector is responsible for the acquisition and renewal of billions of dollars of infrastructure assets. These are procured via a range of processes which include quotation and open tender process. There are a vast array of suppliers willing to supply services/assets and there is a high frequency of transactions. As a consequence there is considerable observable market evidence of key assumptions that could be used to determine the value of specialised public sector assets.
3.8	A statement is made that "exit based prices …. Are unlikely to be useful for many operational assets". It further tries to argue that the value of operational assets may be greater than its purchase price. Both statements are of great concern. No argument or evidence is provided to support these assertions which I argue is grossly incorrect. It should be noted that a range of jurisdictions the 'exit' price model (per IFRS13 and existing IPSAS17) has been used successfully to determine the value of operational assets. Is the IPSASB saying that the IFRS and jurisdictions that apply Fair Value have got it wrong? Even if the value to the entity may be theoretically more than what it costs to acquire the asset such service potential cannot be reliably measured. The true determinant of value is what a market participant is willing to pay for an asset given its highest and best use. This coincidentally is the definition of Fair Value and is another reason why the valuation basis should remain as Fair Value.
Footnote 3	This ED seems to have a preference for using "for-profit" arguments and terms despite the IPSAS relating to the public sector which by definition is "not-for-profit". This footnote quotes a definition specifically designed for "for-profit" entities and does not consider what is an "open, active and orderly market" for the public sector. It could be argues that in the public sector there is always evidence of the market value for most assets. The recently issued ED by the IVSC specifically states that market value equals the Fair Value. It does not makes sense to try and value some assets as non-entity specific (market value) and others as entity specific (deprival). Such an approach is inconsistent with the IFRS as well as the International Valuation Standards. This continues to raise concerns over the motivations of the IPSASB to propose a change to Deprival Value rather than maintaining consistency with the existing IPSAS, IFRS and IVSC.

3.10	This paragraph focusses on the "profit motive" rather than acknowledging the role the public sector plays in being responsible for the provision of services. Why the focus on private sector profit motive rather than the public sector environment? This paragraph fails to acknowledge that the general public also have a right to understand the size and value of assets controlled by the public sector (using their public monies) and whether the relative wealth of those assets has increased or decreased in value. Previous paragraphs have already highlighted the importance of adjusting prices to reflect current values. Therefore it makes sense that the public should be provided with accountability around what those values are.
3.11	This paragraph highlights the confusion between the concept of depreciation (measures the value of consumption of the service potential) and the cost to provide the service (lifecycle costs). The pricing decision has nothing to do with depreciation. To ensure intergenerational equity the pricing decisions should be based on the actual lifecycle costs to deliver the service. With good asset management planning and frameworks the cost to deliver those services will be lower than if the asset management planning was poor. Hence the pricing should be based on the actual costs to deliver the service. Depreciation on the other hand measures the value of the loss of service potential consumed through usage. This figure is significantly different than the average annualised cost calculated from asset management plans.
3.12	Once again this paragraph is base around the commercial environment of "for-profit" entities rather than the not-for-profit environment of the public sector. The focus is one how much the entity could realise from a sale. Based on this it argues that users of the financial statements have no use of information about changes in revenues and expenses related to changes in market value. I strongly disagree with this assertion. No argument is put forward for such an assertion and this no doubt is linked to the pre-occupation with trying to apply commercial for-profit concepts to the not-for-profit public sector. In simple terms the difference between the assets and liabilities of a public sector entity represent the net wealth of the community's assets (community equity). Various jurisdictions around the world have previously adopted Fair Value as the measurement basis and report via reports to parliament on a range of KPIs using the financial statements. The resulting net surplus/deficit and movements in the community equity are an essential element to understanding whether a government entity's net wealth has increased or decreased and the rate at which the service potential of the assets is being consumed.

3.13	The paragraph makes the statement that "if exit-based market values are significantly lower than historical cost market value is likely to be less relevant than historical cost". No argument is provided to support this assertion. If there is significant movement in the market value of assets resulting in a significant reduction below the historical cost: the financial statements should reflect the loss of value as the community deserves full accountability. Did the loss result from poor procurement and paying over-priced acquisition costs? Has there been a change in the market or technology resulting in changes to how services are to be delivered? The financial statement disclosures should address these issues if material and the Fair Value basis of measurement will take them into account.
3.16	The section states that "exit based values are only likely to be relevant to assessments of financial capacity and not to assessments of the cost of services and operational capacity" This statement reeks of a predisposition to cash accounting rather than accrual accounting. To preserve intergenerational equity it is important that each generation pays its fair share. This includes funding the cost of acquisition, operations, maintenance, renewal and disposal. It is important that current cost be used to determine the true cost of providing the service. Previous paragraphs have highlighted the inability of historical cost to provide meaningful information. Many public sector assets are different to private sector assets purely because of their function and the need to maintain their capability through renewal for many generations. These are commonly referred to as cyclical maintenance assets. Due to the changing price of money over time the cost to upgrade, renew or even maintain these assets may be far greater than the historical cost of the original acquisition. Form an accountability perspective, if the current cost of an asset has increased significantly it is important that the depreciation expense figure also be reported using values based on market evidence.

3.17	The definition of replacement cost should be replaced with that used by the IFRS to ensure harmonisation and reduce confusion among users of financial statements. This definition of Replacement Cost provided by the ED is *The most economic cost required for the entity to replace the service potential of an asset (including the amount an entity would receive from its disposal at the end of its useful life) at the reporting date".* This definition is sometimes referred to as the "UK version of Deprival" as it is significantly different to that provided under the IFRS and specifically excludes from the valuation some aspects of the full service potential of the asset. It is also different to the pure definition of deprival value and that used in Australia in the 1990's. *Deprival value is based on the premise that the value of an asset is equivalent to the loss that the owner of an asset would sustain if deprived of that asset. (wiki)* *Deprival value is described as the cost to an entity if it were deprived of an asset and was required to continue to provide goods and service or deliver programs using that asset.(1994 GUIDELINES ON ACCOUNTING POLICY FOR VALUATION OF ASSETS OF GOVERNMENT TRADING ENTERPRISES)* The biggest differences in definition are that the UK version only places value on that part of the service potential used by the entity and assumes the asset is designed, constructed, located and operated in the most economically way. As a consequence it excludes any service potential (in excess of that used to deliver services) that would be lost to the entity if it were deprived of it. To demonstrate – Assume the entity controlled land in the middle of a CBD but only used it for tennis courts. Under the UK version of deprival value the replacement cost may be based on locating the tennis courts in a less valuable area of the City and hence the value would be much lower than what other market particpants would be prepared to pay for the actual site they are located. Under the IFRS and other definitions of deprival the replacement cost would be based on the highest and best use of the actual site and what potential market particpants would be prepared to pay. In this case they might be prepared to pay $1 million whereas under the UK deprival approach the value may only be reported as $100,000. In reality , if the entity were deprived of the asset, there true loss would be $ 1 million not a theoretical $100,000.

3.18 (b)	The statement about replacement cost (in the public sector context) being an entry value is incorrect. This is only the case when you adopt the narrow UK version of deprival. Under all other deprival methods and Fair Value the replacement cost is an 'exit' price. Both the IVSC and IFRS clearly indicate that the replacement cost in the public sector context is an 'exit' price.
3.20	The first sentence indicates that the replacement cost is the cost of replacing an asset's service potential. However, as noted under 3.17, the definition used under the UK version of deprival does not do this. The ED explicitly excludes some aspects of the service potential. This statement would however be true for assets valued at Fair Value under IFRS or the other versions of Deprival. This suggest the authors of the ED are confused themselves about what is being proposed.
3.21	This paragraph provides an insight into the way in which the recommended approach can be manipulated in order to achieve a desired result for financial reporting. Rather than deal with the actual asset in existence it provides the entity with an opportunity to create a theoretical scenario which suits their purpose. Hence the valuation becomes increasingly more subjective and does not provide the reader with an understanding of the actual service potential embodied within the assets. This example demonstrates that the proposed approach • does not take into account the residual service potential that is also available to the entity. For example the sale of excess land or buildings or income that might be produced from alternative use of the excess buildings. • Creates a total disjoint between the actual asset that exists and what the future asset management requirements and funding needs might be. In reality the school might include 10 buildings that need to be maintained but the valuation and associated depreciation is based on only 3 or 4 buildings of completely different design. • Provides no accountability to the community and is open to manipulation • Provides no mechanism (due to the theoretical nature of asset swhich do not exist and cannot be inspected) to enable the objective measure of depreciation expense. If you can't see a building (because it does not exist) how can you objectively measure the level of remaining service potential (Replacement Cost less accumulated depreciation) and the amount of depreciation expense?

3.22	Again the concept of what replacement cost measures is inconsistent with the definition and example provided in 3.21. This paragraph states that it reflects "all (and only) the service potential that the asset embodies is reflected in the recognised amount". This is untrue. The example and definition clearly indicates that it excludes an service potential not required by the entity to deliver the specific service in the most economical way. If the objective of the exercise is to measure "all" of the service potential embodied in the asset it would be better to adopt the IFRS definition of replacement cost. As accounting setters it is inconceivable that the IASB and IPSASB would puit out different definitions of Replacement Cost.
3.24	This is an argument as to why Replacement Cost under IFRS should be used as the basis for depreciation. By using the UK version of Deprival the depreciation is based on only part of the service potential of the asset and therefore does not represent to true value of service potential consumed.
3.29	Once again this demonstrates a narrow focus based on a commercial operation. In the case of public sector entities the financial capacity is NOT based on the ability to sell assets to meet future needs. It is about the ability to continue to provide services taking into account the cost to provide the services (asset lifecycle costs – acquisition, operation, maintenance, renewal and disposal) and the potential sources of revenue to fund the delivery of the services. Depreciation measures the estimated loss of service potential consumed over the year and accordingly should be based on the full service potential of the asset valued at current cost (per IFRS) not based on a theoretical efficient scenario that only takes into account the currently used portion of the asset's service potential (UK version of deprival).
4.9	The wording of this paragraph is inconsistent with the definition of replacement cost. This paragraph supports the normal view of replacement cost under IFRS and other deprival models that the replacement cost reflects the loss the entity would sustain if it were deprived of the asset. The definition used in this ED is the UK version of Deprival which specifically excludes the service potential that exists in the asset but is not currently being used by the agency.

MAJOR ISSUES

Difference between UK and other versions of Deprival Value

Throughout the ED there are a range of inconsistencies which highlight the differences between Deprival Value (as applied in the UK) and Deprival Value (elsewhere).

The fundamental difference is that the UK versions (as proposed by the ED) only values the service potential embodied in the asset that is being currently used by the entity and then adjusts it to assume the operation is as economically efficient as possible. As a result it does not report on the actual asset in existence but on a theoretical scenario that might never exist.

In comparison the traditional views of Deprival and Fair Value under the IFRS are consistent that the Replacement Cost represents the full service potential embodies within the asset – even if it is not be utilised efficiently by the agency. The value can be determined by considering the highest and best use that market participants would be prepared to pay to acquire that asset's service potential.
The following example has been developed to demonstrate the differences in approach.

Assumptions

Asset is a school located in CBD environment.
Originally constructed 100 years ago on land which was then on edge of town.

		Replacement Cost	WDV
Current Actual Assets			
Land	10 hectares	3,000,000	
Buldings	500 students capacity	12,000,000	7,000,000
		15,000,000	7,000,000
Optimise theoretical scenario		on same site	different site
Land	2 hectares	600,000	500,000
Buldings	100 students capacity	2,400,000	2,400,000
		3,000,000	2,900,000
Net selling price		7,000,000	

Fair Value under the IFRS would be determined as follows –

Fair Value

Land is based on the Market Value or Replacement Cost of the existing land	3,000,000
While the school only requires 50% of the space the still use all buildings which provides for greater space and the ability to use spaces for specific purposes. Likewise, because it is in a CBD environment, the rooms are used by a range of community groups.	
Based on modern equivalent construction the GRC was	12,000,000
After assesing condition and allowing for depreciation the DRC was	7,000,000

However under the Deprival Method there are three alternative methods to use. Each depends on the definition of what constitutes the Replacement Cost (all or part service potential) and whether or not optimisation is applied on a gradual incremental basis or based on a purely theoretical fully optimised scenario. The steps involve the determination of Replacement Cost, Value in Use and Net Selling Price. This example also demonstrates the additional complexity and effort required to determine the Deprival Value.

Replacement Cost

If value all the service pontential in the asset the Replacement Cost will be same as per Fair Value. In this case if the entity was deprived of the land it would lose the full market value of the land that other market particpants would be prepared to pay. This is an opportunity cost representing potential lost future revenue.

However, if optimsed to what the entity would require to continue operations the size of land and number of buildings would reduce. This excludes the service potential embodied in the asset that is not needed for operational purposes.

	If replaced ALL service potential	If replaced with only what is needed
Land	3,000,000	600,000
Buildings		
Replacement Cost	12,000,000	2,400,000
Depreciated Replacement Cost (assume same apportionment)	7,000,000	1,400,000

Value in Use

The most efficient way to operate the school would be to have built it on the outskirts of town on much cheaper land. This excludes the service potential existing in the asset that would not be required by the entity if it could build a theoretical facility in a new location

	If moved to a different site
Land	500,000
Buildings	
Replacement Cost	2,400,000
Depreciated Replacement Cost	1,400,000

Net Selling Price

This is based on analysis of what others may pay for the assets for alternative uses.
As the land is in a prime CBD site other users may be prepared to pay significant funds to redevelop the site for residential, retail or other commercial uses.
This may include keep the existing buildings and either using for commercial purposes or re-fitting as inner CBD residential and retail.

The following Net Selling Prices (after allowing cost of conversion) have been determined by a valuer.

	Net Selling Price
Land	3,000,000
Building (balance of sales price)	4,000,000
	7,000,000

Determining the Deprival Value.

The following provides three different interpretations of the calculation of Deprival Value and compares them to what Fair Value would be calculated as under IFRS.

LAND

	If replaced ALL service potential	If replaced with only what is needed	If moved to a different site
Relisable Value (higher of)			
Value in Use	3,000,000	600,000	500,000
Net Selling Price	3,000,000	3,000,000	3,000,000
	3,000,000	3,000,000	3,000,000
Replacement Cost	3,000,000	600,000	500,000
Deprival	3,000,000	600,000	500,000
Fair Value	3,000,000	3,000,000	3,000,000
Service Potential not recognised	-	2,400,000	2,500,000

BUILDING

	If replaced ALL service potential	If replaced with only what is needed	If moved to a different site
Relisable Value (higher of)			
Value in Use	7,000,000	1,400,000	1,400,000
Net Selling Price	4,000,000	4,000,000	4,000,000
	7,000,000	4,000,000	4,000,000
Replacement Cost	7,000,000	1,400,000	1,400,000
Deprival	7,000,000	1,400,000	1,400,000
Fair Value	7,000,000	7,000,000	7,000,000
Service Potential not recognised	-	5,600,000	5,600,000

The net result is a significant variation between the values depending upon the differences created between the actual asset and its scenario and the theoretical scenario created for the purposes of producing a Deprival Value.

The first scenario is the method applied in Australia in the 1990's whereas the other two scenarios are different example of the UK version of Deprival. This highlights the extreme risks associated with how the Deprival method can be manipulated to produce desired results for financial reporting, taxing or other purposes.

	If replaced ALL service potential	If replaced with only what is needed	If moved to a different site
TOTAL			
Fair Value	10,000,000	10,000,000	10,000,000
Deprival	10,000,000	2,000,000	1,900,000
Variance	-	8,000,000	8,100,000
	0.0%	-80.0%	-81.0%

Inability to reliably measure Depreciation Expense under Deprival Method

The determination of the value is only part of the asset accounting equation. Having determined the value an allowance must be made in the Statement of Financial Performance for Depreciation Expense.

Under Fair Value this is achieved by –

- Componentising the asset
- Determining the -
    - Replacement Cost
    - Residual Value
    - Asset Condition
    - Pattern of Consumption
    - Useful Life

As part of the audit process the auditor assesses the reasonableness of the methodology and obtains sufficient and appropriate evidence over key assumptions. This might include sighting evidence of costs and unit rates, reviewing the asset management plan to obtain reasonable assurance over residual values and useful life, sighting the valuers inspection notes and support for the pattern of consumption.

However, under the UK version of the Deprival method the assets being valued and depreciated may not physically exist as they have been created in a theoretical and hypothetical world. In reality there may be 10 buildings with each component in different condition and subject to different environmental or other factors.

Because the Deprival Value scenario is hypothetical there is no way for a valuer to physically inspect the assets or potential even try and create a link between what exists and the hypothetical scenario. If you are unable to assess condition (because it is a hypothetical building) the valuer cannot determine the level of consumed service potential nor devise a method to ascertain the rate of consumption of that service potential.

Likewise, because the asset does not physically exist and there is no evidence to support the depreciation assumptions, the auditor is unable to obtain sufficient and appropriate audit evidence. As with the example valuation, this highlights the extreme risk of adopting the UK version of Deprival and its ability to be easily manipulated to achieve desired results.

In order to ensure accountability and transparency the ED should only recommend robust and objectives methods (such as Fair Value) that have been repeatedly proven in the filed across a range of jurisdictions.

Complexity and Inefficiency of Proposed Approach

The example valuation highlights the additional steps and complexity of undertaking a valuation using the UK version of Deprival.

The steps to determine Deprival are all in addition to determining Fair Value under IFRS. It should also be noted that for insurance purposes the valuer will determine the replacement cost of the existing asset (as with Fair Value) prior to adding additional allowance for demolition, reconstruction costs, professional fees, etc.

Deprival requires taking the Fair Value replacement cost and then adjusting it further to eliminate any surplus service potential not currently required by the entity.

It then requires the determination of the Value in Use and Net Selling Price. Each may require extensive analysis and discussion on alternative design, location and operation.

Given that these steps are all in addition to the calculation of Fair Value it would be far more efficient and less costly to simply require all entities to value at Fair Value. In addition to be ing a less costly process it would also result in harmonisation with the IFRS and the ability for easy consolidation into Whole of Government Accounts.

Inconsistency of Results and open to manipulation

The results in the example valuation highlights the inconsistency of results and ability of entities to manipulate the results to suit their own purposes.

The process becomes extremely subjective, open to interpretation and very difficult for auditors to obtain sufficient and appropriate evidence.

As the purpose of the financial statements is to provide a mechanism for accountability it is important that the results reported by as objective as possible and the users can rely on the accuracy of the results as being a true and fair view of the performance of the entity.

The proposed Deprival Method does the opposite and raises concerns over the motivation for the IPSASB to recommend such an approach which is arguably designed for deliberate manipulation.