AASB Exposure Draft

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[Month] 2019

Amendments to Australian Accounting Standards – Fair Value Measurement of ~~Non-cash-generating~~ Non-Financial Assets of Not-for-Profit ~~Public Sector~~ Entities Held for their Service Capacity

Comments to the AASB by [date]

Australian Government
Australian Accounting Standards Board

[Draft] Accounting Standard AASB 20~~19~~20-X

The Australian Accounting Standards Board makes Accounting Standard AASB 2019-X *Amendments to Australian Accounting Standards – Fair Value Measurement of ~~Non-cash-generating~~ Non-Financial Assets of Not-for-Profit ~~Public Sector~~ Entities Held for their Service Capacity* under section 334 of the Corporations Act 2001.

Kris Peach

Chair – AASB

Dated … [date]

[Draft] Accounting Standard AASB 20~~19~~20-X
Amendments to Australian Accounting Standards – Fair Value Measurement of ~~Non-cash-generating~~ Non-Financial Assets of Not-for-Profit ~~Public Sector~~ Entities Held for their Service Capacity

Objective

1 This Standard amends AASB 13 *Fair Value Measurement* (August 2015) to add authoritative implementation guidance for application by not-for-profit ~~public sector~~ entities.

Application

2 The amendments set out in this Standard apply to entities and financial statements in accordance with the application of AASB 13 as set out in AASB 1057 *Application of Australian Accounting Standards* (as amended).

3 This Standard applies to annual periods beginning on or after [~~1 July 2020~~a date two years after the issue of the Standard]. This Standard may be applied to annual periods beginning before [~~1 July 2020~~date to be specified]. When an entity applies this Standard to such an annual period, it shall disclose that fact.

4 This Standard uses underlining, striking out and other typographical material to identify some of the amendments to a Standard, in order to make the amendments more understandable. However, the amendments made by this Standard do not include that underlining, striking out or other typographical material. Amended paragraphs are shown with deleted text struck through and new text underlined. Ellipses (…) are used to help provide the context within which amendments are made and also to indicate text that is not amended.

Amendments to AASB 13

5 Paragraphs Aus28.1 and Aus66.1~~–~~–Aus66.2 are added.

…

Application to non-financial assets

Highest and best use for non-financial assets

…

28 The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

(a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).

(b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).

(c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

Aus28.1 Notwithstanding paragraph 28~~(c)~~, ~~in respect of~~ the highest and best use of a non-financial asset of a not-for-profit entity does need not be 'financially feasible' (as described in paragraph 28(c)) if the asset~~s of not-for-profit public sector entities that are~~ is not held primarily for ~~their~~ its ability to generate net cash inflows~~, a use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates sufficient services to justify a not-for-profit public sector market participant buyer incurring the current replacement cost of that asset~~ and, in accordance with paragraph Aus66.1(b), is measured at its current replacement cost.

…

Valuation techniques

…

Aus66.1 Notwithstanding paragraphs 61–66, in respect of a non-financial asset of a not-for-profit ~~public sector~~ entit~~ies,~~y that is not held primarily for its ability to generate net cash inflows, if the asset has a legally restricted use or is subject to a legal restriction on the prices that may be charged for using it: ~~the cost approach shall be used to estimate the fair value of assets that are not held primarily for their ability to generate net cash inflows.~~

(a) if an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is measured at fair value based on the available market evidence for the equivalent restricted asset; and

(b) if an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is, subject to paragraph Aus66.2, measured at its current replacement cost. The asset's current replacement cost is determined consistently with paragraphs B8 – B9, without a discount to the current market buying price of an equivalent but unrestricted asset.

Aus66.2 If a not-for-profit entity lessee cannot measure reliably the current replacement cost of its right-of-use asset under a lease with significantly below-market terms and conditions principally to enable the entity to further its objectives, it measures that asset by discounting the contractual lease payments to their present value using a current market-determined rate of discount.

6 Appendix F *Australian implementation guidance for not-for-profit ~~public sector~~ entities* is added as set out on pages X-X.

7 *Australian illustrative examples for not-for-profit ~~public sector~~ entities* is attached to accompany AASB 13 as set out on pages X-X.

Amendments to AASB 116

8 Paragraph Aus31.1 is added.

Aus31.1 Notwithstanding paragraph 31, in respect of a non-financial asset of a not-for-profit entity that is not held primarily for its ability to generate net cash inflows (ie is held for its service capacity):

(a) if the asset has a legally restricted use or is subject to a legal restriction on the prices that may be charged for using it, and

(b) an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence,

the asset is measured at its current replacement cost.

9 Paragraph Aus37.1 is added.

Aus37.1 Notwithstanding paragraph 37, in respect of a not-for-profit entity, if assets of a similar nature and use in the entity's operations are revalued on a current replacement cost basis in accordance with paragraph Aus31.1, they are classified as a separate class of property, plant and equipment from similar assets revalued on a fair value basis in accordance with paragraph 31.

Commented [JP1]: Staff reviewed this paragraph in light of Board member comment that it was unclear, and concluded it was circular. Current replacement cost will reflect any shortfall in service capacity arising from the highest and best use of an asset, through the measurement of obsolescence. Therefore, staff recommend scoping restricted assets measured at current replacement cost out of the scope of the 'financially feasible use' aspect of an asset's highest and best use. The rationale for this draft proposal is set out in paragraphs BC48 – BC49 of the Basis for Conclusions.

Staff considered the possibility that this scope-out might be unnecessary because restricted assets measured at current replacement cost would not be warranted to be measured at their fair value. However, the draft ED contains a proposal to measure current replacement cost consistently with the cost approach in AASB 13. This might lead readers of the proposed Standard to think paragraph 28(c) of AASB 13 remains applicable to all current replacement cost measurements.

Question for Board members

Q5 Do Board members agree with staff's recommendation to scope restricted assets measured at current replacement cost out of the scope of the 'financially feasible use' aspect of an asset's highest and best use?

Commented [JP2]: The amended paragraph Aus66.1 is highlighted in paragraph 7 of the Cover Memo for this draft ED. Background to it is provided in paragraphs BC13 – BC31 of the Basis for Conclusions. Question 2 in the Cover Memo relates to the wording of paragraph Aus66.1 and paragraph BC28.

Commented [JP3]: This 'reliable measurement' criterion for measuring the current replacement cost of right-of-use assets is explained in paragraph BC95 of the Basis for Conclusions. The Questions for Board members on this criterion, and on how such assets are measured when the criterion is not met, are adjacent to paragraph BC95.

10 Paragraph 73(e)(iv) is amended as follows:

73(e)(iv) increases or decreases resulting from revaluations under paragraphs 31, **Aus31.1,** 39, Aus39.1, 40, Aus40.1 and Aus40.2 and from impairment losses …;

11 Paragraph Aus77.2 is added.

Aus77.2 In respect of a not-for-profit entity, if items of property, plant and equipment are revalued on a current replacement cost basis, the entity shall disclose information that helps users of its financial statements assess both of the following:

(a) the valuation techniques and inputs used to develop those measurements; and

(b) for measurements using significant unobservable inputs, the effect of the measurements on profit or loss or other comprehensive income for the period.

Commented [JP4]: Bolded to show the only text that will be underlined in the clean copy of the ED.

Commented [JP5]: This disclosure is proposed as the current replacement cost (CRC) equivalent of the fair value disclosures in AASB 13.91.

Question for Board members

Q6 Do you agree with these proposed disclosures about CRC measurements?

Commencement of the legislative instrument

~~8~~12 For legal purposes, this legislative instrument commences on … [date].

APPENDIX C

TRANSITION

This appendix is an integral part of the [draft] Standard and has the same authority as other parts of the [draft] Standard. The appendix applies only to not-for-profit entities.

AusC1 For the purposes of the transition requirements in paragraphs AusC2 – AusC6, the date of initial application is the start of the reporting period in which an entity first applies this [draft] Standard.

AusC2 An entity shall apply this [draft] Standard retrospectively with the cumulative effect of initially applying this [draft] Standard recognised at the date of initial application, in accordance with paragraphs AusC4 – AusC6, subject to paragraph AusC3.

AusC3 An entity may elect to apply this [draft] Standard, with retrospective effect (subject to paragraph AusC4), progressively over a three-year period from the date of its initial application.

AusC4 For each reporting period in which this [draft] Standard is initially applied or, in accordance with paragraph AusC3, progressively applied, the entity is not required to restate the comparative amounts for any prior periods presented in respect of the affected assets.

AusC5 The entity shall recognise the cumulative effect of initially applying this [draft] Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application. Where an entity elects to apply the treatment in paragraph AusC3, this adjustment is made as at the beginning of each affected period during the progressive application of this [draft] Standard.

AusC6 For each reporting period in which this [draft] Standard is initially applied or, in accordance with paragraph AusC3, progressively applied, an entity shall provide both of the following additional disclosures:

(a) the amount by which each financial statement line item is affected in the current reporting period by the application of this [draft] Standard as compared with how AASB 13 *Fair Value Measurement* and AASB 116 *Property, Plant and Equipment* were applied before the change; and

(b) an explanation of the reasons for significant changes identified in paragraph AusC6(a).

Commented [JP6]: Retrospective application is proposed to avoid entities potentially applying the new requirements only to assets acquired after initial adoption. However, comparative amounts for prior periods presented would not need to be restated (see paragraph AusC4).

Commented [JP7]: Combined with a two-year initial application period from the date of issue of the Standard, this would provide a five-year period for NFP entities that revalue classes of assets on a rolling basis to complete their transition to the new requirements.

Commented [JP8]: This would avoid asking entities to seek historical data about fair values/current replacement costs or having to assess which requirements are impracticable.

Commented [JP9]:
Question for Board members

Q7 Do Board members agree with the draft transitional provisions in Appendix C?

Appendix F [FOR AASB 13]
Australian implementation guidance for not-for-profit ~~public sector~~ entities

This appendix is an integral part of AASB 13 and has the same authority as other parts of the Standard. The appendix applies only to not-for-profit ~~public sector~~ entities.

Introduction

F1 AASB 13 *Fair Value Measurement* incorporates International Financial Reporting Standard IFRS 13 *Fair Value Measurement*, issued by the International Accounting Standards Board. Consequently, the text of AASB 13 is generally expressed from the perspective of for-profit entities in the private sector. The AASB has prepared this appendix to explain and illustrate the application of the principles of paragraphs 61 – 66 and Aus66.1 – Aus66.2 of the Standard by not-for-profit ~~public sector~~ entities in the public and private sectors, in relation to fair value measurement of non-financial assets. The appendix does not apply to for-profit entities ~~or not-for-profit private sector entities,~~ or affect their application of AASB 13.

F2 This appendix should be read in conjunction with the requirements of this Standard.

Fair value of non-financial assets

F3 Under paragraphs 61 – 66 and Aus66.1 – Aus66.2 of the [draft] Standard, for non-financial assets held by not-for-profit ~~public sector~~ entities (including right-of-use assets of lessees under leases with significantly below-market terms and conditions principally to enable the entity to further its objectives):

(a) if an asset is held primarily for its ability to generate net cash inflows ~~(ie it is a ‘cash-generating asset’)~~, its fair value is measured using whichever of the market approach, cost approach or income approach (or a combination of them) is the most appropriate in the circumstances. This is an unmodified requirement of AASB 13; ~~and~~

(b) if an asset is not held primarily for its ability to generate net cash inflows (ie it is ~~a ‘non-cash-generating asset’~~ held for its service capacity), and the asset has neither a legally restricted use nor is subject to a legal restriction on the prices that may be charged for using it, ~~only the cost approach is used to estimate its fair value (ie the asset’s fair value is measured at current replacement cost, applying the guidance in paragraphs B8 – B9 of AASB 13)~~ its fair value is measured using whichever of the market approach, cost approach or income approach (or a combination of them) is the most appropriate in the circumstances. This is also an unmodified requirement of AASB 13; and

(c) if an asset is held for its service capacity, and the asset has a legally restricted use or is subject to a legal restriction on the prices that may be charged for using it:

(i) if an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is measured at fair value based on the available market evidence for the equivalent restricted asset; and

(ii) if an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is, subject to paragraph F4~~F4~~, measured at its current replacement cost. The asset’s current replacement cost is determined consistently with paragraphs B8 – B9 of AASB 13, without a discount to the current market buying price of an equivalent but unrestricted asset.

F4 Under paragraph Aus66.2 of the [draft] Standard, if a not-for-profit entity lessee cannot measure reliably the current replacement cost of its right-of-use asset under a lease with significantly below-market terms and conditions principally to enable the entity to further its objectives, it measures that asset by discounting the contractual lease payments to their present value using a current market-determined rate of discount.

~~F5 Applying this proposed requirement in paragraph F3(b) to non-cash-generating assets would mean that, in the case of such an asset with a legally restricted use (eg land legally restricted for use as a cemetery, park or land under roads) or that is subject to legal restrictions on the prices that may be charged for using the asset, the asset’s fair value should be measured as follows:~~

~~(a) if an equivalent restricted asset is obtainable in the marketplace, the asset's current replacement cost is equal to its market price based on observable market evidence (ie the fair value measurement of the asset under the cost approach would equal the amount that would be determined under the market approach described in paragraphs B5 – B7 of AASB 13); and~~

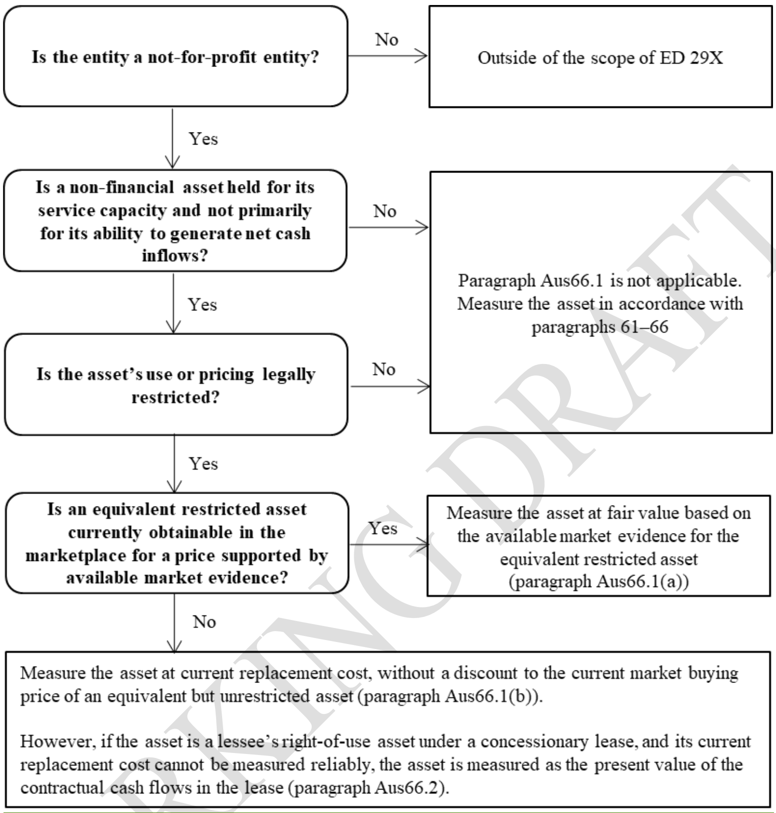
~~(b) if an equivalent restricted asset is not obtainable in the marketplace, the restricted asset's fair value is not measured at a discount to the current price of an equivalent but unrestricted asset.~~

~~F6 Under paragraph F4(b), the asset is measured at the price another not-for-profit public sector entity would be willing to pay to replace the asset in its current condition, 'stepping into the shoes' of the not-for-profit public sector entity holding (ie hypothetically selling) the asset. This price might exceed the amount a for-profit entity market participant buyer would be willing to pay for the asset, which would not exceed the price it would be prepared to invest to generate a commercial return from the asset.~~

~~F7 As referred to in paragraph F3(a), using the cost approach to measure the fair value of a non-financial asset is not limited to non-cash-generating assets of not-for-profit public sector entities. For example, the unmodified text of AASB 13 indicates that the fair value of specialised assets held primarily for their ability to generate net cash inflows in combination with other assets is often measured under the cost approach (AASB 13, paragraph B9).~~

Valuation techniques

F5 The flowchart below summarises the principles in AASB 13 applied by not-for-profit ~~public sector~~ entities in determining the appropriate valuation technique to use when measuring the ~~fair~~ current value of their non-financial assets.



Location of land measured at current replacement cost

F6 When a not-for-profit entity holds land for its service capacity as part of a group of assets (eg a facility) and measures the land at its current replacement cost, either as a measure of fair value or in accordance with paragraph Aus31.1 of AASB 116 *Property, Plant and Equipment*, it would typically be measured by assuming it is replaced in its present location. However, in the rare instances in which each of the following criteria is

Commented [JP10]: Paragraph F6 is consistent with the Board's decisions on this issue at its June 2019 meeting. See also the discussion of this issue in paragraphs BC73 – BC81. The Question for Board members on this issue is adjacent to paragraph BC78.

satisfied, the land's current replacement cost would be measured assuming its replacement in a cheaper alternative location:

(a) management is aware of a cheaper location that might be a suitable alternative for the facility's land component, and is considering whether the facility's service potential can be replaced in that cheaper alternative location;

(b) replacing the facility in that cheaper alternative location is feasible, ie both legally permissible and compatible with the entity's operational requirements for that facility (eg relocation could only be assumed if the facility would provide the necessary accessibility of services to beneficiaries);

(c) the entity can identify the land's feasible alternative location within a reasonable range of estimates (ie there must not exist a number of feasible alternative locations with significantly different market buying prices of the land); and

(d) the current replacement cost of the facility determined on the basis of that alternative location is not exceeded by the price a market participant buyer of the facility would be prepared to pay to remove the buildings and other improvements from the existing facility's site and then sell the property as a vacant site for an alternative use (if such a course of action is legally permissible).

Australian illustrative examples for not-for-profit ~~public sector~~ entities

These illustrative examples accompany, but are not part of, AASB 13. They illustrate aspects of the Australian guidance for not-for-profit ~~public sector~~ entities in AASB 13, but are not intended to provide interpretative guidance.

These examples illustrating aspects of the Australian guidance for not-for-profit ~~public sector~~ entities in AASB 13 complement, and have the same status as, the Illustrative Examples accompanying IFRS 13 Fair Value Measurement, *which are available on the AASB website to website users in Australia.*

IE1 The following examples portray hypothetical situations. They are intended to illustrate how a not-for-profit ~~public sector~~ entity might apply some of the requirements of AASB 13 *Fair Value Measurement* to particular types of assets, on the basis of the limited facts presented. Although some aspects of the examples might be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying AASB 13. The evaluations in each example are not intended to represent the only manner in which AASB 13 could be applied.

Valuation techniques – Assets held primarily for their service capacity rather than their ability to generate net cash inflows (paragraph Aus66.1)

IE2 Paragraph Aus66.1 states that, ~~for~~ in respect of a non-financial asset of a not-for-profit ~~public sector~~ entit~~ies, the cost approach shall be used to estimate the fair value of assets~~y that ~~are~~ is not held primarily for ~~their~~ its ability to generate net cash inflows (ie it is held for its service capacity)~~also termed 'non-cash-generating assets').~~, if the asset has a legally restricted use or is subject to a legal restriction on the prices that may be charged for using it:

(a) if an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is measured at fair value based on the available market evidence for the equivalent restricted asset; and

(b) if an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is, subject to the 'reliable measurement' criterion in paragraph Aus66.2, measured at its current replacement cost. The asset's current replacement cost is determined consistently with paragraphs B8 – B9, without a discount to the current market buying price of an equivalent but unrestricted asset.

~~IE2~~IE3 Example 1 illustrates the application of paragraph Aus66.1 and the elaboration of how to apply that principle set out in Appendix F (Australian implementation guidance).

Example 1 – Assets held primarily for their service capacity
A local council (Council B) recently purchased a parcel of residential land for $30 million, which was rezoned as parkland. The local government does not have the power to rezone the land (that power resides with the State Government's Planning Minister). Land restricted for use as a park in a suitable location and with similar characteristics is not obtainable in the marketplace. At Council B's reporting date, there have been no changes in the market price of land in the area since the parkland was acquired, and the market value of a similarly sized parcel of adjacent residential land is $30 million. A restaurant was built on the parkland with the primary purpose of generating net cash inflows from lessees of the restaurant. In addition, barbecues, picnic facilities and a shelter were built on the parkland to provide services to park visitors (ie ~~primarily not~~ for their ~~ability to generate net cash inflows~~ service capacity). Valuation techniques Council B would measure the fair value of the parkland and the improvements on that land (excluding the restaurant) ~~using the cost approach in AASB 13~~ at current replacement cost, in accordance with paragraph Aus66.1, because those assets are held ~~primarily not~~ for their ~~ability to generate net cash inflows~~ service capacity and ~~. B~~because land restricted for use as a park in a suitable location and with similar characteristics is not obtainable in the marketplace. In accordance with paragraph Aus66.1(b), the restricted parkland's ~~fair value~~ current replacement cost should not be measured at a discount to the current price of suitable unrestricted land that would be purchased in a replacement transaction. Based on the current market price of adjacent residential properties, the ~~fair value~~ current replacement cost of the parkland at the

reporting date is estimated as $30 million. ~~The fair value of the improvements on the parkland, other than the restaurant, is measured at the current replacement cost of the improvements.~~

The restaurant's fair value is measured separately from ~~that~~ the current replacement cost of the parkland, taking care not to double-count the value of the land under the restaurant, because ~~it~~ the restaurant is held with the primary purpose of generating net cash inflows—that is, paragraph Aus 66.1 does not apply to it (see also paragraph F3(a) of the Australian Implementation Guidance for Not-for-Profit Entities). Council B would use judgement in selecting an appropriate valuation technique under paragraphs 61 – 66 of AASB 13. Because the restaurant is capable of generating net cash inflows separately from the parkland, Council B concludes that either the income approach or the market approach would be appropriate to measure the fair value of the restaurant. Council B takes into account estimates under each of those approaches, maximising the use of relevant observable inputs to the fair value estimate (in accordance with paragraph 61 of AASB 13).

Highest and best use for non-financial assets

Legally permissible uses of an asset (paragraph 28(b))

~~IE3~~IE4 Example 2 illustrates whether legal restrictions might be treated differently at a parent entity level (e.g. State Government level), compared with an individual entity (e.g. government department) level, when those restrictions were imposed by the parent entity.

Example 2 – Legal restrictions on the use of an asset treated differently at different levels within a group

At 30 June 20X0 (the reporting date), the Department of Infrastructure held a parcel of vacant land adjacent to an inner suburban railway station that its State Government has legally restricted for use as a parking lot pending a long-term decision on its best use. If the Department sold the parcel of land at the reporting date, the restriction over the land's restricted use would transfer to the market participant buyer. The State Government's Planning Minister can rescind the restriction through an administrative order (ie without parliamentary approval).

The Department concludes that the restricted land is held primarily to generate net cash inflows because the State Government has privatised the delivery of commuter parking services.

Treatment of the legal restriction at the level of the Department of Infrastructure

The Department of Infrastructure cannot rescind the legal restriction because the power of rescission vests in the Planning Minister. Therefore, the legal restriction would transfer to a market participant buyer of the parcel of land from the Department. Accordingly, the Department measures the fair value of the parcel of land as at 30 June 20X0 by taking the legal restriction into account in identifying the land's highest and best use, in accordance with paragraph 28(b) of AASB 13.

Valuation technique

~~The Department concludes that the restricted land is held primarily to generate net cash inflows because the State Government has privatised the delivery of commuter parking services.~~ The Department ~~also~~ concludes that the income approach described in paragraphs B10 – B30 of AASB 13 is the most appropriate for measuring the fair value of the land, taking into account the best estimate of the present value of the parking fees the land will generate and the cost to a market participant buyer to convert the vacant land to a car park. Using this approach, the land's fair value is estimated at $2.8 million. This estimate is corroborated by observable market data for a nearby parking station operated by a private company. Therefore, the Department measures the land's fair value at $2.8 million.

Treatment of the legal restriction at the level of the State Government

The State Government can rescind the restriction without parliamentary approval because the power of rescission vests in the Planning Minister, who can rescind the restriction through an administrative order. Thus, the State Government has the unilateral capacity to remove the restriction and, consequently, the restriction is, in effect, self-imposed at the State Government level. Therefore, in preparing its whole-of-government consolidated financial statements for the year ending on 30 June 20X0, the State Government measures the parcel of land's fair value by not assuming that the restriction for use as a parking lot would definitely transfer to the market participant buyer in a hypothetical sale at the measurement date. The measurement of the asset's fair value reflects the present existence of the restriction but also the State

Government's option to rescind the restriction. Therefore, the fair value measurement of the parcel of land by the State Government takes into account the effects of:

(a) the risk that the State Government is unable to rescind the restriction; and

(b) the current cost (if any) of rescinding the restriction, if it could be rescinded.

The State Government assesses that the risk of being unable to rescind the restriction is negligible in light of not being responsible for transport services, the present existence of alternative parking and the fact that the land is not yet providing a service to which community members have become accustomed. In addition, the current cost of rescinding the restriction is almost zero, because it would be effected through an administrative order.

Valuation technique

The State Government measures the fair value of the parcel of land on the basis of its highest and best use being for a shopping development, without any deduction for risk or cost of rescission. Using the market approach described in paragraphs B5 – B8 of AASB 13, the State Government measures the land's fair value at $4.0 million.

In the preparation of the whole-of-government financial statements as at 30 June 20X0, a consolidation adjustment of $1.2 million is made to remeasure the fair value of the parcel of land from $2.8 million to $4.0 million.

~~Cost approach (paragraphs B8–B9)~~

Nature of costs included in current replacement cost

~~IE4~~IE5 Example 3 illustrates the costs included in the replacement cost of a non-financial asset when measuring its ~~fair value using~~ current replacement cost, whether under the cost approach in paragraphs B8 – B9 or in accordance with paragraph Aus31.1 of AASB 116 *Property Plant and Equipment*.

Example 3 – Costs included in the current replacement cost of a road

Local Government A measures its roads (including land under roads) at ~~fair value using the cost approach set out in paragraphs B8 – B9 of AASB 13~~ current replacement cost.

Year ending 30 June 20X0

As at 30 June 20X0, Local Government A controlled a new road in a new hilly housing estate to which the following costs[1] (measured using current prices[2]) relate. Local Government A assesses whether each of these costs should be included in the road's current replacement cost (before deducting obsolescence).

	Cost	~~Amount included under Views 1 and 3~~	~~Amount included under View 2~~
	$'000	~~*$'000*~~	~~*$'000*~~
Land	12,000[3]	~~12,000~~	~~–~~
Design work	2,200	~~2,200~~	~~–~~

1 In this example, it is assumed that the road's construction period is short, and therefore that the issue of whether borrowing costs should be included does not arise. Paragraphs BC~~57~~82 – BC~~66~~86 of the Basis for Conclusions discuss views regarding whether material borrowing costs should be included in the current replacement cost of an asset ~~measured at fair value using the cost approach~~.

2 These costs are not termed 'current replacement costs' here, because doing so would imply pre-empting the analysis of the issue addressed in this example, and would therefore be circular.

3 Consistent with paragraph Aus66.1(b) of this Exposure Draft, this land is not measured at a discount to the current price of equivalent but unrestricted land. This example does not focus on the measurement implications of any restrictions on the land's use or user pricing, which are illustrated in Examples 1 and 2.

Commented [JP11]: This example has been edited to reflect the Board's decision in June 2019 that the current replacement cost of the assets composing a facility (eg a road and land under the road, whether reported jointly or separately) includes all necessary costs intrinsically linked to acquiring those assets at the measurement date.

The deleted columns illustrated different views regarding the costs to include in current replacement cost. The Board's decision made those illustrations redundant.

The discussion below of the fact pattern as at 30 June 20X1 reflects the Board's decision in June 2019 that an asset's current replacement cost takes into account any make-good costs that must be incurred for surrounding facilities disturbed when the asset is replaced (eg drainage works disturbed when replacing a road).

Commented [JP12]: The footnote was added in response to a comment in point 1 on page 5 of the ACAG letter dated 23/9/2019.

Earthworks	10,000	~~10,000~~	~~–~~
Formation	5,000	~~5,000~~	~~–~~
Pavement	3,000	~~3,000~~	~~3,000~~
Surfacing	2,000	~~2,000~~	~~2,000~~
Disruption of traffic (traffic control and detour costs)	1,000	~~1,000~~	~~1,000~~
Total	35,200	~~35,200~~	~~6,000~~

Accounting treatment

Local Government A concludes that each of these costs should be included in the road's current replacement cost, and measures the road's current replacement cost (before deducting obsolescence) as at 30 June 20X0 as $35,200,000. This is because the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility (as referred to in paragraph B9 of AASB 13 ~~regarding application of the cost approach~~) would include each of those costs, including ~~incidental~~ intrinsically linked disruption costs.

Local Government A presents a single line item entitled 'roads and land under roads'. If it reported land under roads as a separate line item or within a line item entitled 'land', it would exclude the $12,000,000 land component from the measure presented for the line item entitled 'roads'.

Year ending 30 June 20X1

During the year ending 30 June 20X1, another entity's drainage works were installed under the road. Consequently, as at 30 June 20X1, if the road were replaced, it would be necessary to incur additional current costs of $2,500,000 to ~~repair damage to~~ make good drainage works necessarily ~~resulting from~~ disturbed during replacement of the road's components.

For simplicity, it is assumed that none of the replacement costs as at 30 June 20X0 (listed above) changed during the year ending 30 June 20X1.

Accounting treatment

Local Government A concludes that the current make-good cost of ~~repairing damage to~~ drainage works of another entity necessarily ~~resulting from~~ disturbed during replacement of the road's components ($2,500,000) should be included in the road's current replacement cost (before deducting obsolescence) as at 30 June 20X1. This is because the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility would include that ~~incidental disruption~~ make-good cost. Consequently, Local Government A measures the road's current replacement cost (before deducting obsolescence) as at 30 June 20X1 as $37,700,000 (calculated as $35,200,000 + $2,500,000).

As at 30 June 20X0, Local Government A did not anticipate the additional ~~current~~ make-good cost of $2,500,000 to ~~repair damage to~~ another entity's drainage works ~~necessarily resulting from replacement of the road's components~~. This is because the operating environment of the road as at 30 June 20X0 did not require incurring that ~~incidental disruption~~ make-good cost if the road were replaced as at that date.

Commented [JP13]: ACAG, in point 3 on page 5 of its letter dated 23/9/2019, requested guidance on how to measure disruption costs. This draft ED does not include such guidance, because it will depend on an entity's circumstances whether these costs are necessarily incurred (ie 'intrinsically linked' to acquiring the assets).

Commented [JP14]: Comment added in response to Board member comments during the June 2019 Board meeting. This comment also addresses a comment in point 2 on page 5 of the ACAG letter dated 23/9/2019.

Commented [JP15]: Clarification added in response to request in point 3 on page 5 of the ACAG letter dated 23/9/2019.

Commented [JP16]: ACAG, in point 4 on page 5 of its letter dated 23/9/2019, requested guidance on how an asset should be valued when a part of an asset is replaced, often multiple times over the life of the whole asset. Such guidance has not been included in this draft ED, because future actual replacements and their frequency are separate issues from determining the current cost to replace a facility (or other asset) if that facility presently does not exist.

Economic obsolescence

~~IE5~~IE6 Examples 4 and 5 illustrate when economic obsolescence of an asset held primarily to provide services should be identified, and how it should be measured, if the asset is measured at current replacement cost, whether under the cost approach in paragraphs B8–B9 of AASB 13 or under paragraph Aus31.1 of AASB 116.

Example 4 – Assets with temporary overcapacity
A rural town's public school has a capacity for 500 students but, because of the local demographic changes, a school for 400 students would meet current requirements. The government expects that the demand for the school's services will increase to 500 students within the next three years as a result of a planned infrastructure project. The school is legally restricted for use as a school, and an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence. Valuation of the school In accordance with paragraph Aus66.1 of AASB 13, because the school's non-financial assets (composed of its land, buildings and other facilities) are ~~not~~ held ~~primarily~~ for their ~~ability to generate net cash inflows~~ service capacity and have a legally restricted use, and because equivalent restricted assets are not obtainable in the marketplace at the measurement date for a price supported by observable market evidence, ~~the appropriate valuation technique to measure the fair value of~~ the school's non-financial assets are measured at current replacement cost ~~is the cost approach set out in~~ determined consistently with paragraphs B8 – B9 of AASB 13. Economic obsolescence ~~Under the cost approach,~~ Applying the principles of paragraphs B8 – B9 of AASB 13 in measuring the current replacement cost of the school's non-financial assets, the school assesses whether economic obsolescence of those assets has arisen due to a decline in the market demand for the services those assets provide. The apparent but temporary excess capacity of the school would not be identified as giving rise to economic obsolescence because it is only temporary. The apparent excess capacity is in fact standby capacity forming part of the service capacity of the school's non-financial assets.

Example 5 – Assets with overcapacity that is highly unlikely to reverse
In this example, the facts of Example 4 apply, except that, due to demographic changes, a school for 100 students would meet current and reasonably foreseeable requirements (including a buffer for any underestimated student demand). There is only an insignificant chance that this reduction in needed capacity will reverse within the foreseeable future. At the school's reporting date (30 June 20X0), the gross replacement cost of the school if its capacity for 500 students were replaced would be $16 million, composed of $10 million for the buildings and other facilities and $6 million for the land (for which the replacement cost equals its estimated market value). If a school for 100 students were to be built at the reporting date, the gross replacement cost of the building and other facilities would be $4.0 million and the replacement cost of the land would be $2.7 million[4]. The State Government has not made a formal decision to reduce the school's physical capacity. Valuation of the school For the same reasons as in Example 4, ~~the appropriate valuation technique to measure the fair value of~~ the school's non-financial assets ~~is the cost approach~~ are measured at current replacement cost. Economic obsolescence ~~Under the cost approach, i~~In measuring the current replacement cost of the school's non-financial assets, the school assesses whether economic obsolescence of those assets has arisen due to a decline in the market

[4] The gross replacement cost of a school catering for 100 students exceeds one-fifth of the gross replacement cost of a school catering for 500 students. That is, a linear relationship between expected student enrolments and economic obsolescence does not exist because, to some extent, facilities will be needed regardless of the school's number of enrolments—for example, the administration office, cafeteria, and one or more toilet blocks, gymnasiums and car parks.

demand for the services those assets provide. The decline in the market demand for this school's services is an indicator of economic obsolescence because there is only an insignificant chance that the reduction in needed capacity (from 500 students to 100 students) will reverse within the foreseeable future. Therefore, the current replacement cost of the school should assume replacement of a school catering for 100 students to reflect economic obsolescence, subject to the impact of any alternative uses that affect the school's capacity that would presently be replaced (see below).

Consideration of alternative uses

In measuring the school's economic obsolescence, consideration is given to whether some or all of the school's land, buildings and equipment that are surplus from a schooling perspective might have alternative community uses, reducing the amount of economic obsolescence that would otherwise be identified. Specifically, consideration is given to whether surplus capacity from a schooling perspective could be used for State Government-provided sporting and social services, namely, martial arts classes and computing classes.

The school concludes that alternative community uses of the school's surplus capacity for schooling would not affect the amount of the school's capacity that would be replaced in a hypothetical replacement transaction (ie if the school were deprived of its facilities, which is the assumption underpinning an assessment of the amount that a market participant buyer would be prepared to pay for the school). A decision to use the school's existing surplus capacity for other services or activities, now that the school already exists, does not necessarily indicate that those alternative uses warrant constructing schooling capacity to cater for those activities upon replacement of the school. In the circumstances of this particular school, it is concluded that it would be more economical to hire other premises to conduct those alternative State Government-provided activities than to construct surplus capacity from a schooling perspective. Therefore, the amount of the school's capacity that would be replaced upon deprival is limited to the amount needed for school student tuition.

Based on these conclusions, the school's current replacement cost as at 30 June 20X0 is estimated as $6.7 million.

Current replacement cost of land

~~IE6~~IE7 Examples 6A and 6B illustrate how to measure the current replacement cost of land, ~~when measuring its fair value using~~ whether under the cost approach in paragraphs B8–B9 of AASB 13 or under paragraph Aus31.1 of AASB 116. Specifically, they illustrate whether the current replacement cost of land should be measured by assuming that the land is replaced in its ~~current~~ existing location.

Example 6A – Location of land: highest bidder can extract value unavailable to the reporting entity

Barton Hospital is a centrally located public hospital in a major city. The hospital is ~~not~~ held ~~primarily~~ for its ~~ability to generate net cash inflows~~ service capacity.

The hospital's land is ~~not subject to any special zoning requirements or other legal restrictions~~ zoned for use as a hospital, and this legal restriction would transfer to any market participant buyer of that land. The hospital's services could be provided equally effectively in an ~~nearby~~ alternative location where the land is 20% cheaper. The cheaper land in the alternative location is not presently restricted for use as a hospital.

The highest and best use of the property is a hospital, because the highest bidder for the hospital (if the hospital's management sold the hospital) would be a for-profit entity that operates private hospitals. That for-profit entity bidder can extract value from the hospital site that is unavailable to Barton Hospital because, unlike Barton Hospital, it can use the location to generate higher returns than it could generate from a cheaper site.

The management of Barton Hospital considers how to measure the ~~fair~~ value of the hospital's land—in particular, whether the land's market value estimate should reflect the price of suitable land in a cheaper feasible site.

Valuation technique

~~Because t~~The hospital is ~~not~~ held ~~primarily~~ for its ~~ability to generate net cash inflows~~ service capacity and its land is legally restricted for use as a hospital. In addition, equivalent restricted land is not obtainable in the marketplace at the measurement date. Therefore, in accordance with paragraph Aus66.1 of AASB 13, ~~its fair value~~ Barton Hospital's land is measured at its current replacement cost.

The current replacement cost of the hospital's land is measured by reference to observable market prices of comparable land. Because ~~the hospital's land is not subject to any special zoning requirements or other legal restrictions~~ equivalent restricted land is not obtainable in the marketplace at the measurement date, in applying paragraph ~~F4~~Aus66.1 of ~~the Australian Implementation Guidance for Not-for-Profit Public Sector Entities~~ AASB 13 there is no potential discount to apply to the observable market prices of adjoining or other comparable land. Applying the principle of highest and best use in paragraph 27 of AASB 13 (which is relevant to fair value measurements and measurements of current replacement cost under paragraph Aus31.1 of AASB 116), the land's current replacement cost is measured using the assumptions of the highest bidder for the hospital, which is a for-profit entity that operates private hospitals. The highest bidder for the hospital would bid for its land in its existing location.

Therefore, the market value estimate of the hospital's land is an estimate of the price of the land in its ~~current~~ existing location, rather than the price of suitable land in a cheaper feasible site.

Example 6B – Location of land: highest bidder is another not-for-profit entity

The fact pattern is the same as in Example 6A, except that the highest bidder for the hospital would not be a for-profit entity (because a for-profit entity bidder could not extract value from the hospital site that is unavailable to Barton Hospital). Consequently, the highest bidder for the hospital (if the hospital's management sold the hospital) would be a market participant buyer that would continue to operate the hospital but would be unwilling to pay more for the hospital land than the market price of land in a suitable alternative site (ie at a 20% discount to the price of the land in the hospital's existing site).

Because Barton Hospital's land is zoned for use as a hospital, and this legal restriction would transfer to any market participant buyer of that land, replacing Barton Hospital in the cheaper alternative location would involve two hospitals servicing the same patient catchment. Therefore, replacing the hospital in that cheaper alternative location is not feasible.

Commented [JP17]: Examples 6A & 6B have been amended to conform to the Board's decisions in June 2019 and the proposed amendments to paragraph Aus66.1.

The management of Barton Hospital considers how to measure the fair value of the hospital's land—in particular, whether the land's market value estimate should reflect the price of suitable land in a cheaper feasible site.

Valuation technique

~~Because t~~The hospital is ~~not~~ held ~~primarily~~ for its ~~ability to generate net cash inflows~~ service capacity and its land is legally restricted for use as a hospital. In addition, equivalent restricted land is not obtainable in the marketplace at the measurement date. Therefore, in accordance with paragraph Aus66.1 of AASB 13, ~~its fair value~~ Barton Hospital's land is measured at its current replacement cost.

Because replacing the hospital in the cheaper alternative location is not feasible, in accordance with paragraph F6 of the Australian Implementation Guidance, the current replacement cost of the land is measured assuming replacement in its existing location.

~~Because the market participant buyer would be unwilling to pay more for the hospital land than the market price of land in a suitable alternative site, the market value estimate of the hospital's land is measured by reference to the price in that alternative location (ie at a 20% discount to the price of the land in the hospital's existing site).~~

Extra Example 6 – Location of unrestricted land: *illustrating comments received from a Board member out of session*

Commented [JP18]: This Board member's alternative view on this issue is presented adjacent to paragraph BC78, and the Question for Board members is presented below that.

Scarborough Prison is held for its service capacity. Its land is not subject to any special zoning requirements or other legal restrictions on use.

The prison was built on land that was originally on the outskirts of a city. Over time, the city has grown, and the prison land has an alternative use as residential land.

The prison is old, and its buildings and other improvements are nearing the end of their economic life. At the reporting date of 30 June 20X2, the remaining economic life of the improvements is 5 years, and their current replacement cost is estimated as $7 million.

At 30 June 20X2, the land has a net selling price, based on its feasible alternative use as residential land, of $20 million (comprising a gross market price of $22.5 million and removal costs for the improvements of $2.5 million).

The management of Scarborough Prison is aware that the prison could be relocated to cheaper land outside the city for $15 million at 30 June 20X2, and is considering whether the prison's service potential can feasibly be replaced in that cheaper alternative location. There are no other obvious candidates for a feasible alternative site for the prison.

The management of Scarborough Prison considers how to measure the fair value of the prison's land—in particular, whether the land's market value estimate should reflect the price of suitable land in the identified cheaper alternative feasible site.

Valuation technique

[*Application of paragraph F6 of the Australian Implementation Guidance is discussed below in normal font; the alternative analysis of the Board member referred to adjacent to paragraph BC78 is presented in italics*]

In accordance with paragraph F3(b) of the Australian Implementation Guidance for Not-for-Profit Entities, the prison assets are measured in accordance with the unmodified requirements of AASB 13 because the prison is held for its service capacity and its land is not subject to any special zoning requirements or other legal restrictions on use. In applying AASB 13, the management of Scarborough Prison concludes that the cost approach should be used to measure the prison (ie it is to be measured at current replacement cost) because of the specialised nature of its assets.

Because the management of Scarborough Prison is aware that the prison could be relocated to cheaper land outside the city at 30 June 20X2, and is considering whether the prison's service potential can feasibly be replaced in that cheaper alternative location for which there are no other obvious candidates, criteria (a) – (c) in paragraph F6 of the Australian Implementation Guidance for Not-for-Profit Entities for assuming replacement occurs in a cheaper alternative location are satisfied.

The management of Scarborough Prison calculates what the current replacement cost of the facility would be at 30 June 20X2 if it were determined on the basis of that alternative location, namely, $22 million (ie $15 million for the cheaper land + $7 million for the current replacement cost of the improvements). It then assesses whether that amount is exceeded by the price a market participant buyer of Scarborough Prison would be prepared to pay to remove the buildings and other improvements from the existing prison's site and then sell the property as a vacant site for an alternative use (since such a course of action is legally permissible). That latter amount is $20 million, which is calculated by using consistent assumptions about the highest and best use of each asset comprising the prison (ie it excludes the current replacement cost of the improvements in their existing use, namely, $7 million, because including those improvements would assume a continuing use that is inconsistent with the highest and best use of the land underlying its market value—an alternative use, ie residential development).

Therefore, with reference to paragraph F6(d), the current replacement cost of the prison determined on the basis of the alternative location ($22 million) is not exceeded by the price a market participant buyer of the prison would be prepared to pay to remove the buildings and other improvements from the existing prison's site and then sell the property as a vacant site for an alternative use ($20 million). The prison meets all the criteria in paragraph F6 of the Australian Implementation Guidance for Not-for-Profit Entities for its current replacement cost to be measured on the basis of an alternative location. The prison's current replacement cost at 30 June 20X2 is measured at $22 million.

The alternative view of the Board member referred to in the margin adjacent to paragraph BC78 is that applying paragraph F6(d) implies the management of Scarborough Prison would make the economically irrational decision to scrap improvements with a current replacement cost of $7 million in order to save $5 million on the current cost of the land component of the prison. The Board member considers that the current replacement cost of the existing prison should be calculated as $20 million (the land's net selling price in its existing location at 30 June 20X2) + $7 million (the current replacement cost of the improvements on the existing site at that date) ie $27 million.

Right-of-use assets under concessionary leases

Commented [JP19]: The measurement of right-of-use assets of NFP entity lessees under concessionary leases is discussed in paragraphs BC87 – BC106.

IE8 Examples 7 and 8 illustrate how to measure the value of a right-of-use asset held primarily to provide services under a concessionary lease. Example 7 is of a right-of-use asset:

(a) that is legally restricted in the uses to which it may be put and the prices that may be charged for using it; and

(b) for which an equivalent restricted right-of-use asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence (which would impound the discount resulting from the restriction).

IE9 Example 8 is of a right-of-use asset:

(a) that is legally restricted in the uses to which it may be put; and

(b) for which an equivalent restricted right-of-use asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence.

Example 7 – Restricted right-of-use asset that can be acquired in the market with that restriction

Three mini-vans donated to Community Centre A are legally restricted for use in providing community services; that restriction transfers to any purchaser or lessee of the vehicles. Community A wants to maximise its returns on the mini-vans to further its own objectives and leases out one of the mini-vans to Community Centre B for at a 'restricted market' rate of $750 per month with a remaining lease term of 3 years as at 30 June 20X3.

The reporting entity (Community Centre C) has a right to use a highly similar mini-van under a concessionary lease (i.e significantly below market lease payments of $50 per month) that imposes similar restrictions on its use and has a remaining lease term of 5 years as at 30 June 20X3. If Community Centre C had been unable to obtain the concessionary lease, it would have been able to obtain a lease of a mini-van from another Community Centre at a ‘restricted market’ rate of lease rentals.

There is no indication that lease rentals for similarly restricted rights to use mini-vans would differ materially between three- and five-year leases. The current discount rate typical for motor vehicle leases of up to 5 years is 6 per cent per annum.

The current market rate of lease rentals for 5-year leases of the same type of mini-van, but without any legal restrictions on use, is $1,200 per month.

Community Centre C assesses how to measure the fair value of its right-of-use asset under its concessionary lease of a mini-van.

Valuation of the right-of-use asset

Community Centre C’s right-of-use asset under its concessionary lease is held for its service capacity. An equivalent restricted right-of-use asset to that of Community Centre C’s right-of-use asset under its concessionary lease of a mini-van is obtainable in the marketplace at the measurement date (30 June 20X3) for a price supported by observable market evidence. That equivalent restricted asset is the right-of-use asset of Community Centre B in its lease of a restricted-use mini-van from Community Centre A. The lease rental in that lease impounds the effect of the restriction, which would transfer to any market participant buyer of that right-of-use asset. Therefore, in accordance with paragraphs Aus66.1(a) and F3(c)(i), Community Centre C’s right-of-use asset is measured at fair value based on the available market evidence for Community Centre B’s right-of-use asset. In this instance, the fact that Community Centre C’s right-of-use asset under its concessionary lease is not held primarily for its ability to generate net cash inflows does not affect the method of measuring the asset.

Community Centre C disregards the below-market lease payments of $50 per month when measuring its right-of-use asset because those payments reflect the value of the right-of-use asset minus the financial support Community Centre C receives from the lessor in the form of a discounted rate of lease rentals. It also disregards the current market lease rentals for unrestricted mini-vans, because there is an observable market price for Community Centre C’s mini-van’s restricted right-of-use asset, which could be bought and sold in the marketplace.

Using the available market evidence for Community Centre B’s right-of-use asset, Community Centre C measures its right-of-use asset as 5 years × 12 monthly payments of $750 discounted at a rate of 6% per annum, ie the present value of $45,000—which is $38,794.

Example 8 – Restricted right-of-use asset for office space under a concessionary lease; cannot be acquired in the market with that restriction

On 30 June 20X1, Charity X receives an asset in the form of a right to use office space as a lessee under a two-year concessionary lease provided by a lessor with temporarily surplus office space. The lease restricts Charity X from using the office space for any commercial purpose (including sub-leasing it). The office space is in a central business district of a major city, and the monthly market rental for the space (based on market comparison) is estimated at $100,000. If Charity X had not been provided the right-of-use asset in a concessionary lease, it would have rented office space in an inner suburb at a monthly market rate of $50,000 because it lacks the financial resources to pay a commercial rental for central business district office space.

The current discount rate typical for leases of office space for 2 years is 4.5 per cent per annum.

As a hypothetical market participant buyer of its right-of-use asset, Charity X would have been unable to replace that right-of-use asset for a discounted price that impounds the effect of the restriction; it could only replace that right-of-use asset by renting at a full commercial rate.

Charity X assesses how to measure the value of its right-of-use asset under its concessionary lease of the office space.

Valuation of the right-of-use asset

Charity X's right-of-use asset under its concessionary lease is held for its service capacity. In addition, an equivalent restricted right-of-use asset to that of Charity X's right-of-use asset is not obtainable in the marketplace at the measurement date (30 June 20X1) for a price supported by observable market evidence. Therefore, in accordance with paragraphs Aus66.1(b) and F3(c)(ii), Charity X's right-of-use asset is measured at the current replacement cost of its service capacity.

Applying by analogy the principles in paragraph F6(d) of the Australian Implementation Guidance for Not-for-Profit Entities, the current replacement cost of the right-of-use asset would not be based on an alternative location because the resulting value is exceeded by the price a market participant buyer of the right-of-use asset would be prepared to pay in the existing location. This conclusion is consistent with the fact that office space in the existing central business district location provides greater service capacity than office space in an inner suburb—for example, a central business district location generally assists an entity to attract and retain staff. Therefore, the current replacement cost of Charity X's right-of-use asset is estimated by reference to market rentals in its central business district location.

The fact that Charity X lacks the financial resources to pay a commercial rental for central business district office space does not affect the measurement of the current replacement cost of its right-of-use asset under the concessionary lease. A lesser amount that Charity X is willing to pay for office space is a characteristic of that entity, and not of the asset it presently holds.

Charity X measures the current replacement cost of its right-of-use asset as at 30 June 20X1 as 2 years × 12 monthly payments of $100,000 discounted at a rate of 4.5% per annum, ie the present value of $2,400,000—which is $2,291,066.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, AASB 2019-X Amendments to Australian Accounting Standards – Fair Value Measurement of ~~Non-cash-generating~~ Non-Financial Assets of Not-for-Profit ~~Public Sector~~ Entities Held for their Service Capacity.

Introduction

BC1 This Basis for Conclusions summarises the Australian Accounting Standards Board's considerations in reaching the conclusions in this Exposure Draft (ED). It sets out the reasons why the Board developed the ED, the approach taken to developing the ED and the key decisions made. In making decisions, individual Board members gave greater weight to some factors than to others.

Fair Value Measurement for Public Sector Entities Project

Reasons for undertaking the Project

BC2 The Board initially considered the application of AASB 13 *Fair Value Measurement* for not-for-profit and public sector entities in 2011 when IFRS 13 *Fair Value Measurement* was issued. At its March and June 2011 meetings, the Board decided not to include any not-for-profit entity modifications to IFRS 13 in AASB 13.

BC3 At its December 2014 meeting, the Board considered feedback from constituents regarding the application of AASB 13. The Board decided to undertake a narrow-scope project to give relief from certain AASB 13 disclosures, limited to property, plant and equipment within the scope of AASB 116 *Property, Plant and Equipment* that are held for their current service potential rather than to generate future cash inflows, and relief from disclosure of quantitative and qualitative information about the significant unobservable inputs in the fair value measurement of such assets. This project resulted in AASB 2015-7 *Amendments to Australian Accounting Standards - Fair Value Disclosures of Not-for-Profit Public Sector Entities.*

BC4 During the due process of developing AASB 2015-7 and consideration of ITC 34 *AASB Agenda Consultation 2017-2019* (in which the Board sought views on the AASB's priorities for its work program for the period 2017–2019), some constituents in the public sector requested the Board to provide guidance clarifying how the requirements in AASB 13 would be applied to the fair value measurement of public sector entity assets.

BC5 Many constituents in the public sector commented that applying AASB 13 has been challenging and costly and would like guidance on how to measure the fair value of public sector entity assets, in particular (but not limited to):

- valuation techniques to use for a public sector entity asset where there are few or no market participants (other than the entity) and where information about the inputs to a current replacement cost model may be scarce;
- the concept of obsolescence under the cost approach;
- how government-imposed restrictions on non-financial assets should be accounted for; and
- how to measure the fair value of public sector entity assets using the cost approach.

BC6 The Board noted that the measurement issues seem to be widespread across the not-for-profit public sector and involve divergence in practice. Having regard to the feedback received, the Board decided to undertake the Fair Value Measurement for Public Sector Entities Project (the Project) to identify key issues in applying the requirements of AASB 13 to public sector entity assets measured at fair value and develop public-sector-specific guidance in relation to identified issues.

BC7 In addition, in consideration of its Service Concession Arrangements: Grantors project, the Board decided at its February 2016 meeting that because a service concession asset is a specialised asset that the grantor uses for its service potential to achieve public service objectives, only the cost approach to measuring fair value is relevant, and where the operator has been granted the right to future cash flows, this need not be considered in the measurement of the grantor's service concession asset. When developing AASB 1059 *Service Concession Arrangements: Grantors*, the Board noted that it has not provided guidance on the measurement of public sector assets on the grounds that this would best be developed in a future project on the measurement of public sector assets – the Fair Value Measurement for Public Sector Entities Project.

BC8 The Board's strategy for the period 2017-2021 identifies seven strategic objectives. The Project is consistent with the following strategic objectives:

- strategic objective 1 'Develop, issue and maintain principles-based, Australian accounting and reporting standards and guidance that meet the needs of external report users (including financial reports) and are capable of being assured and enforced. For 'publicly accountable' entities maintain IFRS compliance; for others, use IFRS Standards (where they exist), and transaction neutrality (modified as necessary), or develop Australian-specific standards and guidance.' The Project recognises that modifications in the form of amendments or further guidance may be necessary to AASB 13 in response to user feedback to clarify the application of AASB 13 in measuring the fair value of assets held by not-for-profit public sector entities; and
- strategic objective 4 'Attain significant levels of key stakeholder engagement, through collaboration, partnership and outreach.' Undertaking the Project, and the consultative manner in which the Project has been conducted (see paragraphs BC9 – BC10) show that the Board seeks and responds to stakeholder feedback; thereby providing support to the Board's strategy of encouraging active stakeholder participation.

Fair Value Measurement Project Advisory Panel and outreach activities

BC9 The AASB established the Fair Value Measurement Project Advisory Panel (the Panel) to provide a forum for the AASB to consult on specific fair value measurement issues. The Panel consists of industry experts that have experience in dealing with fair value measurement issues, and includes asset valuers and financial statement preparers and auditors. The AASB has held three meetings with the Panel: 6 November 2017, 16 May 2018 and 10 April 2019. The Project has been assisted considerably by extensive background research performed by two Panel members. Some of that work is reflected in this Exposure Draft as well as Board agenda papers.

BC10 As part of the Project, the AASB has also consulted asset valuers from major accounting firms and the Australian Valuation Standards Committee to seek understanding of how asset valuations are carried out in practice, and whether (and, if so, in what manner) the principles in AASB 13 differ from these practices.

Reasons for developing the Exposure Draft

~~BC2~~BC11 ~~The Board has heard from some public sector stakeholders that there is diversity in practice in how the principles in AASB 13 *Fair Value Measurement* are applied in measuring the fair value of non-financial assets held by not-for-profit public sector entities. Many non-financial assets held by not-for-profit public sector entities are 'non-cash-generating', that is, they are held primarily for continuing use of their service capacity rather than for their ability to generate net cash inflows.~~ Because IFRS 13 (and, therefore, AASB 13) is generally expressed from the perspective of for-profit entities in the private sector, there is a need for ~~public-~~sector-specific guidance to assist not-for-profit ~~public sector~~ entities in ~~identifying the appropriate valuation approach to determine~~ addressing the issues they encounter in measuring the fair value of their non-financial assets, particularly ~~non-cash-generating~~ assets held for their service capacity and therefore not primarily for their ability to generate net cash inflows. During the course of its project, the Board formed the view that, although the issues were raised primarily in respect of not-for-profit entities in the public sector, the principles it is proposing are also appropriate for not-for-profit entities in the private sector. A prime example of this is the set of proposed principles for measuring the fair value of not-for-profit entity lessees' right-of-use assets under concessionary leases (see paragraph BC12(d)).

~~BC3~~BC12 After considering input from ~~its Fair Value Measurement Project Advisory Panel (~~the Panel~~)~~, the Board decided to propose amendments to Australian Accounting Standards (principally AASB 13) and illustrative guidance to assist the application of the following principles:

(a) highest and best use (paragraphs 27–30), including consideration of the physical characteristics of an asset and legal restrictions imposed on the use of an asset or the prices that may be charged for using an asset;

(b) when to ~~use the cost approach (paragraphs 61–Aus66.1), including clarifying that the fair value of non-cash-generating assets must be measured using the cost approach only~~ measure a non-financial asset at current replacement cost;~~ and~~

(c) ~~the cost approach (paragraphs B8–B9),~~ how to measure the current replacement cost of a non-financial asset, including the nature of component costs to include in ~~an asset's current replacement cost~~ that amount, consideration of borrowing costs and other finance costs, the trigger for economic obsolescence, and whether the current replacement cost of the land component of ~~a non-cash-generating~~ real property held for its service capacity should always be measured in the land's present location; and

(d) how to measure the fair value of not-for-profit entity lessees' right-of-use assets on initial recognition, in respect of leases with significantly below-market terms and conditions principally to enable the entity to further its objectives ('concessionary leases') in accordance with AASB 1058 *Income of Not-for-Profit Entities*, particularly in respect of restrictions affecting such right-of-use assets and the specialised nature of many assets underlying the leases. Guidance was also developed on measuring such right-of-use assets at current replacement cost.

~~Valuation techniques – Non-cash-generating~~ Addressing the measurement of non-financial assets held for their service capacity (paragraph Aus66.1)

~~BC4~~BC13 Many non-financial assets ~~held by~~ of not-for-profit ~~public sector~~ entities are ~~non-cash-generating~~ held for their service capacity, and some of those assets have legal restrictions imposed on their use or the prices that can be charged for using them. Constituents have asked the Board to clarify how to apply the principle in paragraph 28(b) of AASB 13 that the highest and best use of a non-financial asset takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property). Paragraph IE29 of the Illustrative Examples accompanying IFRS 13 indicates that legal restrictions on the use of an asset that would not transfer to market participant buyers of the asset would not be taken into account in the asset's fair value measurement; however, the reverse is not always true. Legal restrictions on the use of an asset affect the identification of the highest and best use of the asset—and therefore its fair value—*if, and only if, market participants would take those legal restrictions into account when pricing the asset*. The Board has been informed that uncertainty and diverse interpretation have arisen regarding how to identify whether particular legal restrictions transferable to market participant buyers would affect pricing decisions made by those buyers. The Board observed that providing guidance on this issue arising in respect of assets held for their service capacity would not have implications for for-profit entities applying AASB 13, because all assets of for-profit entities are held primarily for their ability to generate net cash inflows (whether directly or indirectly).

~~BC5~~BC14 Legal restrictions imposed on the use of an asset held by a not-for-profit ~~public sector~~ entity, or on the prices that can be charged for using that asset, might significantly reduce the price that a for-profit entity would currently be prepared to pay for the asset (compared with otherwise-identical unrestricted assets). A for-profit entity market participant buyer would be unwilling to pay more for an asset than the amount on which it can generate a commercial rate of return. For example, if land is acquired by a local government from private sector owners and immediately thereafter becomes legally restricted for use as a cemetery, park or land under roads, that restriction would typically prevent a market participant from generating a commercial return on the price paid immediately beforehand to the private sector vendors (for the unrestricted parcel of land). Many public sector commentators argue that, if the market approach or income approach were applied to measure the fair value of the newly restricted land, the resulting fair value measurement would be an amount significantly less than the amount paid to acquire the asset.

~~BC6~~BC15 If restricted land in a suitable location and with similar characteristics was obtainable in the marketplace (impounding the discount resulting from the restriction):

(a) no market participant buyer would be willing to pay more than the price of that restricted land. As paragraph B9 of AASB 13 states: " … a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.";

(b) the market approach and income approach would be valid candidates for estimating the fair value of the not-for-profit public sector entity's existing restricted land under paragraphs 61 – 66 and B5 – B33 of AASB 13; and

(c) if a not-for-profit ~~public sector~~ entity (eg the local government referred to in paragraph BC14~~BC514~~) paid a higher price to acquire unrestricted land immediately before the measurement date, that price would exceed the fair value of the restricted land (ie that entity would have made an uneconomic decision to acquire unrestricted land when suitable restricted land is available for a lower price).

BC16 Accordingly, the Board decided to specify in paragraph Aus66.1 of the proposed amendments of AASB 13 that, if a non-financial asset held for its service capacity and measured at fair value:

(a) has a legally restricted use or is subject to a legal restriction on the prices that may be charged for using it; and

(b) an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset's fair value is measured based on the available market evidence for the equivalent restricted asset. This is consistent with paragraphs 61 – 66 of AASB 13.

BC17 The measurement of the fair value of the non-financial assets referred to in paragraph BC16~~BC16~~ has not been the subject of diversity in practice.

Equivalent restricted asset is not obtainable in the marketplace

~~BC7~~BC18 ~~However,~~ The source of uncertainty and diversity in practice for restricted assets concerns those for which an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence (eg land in a suitable location and with similar characteristics to the asset being measured by a not-for-profit ~~public sector~~ entity often is unobtainable in the marketplace, because such land (and the buildings and other improvements on that land) are generally held by the not-for-profit ~~public sector~~ entity for continuing use of their service capacity rather than for sale). In such cases, a market participant buyer that is a not-for-profit ~~public sector~~ entity could not acquire the land for an amount impounding the discount resulting from the restriction. Such an entity might have no choice but to acquire unrestricted land that subsequently becomes subject to a legal restriction. ~~Consequently, the legal restrictions would have no effect on the price that another not-for-profit public sector entity would currently be prepared to pay for the land.~~

~~BC8~~BC19 Some of the Board's ~~public~~ not-for-profit sector constituents questioned whether the characteristics of the market participant buyer should be assumed to be similar to that of the entity holding the asset being measured at fair value under AASB 13. Accordingly, in the circumstances described in paragraph BC18~~BC7~~18, they argued it is unclear whether the market approach or income approach referred to in paragraph 62 of AASB 13 would be valid candidates for estimating the fair value of the not-for-profit ~~public sector~~ entity's existing restricted land.

BC20 From its outreach activities, the Board identified three main suggested options for modifying AASB 13 to address the uncertainty and diversity in practice regarding the application of that Standard by not-for-profit entities when an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence:

(a) Option 1: specify that any (or a combination) of the market, income and cost approaches may be applied to measure the restricted asset's fair value, which should be measured at a significant discount to the current price of comparable unrestricted asset;

(b) Option 2: specify that the restricted asset must be measured at current replacement cost, which should be measured without a discount to the current price of comparable unrestricted asset—this would not necessarily achieve conformity with IFRS 13 *Fair Value Measurement*, because the market and income approaches would not be permitted; and

(c) Option 3: specify that both treatments under either Option 1 or Option 2 are permitted when applying AASB 13, ie provide an accounting policy choice regarding how to measure such a restricted asset.

BC21 These options are discussed in paragraphs BC22 – BC47.

BC22 The Board quickly rejected Option 3. It noted that, although Option 3 would cause the least disruption to existing practice, codifying significant diversity in practice by providing an explicit accounting policy choice would be incompatible with the Board's function, under its *Policies and Processes*, to "facilitate the development of accounting standards that require the provision of financial information that … facilitates comparability" (paragraph 2). The Board considers that it would be futile to modify AASB 13 on the primary issue raised in this project without reducing the significant existing diversity in practice surrounding this issue.

~~BC9~~BC23 Some commentators in the ~~public~~ not-for-profit sector have argued that, in the circumstances described in paragraph BC18~~BC7~~18, Option 1 should be adopted, ie the market approach or income approach should be applied and the restricted land's fair value should be measured at a significant discount to the current price of comparable unrestricted land. Their reasons include that:

(a) the prices for unrestricted land reflect uses of the land, and rights to charge rentals for using the land, that are not permitted under the restriction. If the restricted land's fair value were measured without a discount to the current price of comparable unrestricted land, the measurement would lack comparability because it would depict different assets as having the same value;

(b) market participant buyers would be unwilling to pay more for the land than the amount on which they can generate a commercial rate of return (this argument reflects a view that only the pricing decisions of for-profit entity market participants should be taken into account);

(c) measuring the fair value of assets[5] at amounts exceeding the net cash inflows from their permitted use discounted at a commercial rate of return would not faithfully represent the assets' contribution to the entity's solvency; and

(d) this treatment has been widely adopted in a number of jurisdictions.

~~BC10~~BC24 However, the Board is concerned that such a measurement of the restricted land's fair value would:

(a) in effect, measure the land at its scrap value. This would not represent faithfully the current market price of the land's service capacity. In addition, it would contradict the Board's conclusion, in making AASB 2016-4 *Amendments to Australian Accounting Standards – Recoverable Amount of Non-Cash-Generating Specialised Assets of Not-for-Profit Entities*, that the fair value of an asset ~~not~~ held ~~primarily~~ for its ~~ability to generate net cash inflows~~ service capacity (which typically is a specialised asset ~~held for continuing use of its service capacity~~) is not its scrap value. The Board stated that this conclusion in AASB 2016-4 is "because an exit price reflects the sale of an asset to a market participant that has, or can obtain, the complementary assets … needed to use the specialised asset in its own operations. In effect, the market participant buyer steps into the shoes of the entity that holds that specialised asset" (Basis for Conclusions on AASB 2016-4, paragraph BC15). In the context of this Exposure Draft, a market participant buyer stepping into the shoes of a not-for-profit ~~public sector~~ entity holding a ~~non-cash-generating~~ non-financial asset for its service capacity is another not-for-profit ~~public sector~~ entity that needs that asset to provide services to beneficiaries[6]; and

(b) if the restricted land had necessarily been acquired by purchasing unrestricted land, cause the imposition of the restriction to result in a heavy write-down of the asset's fair value. Such a write-down would represent unfaithfully that the land's service capacity has reduced significantly.

~~BC11~~BC25 The Board considers that its concerns described in paragraph BC24~~BC10~~24 apply equally to restricted assets other than land. For example, if the fair value of restricted land were to be measured at a significant discount to the current price of comparable land for the reasons in paragraph BC23~~BC23~~, the fair value of buildings restricted for use as public schools or public hospitals should for consistency be measured at scrap values. This would result in statements of financial position of not-for-profit ~~public sector~~ entities representing unfaithfully that those entities essentially only possess financial assets.

BC26 For the reasons in paragraphs BC24~~BC10~~24 – BC25~~BC11~~25, the Board proposes requiring that, in respect of a non-financial asset of a not-for-profit ~~public sector~~ entit~~yies,~~ that is held for its service capacity:

(a) if the asset has a legally restricted use or is subject to a legal restriction on the prices that may be charged for using it; and

(b) an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence,

~~the cost approach shall be used~~ where another Australian Accounting Standard (eg AASB 116 *Property, Plant and Equipment*) has required the asset to be measured at ~~to estimate the~~ fair value, ~~of their non-cash-generating assets[7] (ie those assets' fair values would~~ the asset is to be measured at current replacement cost, applying the guidance in paragraphs B8 – B9 of AASB 13~~)~~: see paragraph Aus66.1 of the [draft] Standard. In ~~A~~applying this proposed requirement, the asset's current replacement cost would be measured without a discount to the current market buying price of an equivalent but unrestricted asset. For example, ~~mean that,~~ in the case of the restricted land described in paragraph BC14~~BC5~~14:

~~(a) if restricted land in a suitable location and with similar characteristics was obtainable in the marketplace (impounding the discount resulting from the restriction), the land's current replacement cost would equal its market price based on observable market evidence (ie the fair value measurement of the land~~

[5] Either on a stand-alone basis or as part of a group of interdependent assets, under the valuation premises outlined in paragraph 31 of AASB 13.

[6] Paragraphs BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13 state that: "… for specialised non-financial assets that have a significant value when used together with other non-financial assets, for example in a production process, but have little value if sold for scrap to another market participant that does not have the complementary assets, … the scrap value for an individual asset would be irrelevant because the valuation premise assumes that the asset would be used in combination with other assets … . Therefore, an exit price reflects the sale of the asset to a market participant that has, or can obtain, the complementary assets … needed to use the specialised asset in its own operations. In effect, the market participant buyer steps into the shoes of the entity that holds the specialised asset. … When a market price does not capture the characteristics of the asset … that price will not represent fair value. In such a situation, an entity will need to measure fair value using another valuation technique (such as an income approach) or the cost to replace or recreate the asset (such as a cost approach) depending on the circumstances and the information available." Although the IASB refers to the market participant buyer stepping into the shoes of an entity holding a *specialised* asset, the IASB's conclusion can logically be extended in a not-for-profit entity context to any assets (whether specialised or not) that contribute more to an entity when used together with other non-financial assets than their selling price to another market participant without the complementary assets. The market participant buyer stepping into the shoes of the not-for-profit ~~public sector~~ entity holding the ~~non-cash-generating~~ asset held for its service capacity obtains value from that asset in the first instance by providing needed services to beneficiaries, but also obtains value through financial support [in the form of rates, taxes, grants and appropriations] and through any user charges.

~~[7] Paragraphs BC19 – BC24 discuss in more detail the Board's consideration of how to delineate the assets to which this proposed requirement should apply.~~

~~under the cost approach would equal the amount that would be determined under the market approach described in paragraphs B5 – B7 of AASB 13); and~~

if restricted land in a suitable location and with similar characteristics was not obtainable in the marketplace, the restricted land's ~~fair~~ value should not be measured at a discount to the current price of suitable unrestricted land.

BC27 For the purposes of paragraph BC26~~BC26~~, a reference to another Australian Accounting Standard requiring an asset to be measured at fair value includes circumstances in which an entity has *elected* to apply the revaluation model for measurement after initial recognition to the asset and the other assets in the same class (eg the revaluation model in paragraph 31 of AASB 116) and, in turn, the relevant Standard requires the asset to be measured at fair value at the date of the revaluation. This proposed Standard includes a proposed consequential amendment to AASB 116 catering for circumstances in which the revalued carrying amount of an item of property, plant and equipment is, under the requirements of this proposed Standard, current replacement cost and not necessarily fair value (new paragraph Aus31.1): see also paragraph BC28~~BC28~~.

~~BC12 Under the Board's proposal, the same principle would apply to all restricted non-cash-generating assets[8] held by not-for-profit public sector entities (eg their non-cash-generating buildings, plant and equipment). Measuring the fair value of a restricted non-cash-generating asset held by a not-for-profit public sector entity at the price another not-for-profit public sector entity would need to pay to acquire its service capacity is not constrained by a general lack of observable sale transactions of that nature. Paragraph BC30 of the IASB's Basis for Conclusions on IFRS 13~~ ~~*Fair Value Measurement*~~ ~~states that the definition of fair value in AASB 13 (IFRS 13) assumes a hypothetical exchange transaction. Furthermore, under the contrary approach described in paragraph BC9, measuring the fair value of a restricted asset at a significant discount to the current price of comparable unrestricted assets often involves the use of unobservable inputs to determine the amount of the discount – that is, a hypothetical transaction is also assumed.~~

~~BC13~~BC28 Other points made by the Board in response to the arguments for ~~the contrary view~~ Option 1 in paragraph BC23~~BC9~~23 are that:

~~(a) the Board considers that (with reference to paragraph BC9(a)) its proposal would result in measurements of restricted assets that lack comparability only if the concept of fair value in AASB 13 was an asset's current cash equivalent (which is the amount of cash that can be obtained immediately from sale of an asset on a stand-alone basis). The Board observes that the concept of fair value in AASB 13 is not limited to an asset's current cash equivalent and considers that the concept of fair value in AASB 13 is consistent with measuring the current value of an asset in its highest and best use to any market participant – including the holder of the asset – and that restrictions might, but do not necessarily, affect that value for a not-for-profit public sector entity. Therefore, the Board considers that adopting its proposal in paragraph BC12 would not cause a loss of comparability between fair value measurements of restricted and unrestricted assets;~~

~~(b) the Board disagrees with the implicit view in paragraph BC9(b) that only the pricing decisions of for-profit entity market participants should be taken into account when measuring a non-cash-generating asset of a not-for-profit public sector entity. It considers that the market participant buyer stepping into the shoes of that entity (see paragraph BC10(a)) would be another not-for-profit public sector entity if that entity would need to pay more for the non-cash-generating asset than the amount on which a market participant buyer could generate a commercial rate of return;~~

~~(c)~~ with reference to the argument in paragraph BC23~~BC9~~23(c) that measuring the fair value of assets at amounts exceeding the net cash inflows from their permitted use discounted at a commercial rate of return would not faithfully represent the assets' contribution to the entity's solvency, the Board ~~observes that:~~

~~(d)~~(a) ~~the concept of fair value in AASB 13 is not limited to an asset's current cash equivalent (see paragraph BC14(a))~~ proposes that current replacement cost measurements of particular restricted assets are not to be presented as 'fair value measurements' in financial statements, because using current replacement cost may not be compliant with AASB 13. Consequently, the assets' measurements should not be misconstrued as measures of the net cash inflows from their permitted use discounted at a commercial rate of return; and

~~(i) if the non-cash-generating assets of not-for-profit public sector entities were to be measured at their current cash equivalents (with the aim of better depicting the assets' contribution to the entity's solvency), those assets would be measured at their scrap values and the entities' statements of financial position would represent unfaithfully that, in effect, those entities only hold financial assets; and~~

Commented [JP20]: This important point is part of the subject of Question 2 in the Cover Memo.

~~[8] By definition, this proposal applies to non-financial assets. Non-financial assets are not explicitly referred to in the subject matter of this proposal, because they are implicit in references to 'non-cash-generating assets'.~~

~~(ii) the solvency of any entity depends, in the first instance, on the entity's ability to generate net cash inflows from the goods and services it provides to customers or beneficiaries (either through exchange transactions or non-exchange transfers). In this regard, the solvency of a not-for-profit public sector entity depends in large part of the willingness and capacity of its financial contributors to continue supporting its operations (which depends on a range of factors, including, importantly, the entity's service performance); and~~

~~(c)~~(b) observes that, with reference to the implication of paragraph BC23~~BC923~~(d) that ceasing to measure the ~~fair~~ value of restricted land at a significant discount to the current price of comparable unrestricted land would result in a widespread change to current practice, ~~the Board observes that~~ measuring the fair value of other restricted assets at a significant discount to the current price of comparable assets (eg measuring the fair value of buildings restricted for use as public schools or public hospitals at scrap values) would also be a significant change to current practice. The Board considers it is essential that whichever policy is applied to measure the current value of restricted non-financial assets held by not-for-profit entities, it must be applied consistently to land and non-financial assets other than land.

~~BC14~~BC29 The Board's proposal to modify AASB 13 to specify using ~~the cost approach~~ current replacement cost to measure the ~~fair~~ current value of ~~non-cash-generating~~ non-financial assets for not-for-profit ~~public sector~~ entities held for their service capacity is broadly consistent with the requirement in AASB 1059 *Service Concession Arrangements: Grantors* to use ~~the cost approach~~ current replacement cost to measure the fair value of a grantor's service concession assets (AASB 1059, paras. 7, 8, and 9(b)). This requirement reflected the AASB's view that, if the grantor in a service concession arrangement compensated the service concession operator for the service concession asset and service provision by granting the operator a right to earn third-party user tolls, the service capacity embodied in the grantor's service concession asset is unaffected by granting the operator a right to toll, because the asset provides the same utility to the public regardless of that grant. Unlike other approaches to measuring fair value, the cost approach (current replacement cost) results in the same measure of the fair value of a particular service concession asset regardless of whether the operator was granted a right to earn third party user tolls (AASB's Basis for Conclusions on AASB 1059, paragraphs BC50 – BC53 and BC62 – BC66). As with AASB 1059, using current replacement cost to measure particular non-financial assets may not be compliant with IFRS 13 because neither the market approach nor income approach may be used to measure the asset. In contrast with current replacement cost measurements of a grantor's service concession assets, current replacement cost measurements of other non-financial assets held for their service capacity are not to be presented as 'fair values', because of the significance of the effect of many restrictions on those non-service concession assets.

~~BC15 As indicated in AASB 2016-4, non-cash-generating assets are not held primarily for their ability to generate net cash inflows, and typically are specialised assets held for continuing use of their service capacity. Because non-cash-generating assets are not necessarily specialised, and because it sometimes is debatable whether particular assets (such as restricted land) are specialised, the Board's proposed requirement for not-for-profit public sector entities to use the cost approach to measure the fair value of particular assets does not explicitly refer to specialised assets (see also the footnote to paragraph BC10(a)). The Board's proposal is delineated as applying to non-cash-generating assets, because the fact that these assets are not held primarily for their ability to generate net cash inflows is the key reason why their fair value should not be measured using the market approach or income approach where the resulting measures of fair value differ from the assets' current replacement cost.~~

~~BC16~~ The Board's proposal to require that, in respect of not-for-profit ~~public sector~~ entities, restricted assets described in paragraph BC18~~BC18~~ ~~the cost approach shall be used to estimate the fair value of non-cash-generating assets~~ are to be measured at current replacement cost would not preclude using observable market prices when they are materially the same as current replacement cost. For example, this could occur when~~:~~

~~BC17~~BC30 ~~-~~such assets are compulsorily acquired and the compensation arrangements are based on market value principles~~; or~~.

~~(a) a restricted asset highly similar to that held by the entity was obtainable in the marketplace (impounding the discount resulting from the restriction).~~

~~BC18~~BC31 The Board considers that it presently is not sufficiently clear under AASB 13 how to measure the fair value of non-financial assets of a not-for-profit entity held for their service capacity, particularly when such assets are subject to ~~whether particular~~ legal restrictions transferable to market participant buyers ~~would affect pricing decisions made by buyers of non-cash-generating assets held by not-for-profit public sector entities, and particularly whether the characteristics of the market participant buyer should be assumed to be similar to that of the entity holding the asset~~ (ie more than one approach could be justified). Therefore, the Board's proposal to require using ~~the cost approach~~ current replacement cost to measure the ~~fair~~ current value of ~~non-cash-generating~~ non-financial assets of not-for-profit ~~public sector~~ entities held for their service capacity~~,~~ (except where the asset is restricted and an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence[9]) is designed to reduce uncertainty and diversity in practice in how ~~the principles in AASB 13 are applied~~ to measure the current values of these assets. The Board observes that:

(a) would not necessarily change practice for some ~~of those~~ not-for-profit entities (other than changing the manner in which those current value measurements are presented in financial statements); and

(b) does not indicate that entities ~~applying a different approach to account for restrictions~~ changing practice in how they measure those assets ~~are departing from~~ made an error in applying the existing requirements of AASB 13.

Boundary of the proposed requirements

~~BC19~~BC32 Paragraphs BC33~~BC20~~33 – BC39~~BC24~~39 discuss the Board's considerations in identifying the boundary of its proposed requirements ~~that~~ for measuring the ~~fair~~ current values of particular non-financial assets of not-for-profit ~~public sector~~ entities ~~is to be estimated using the cost approach~~.

BC33 ~~As mentioned in paragraph BC16, t~~The Board's measurement proposals ~~is~~ are delineated as applying to ~~non-cash-generating~~ non-financial assets held for their service capacity, because the fact that these assets are not held primarily for their ability to generate net cash inflows is the key reason why it is unclear whether their fair value should ~~not~~ be measured using the market approach or income approach where the resulting measures ~~of fair value~~ differ from the assets' current replacement cost. The Board refined the scope of its proposed requirements to those assets with a legally restricted use or that are subject to a legal restriction on the prices that may be charged for using them, because the existence of such restrictions is at the heart of the uncertainty and diverse practices.

BC34 For the avoidance of doubt, the Board decided to propose specifying that, if an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is measured at fair value based on the available market evidence for the equivalent restricted asset (see paragraph Aus66.1(a)). The Board does not expect that proposed requirement to result in changed practice.

~~BC20~~BC35 ~~That is, t~~The proposed measurement requirement that other restricted assets held for their service capacity are to be measured at current replacement cost is designed to avoid not-for-profit ~~public sector~~ entities measuring those assets at scrap value ~~their assets that are not held primarily for their ability to generate net cash inflows~~. ~~In AASB 2016-4, assets not held primarily for their ability to generate net cash inflows were termed 'primarily non-cash-generating assets'. For brevity, 'non-cash-generating assets' is the phrase used in this Basis for Conclusions to refer to assets that are not held primarily for their ability to generate net cash inflows, although the longer phrase is used in the [draft] Amending Standard (the Board concluded it is unnecessary to use 'primarily' twice).~~

~~BC21~~BC36 The Board tested ~~that~~ the boundary for these proposed requirements firstly by considering whether ~~the cost approach to measuring fair value~~ current replacement cost should be mandated in respect of any ~~cash-generating~~ non-financial assets held for not-for-profit ~~public sector~~ entities primarily for their ability to generate net cash inflows, particularly if those assets are specialised and/or their uses (or the prices that may be charged for using them) are legally restricted. The Board:

(a) noted that AASB 13 already indicates, in effect, that the fair value of specialised assets held primarily for their ability to generate net cash inflows in combination with other assets is often measured under the cost approach—ie at current replacement cost as a measure of fair value (AASB 13, paragraph B9 and the IASB's Basis for Conclusions on IFRS 13, paragraphs BC78 – BC79), but does not mandate using the cost approach for all specialised assets; and

(b) considered that, if a specialised asset is held primarily for its ability to generate net cash inflows on a stand-alone basis, and is subject to a legal restriction, the asset's fair value would not exceed the price a market participant buyer would be prepared to invest to generate a commercial return from the asset. (Restrictions over assets that would transfer with the assets to market participant buyers generally result in those assets being specialised.) Therefore, if sales evidence of similarly restricted assets were unavailable but market prices were observable for similar but unrestricted assets, it would be appropriate to apply a discount to the market price of the comparable asset when measuring the fair value of the restricted asset. For example, assume that:

   (i) a not-for-profit ~~public sector~~ entity held a surplus building subject to heritage preservation requirements, to generate rental income and for capital appreciation;

   (ii) that entity originally acquired the building for service-delivery and administrative purposes because of its location and physical capacity: it is not required to retain the building for

9 See paragraph Aus66.1.

heritage purposes (the heritage preservation requirements simply transfer to any market participant buyer); and

(iii) the heritage preservation requirements increased the building's maintenance costs and impeded changing the layout of its accommodation in response to tenants' needs, and therefore that under either the market approach or income approach, the building's fair value is estimated to be 10 per cent less than the observable market price of an adjacent unrestricted building that is otherwise identical.

In that example, a for-profit entity market participant buyer would be unwilling to pay more for the heritage building than the price of the adjacent building minus a 10 per cent discount. Similarly, the not-for-profit ~~public sector~~ entity would be unwilling to pay more than that discounted price for the heritage building if it hypothetically were bidding for it, and (because of the nature of the asset) another not-for-profit ~~public sector~~ entity stepping into its shoes would be unwilling to pay more than that discounted price for the heritage building. It is unrealistic to expect that another market participant buyer would have a need for that specific heritage building and be willing to pay more than a for-profit entity market participant buyer if the reporting entity (ie the not-for-profit ~~public sector~~ entity holding the building) is not; and

(c) noted that the issues raised regarding how to measure the fair value of specialised and/or restricted assets generally relate to ~~non-cash-generating~~ assets held for their service capacity.

~~BC22~~BC37 For the reasons in paragraph BC36~~BC2136~~, the Board concluded that ~~the cost approach~~ current replacement cost, either as a measure of ~~to measuring~~ fair value or a separate measurement basis, should not be mandated for ~~cash-generating~~ assets ~~held for~~ of not-for-profit ~~public sector~~ entities held primarily for their ability to generate net cash inflows, regardless of whether they are specialised ~~and/or subject to legal restrictions~~.

~~BC23~~BC38 The Board considered whether the boundary for its proposed requirement ~~(namely, that the fair value of particular non-financial assets of not-for-profit public sector entities is to estimated using the cost approach)~~ to use current replacement cost to measure the current value of non-financial assets of not-for-profit entities held for their service capacity (except where the asset is restricted and an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence) should be based on one or more of the factors to consider when selecting a measurement basis for assets, as identified by the International Public Sector Accounting Standards Board (IPSASB) in its Consultation Paper entitled *Measurement* (April 2019). Those factors identified by the IPSASB in that Consultation Paper (paragraph 1.5(b)) that are related to the nature and circumstances of the asset, and the Board's responses to them, are set out below:

(a) The asset was acquired in a non-exchange transaction – the Board concluded that this should not affect how to measure an asset's ~~fair~~ current value as at a particular date, because market conditions affecting an asset at that date are independent of how the asset was acquired;

(b) The assets are held to provide services ('non-cash-generating assets'), to generate a commercial return ('cash-generating assets') and/or for trading or sale – the Board noted that this distinction draws upon the distinction between 'cash-generating assets' and 'non-cash-generating assets' in IPSAS 26 *Impairment of Cash-Generating Assets* and IPSAS 21 *Impairment of Non-Cash-Generating Assets*.[10] IPSAS 21 defines 'cash-generating assets' as "assets held with the primary objective of generating a commercial return" and 'non-cash-generating assets' as "assets other than cash-generating assets". Under IPSAS 21, the value in use of a non-cash-generating asset is measured by reference to the asset's replacement cost or restoration cost (described as the present value of the asset's remaining service potential) instead of the present value of future cash flows expected from the asset. The substance of the definition of a 'non-cash-generating asset' in IPSAS 21 is similar to the substance of the term ~~'non-cash-generating assets'~~ 'assets held for their service capacity' used in this Exposure Draft. The only noteworthy difference is that under this Exposure Draft's proposals, ~~'cash generating assets'~~ the counterpart to those assets ~~are~~ is assets held primarily for their ability to generate net cash inflows; whereas, under IPSAS 21, ~~those~~ the counterpart to 'non-cash-generating assets' is assets ~~are~~ held with the primary objective of generating a *commercial* return. Those notions are substantially the same. The Board decided to use the term ~~'non-cash-generating asset' with the meaning given to it in AASB 2016-4, particularly because both that Standard and~~ 'assets held for their service capacity' because this Exposure Draft ~~are~~ is concerned with avoiding ~~non-cash-generating~~ those assets being written down (inappropriately) to their scrap values. The Board will review the relationship between the ~~meaning of 'cash-generating assets'~~ terminology in IPSASs and Australian Accounting Standards as part of a broader future review of the similarities and differences between those suites of Standards;

[10] In view of the potential overlap between 'cash-generating assets' and assets held for trading or sale, the Board did not consider referring explicitly to 'assets held for trading or sale' when describing the category/categories of assets for which fair value should not be required to be measured using the cost approach in AASB 13.

(c) The assets are specialised, where they have been created or adapted for a particular purpose – the Board considers that the scope of its proposal for mandating use of ~~the cost approach~~ current replacement cost caters for specialised assets. As noted above, ~~T~~the Board concluded that an asset's being specialised should not always be a determining factor for when ~~the cost approach~~ current replacement cost must be ~~applied~~ used~~(see paragraphs BC21 – BC22)~~; and

(d) There are restrictions on what the entity is able to do with the asset – the Board ~~considers~~ noted that the scope of its proposal for mandating use of ~~the cost approach~~ current replacement cost ~~caters for~~ is limited to particular restricted assets. However, ~~T~~the Board concluded that an asset's being restricted should not of itself ~~always~~ be a determining factor for when ~~the cost approach~~ current replacement cost must be applied: ~~(see paragraphs BC21 – BC22)~~ the non-financial asset must also be held for its service capacity (see paragraph BC36~~BC36~~(b)).

~~BC24~~BC39 The Board also considered the United Kingdom *Government Financial Reporting Manual 2019-20* in determining the boundary for its proposed requirement to use current replacement cost. The only category of property, plant and equipment that the Manual identifies as being measured at fair value using IFRS 13 *Fair Value Measurement* is a surplus asset (ie an asset not being used to deliver services, where there is no plan to bring the asset back into use) without any restrictions on sale and that falls within the scope of neither IAS 40 *Investment Property* nor IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations* (paragraph 7.1.8). The Manual specifies that when assets are held for their service potential (ie they are operational assets used to deliver either front line services or back office functions) and are specialised, their current value should be measured at the present value of the asset's remaining service potential, which can be assumed to be at least equal to the cost of replacing that service potential (paragraph 7.1.4). The Board observes that the boundary of its measurement proposal (ie ~~non-cash-generating~~ assets held for their service capacity) is consistent with the reference in the United Kingdom *Government Financial Reporting Manual 2019-20* to assets held for their service potential.

Whether current replacement cost measurements should include a discount for legal restrictions on the use of assets

BC40 In relation to the proposed requirement to measure restricted assets at current replacement cost in the circumstances described in paragraph BC26~~BC26~~, the Board considered whether an asset's current replacement cost should include a discount for legal restrictions on their use. When an asset's current replacement cost is measured consistently with paragraphs B8 – B9 of AASB 13, that amount represents the amount that would be required currently to replace the asset's service capacity. The Board noted that some commentators argue that the imposition of a legal restriction on the use(s) of an asset reduces the asset's service capacity and, therefore, in principle, this reduction should be reflected in the measurement of the asset's current replacement cost.

BC41 Those commentators also argued that non-financial assets of not-for-profit entities held for their service capacity should not be measured at fair value using the market approach or income approach because the service potential embodied in such assets should not be measured by reference to the net cash inflows the assets are expected to generate. Similarly, they argued that, if such an asset is subject to a legal restriction on the prices that may be charged for its use, and the asset cannot be acquired with that restriction, the current market buying price of an equivalent but unrestricted asset should not be discounted for the effects of restrictions on the asset's capacity to generate net cash inflows.

BC42 The commentators referred to in paragraph BC40~~BC40~~ gave the example of a local government that acquires land for its service capacity and, on initial acquisition, the land may be dedicated for use as a park, sporting complex, car park, water retarding basin, cemetery or an administration office. The land's service capacity includes the ability to be used in any of these manners. Those commentators consider that if, subsequent to acquisition, the land becomes legally restricted for use only as (for example) a cemetery, the land's service capacity has diminished considerably.

BC43 To apply the principle referred to in paragraph BC40~~BC40~~, it would be necessary to distinguish the following components of the total discount to the current market price of an equivalent but unrestricted asset argued for under Option 1 (see paragraph BC20~~BC20~~(a)):

(a) the component relating to the reduction in the net cash inflows that the asset can generate as a result of the legal restrictions affecting the asset, which includes, but is not limited to, any legal restrictions on the prices that may be charged for using the asset (ie a legal restriction on the use of an asset also may affect the net cash inflows the asset may generate); and

(b) the component relating to the legal restriction on the use of the asset.

BC44 The commentators referred to in paragraph BC40~~BC40~~ noted that it would often be exceptionally difficult to measure with reliability the component of the discount referred to in paragraph BC43~~BC43~~(b). This is because market evidence for the total amount of the discount is often difficult to find, and this difficulty is exacerbated for the component in (b)—particularly because the two components in paragraph BC43~~BC43~~ are often interdependent. The Board agreed with this reasoning.

BC45 In considering this issue, the Board had regard to the literature of IPSASB, the United Kingdom Government and the International Valuation Standards Committee. Existing IPSASs (in particular, IPSAS 17 *Property, Plant and Equipment* and IPSAS 21 *Impairment of Non-Cash-Generating Assets*) do not indicate that the amount of an asset's depreciated replacement cost would be reduced for the effects of legal restrictions on the asset's use or the prices that may be charged for using the asset. IPSASB Consultation Paper *Measurement* (April 2019) proposes that, in measuring an asset's replacement cost, an entity considers any factors that might affect the cost of replacing the service capacity of the existing asset, and that the asset's existing use will be considered in the light of (among other things) existing restrictions on the use or sale of the land and/or buildings (paragraph D22). The Consultation Paper does not specify whether a discount would be deducted for the effect of such restrictions when measuring the asset's replacement cost.

BC46 The United Kingdom *Government Financial Reporting Manual 2019-20* does not contain guidance indicating that the cost of replacing an asset's remaining service potential includes a discount for the effect of legal restrictions (paragraphs 7.1.1 – 7.1.14). International Valuation Standard IVS 105 *Valuation Approaches and Methods* does not indicate that the amount of an asset's current replacement cost would be reduced for the effects of legal restrictions on the asset's use or the prices that may be charged for using the asset.

BC47 The Board concluded that, on balance, an asset's current replacement cost should not include a discount for legal restrictions on its use. Some Board members reached this view because they think the current market buying price of an asset's service capacity would only be reduced for the effect of a restriction if, as a result of the restriction, the asset could be acquired for a lower price. Those Board members observed that, in such a circumstance, the asset would be likely to meet the criteria in paragraph BC16~~BC16~~ for measurement at fair value using a market approach ie the circumstance would not arise when current replacement cost is required. Other Board members reached the view that an asset's current replacement cost should not include a discount for legal restrictions on its use because of the practical measurement difficulties of doing so, as referred to in paragraphs BC43~~BC43~~ – BC44~~BC44~~.

Financially feasible use of an asset (paragraph Aus28.1)

BC48 The Board proposes ~~the addition of guidance clarifying the meaning of a~~ that the 'financially feasible' use' aspect of ~~an~~ a non-financial asset's highest and best use (as described in paragraph 28(c) of AASB 13) ~~in relation to non-cash-generating~~ should not be applicable to assets of not-for-profit ~~public sector~~ entities that:

(a) are held for their service capacity;

(b) have a legally restricted use or are subject to legal restrictions on the prices that may be charged for using them; and

(c) because an equivalent restricted asset is not obtainable in the marketplace for a price supported by observable market evidence, are measured at their current replacement cost in accordance with paragraph F4.

~~BC25~~BC49 Paragraph 28(c) of AASB 13 refers to an asset's highest and best use generating an investment return that market participants would require from an investment in that asset put to that use. ~~Without a clarifying modification,~~ Without a scope exemption for the non-financial assets that meet all of the tests in paragraph BC48~~BC48~~(a) – (c), paragraph 28(c) of AASB 13 might nullify the Board's conclusion that the ~~fair value~~ current replacement cost of a ~~non-cash-generating~~ non-financial asset ~~held by~~ of a not-for-profit ~~public sector~~ entity held for their service capacity—determined in accordance with the guidance on current replacement cost in AASB 13—can exceed the amount on which a market participant buyer could generate a commercial rate of return (see paragraph BC~~14~~24). ~~Therefore, the Board proposes including paragraph Aus28.1 to explain a financially feasible use as one that generates sufficient services to justify a not-for-profit public sector market participant buyer incurring the asset's current replacement cost. The reference to an asset's current replacement cost is consistent with the proposed requirement in paragraph Aus66.1 that the fair value of non-cash-generating assets of not-for-profit public sector entities is measured using the cost approach.~~ Therefore, the Board proposes to exempt from the scope of paragraph 28(c) of AASB 13 the non-financial assets that meet all of the tests in paragraph BC48(a) – (c).

Highest and best use for non-financial assets

Physically possible uses of an asset (paragraph 28(a))

~~BC26~~BC50 Paragraph 28(a) of AASB 13 states that the highest and best use of a non-financial asset takes into account the use of the asset that is physically possible (ie the physical characteristics of the asset, such as its location and size, that market participants would take into account when pricing the asset). The Board was asked by constituents to clarify that some restrictions affecting the fair value of assets are physical rather than

Commented [JP21]: **Question for Board members**

Q8 Do Board members agree that an asset's current replacement cost should not include a discount for legal restrictions on its use?

Commented [JP22]: As mentioned in the boxed comment adjacent to paragraph Aus28.1, Staff reviewed that paragraph in light of Board member comment that it was unclear, and concluded it was circular. Current replacement cost will reflect any shortfall in service capacity arising from the highest and best use of an asset, through the measurement of obsolescence. Therefore, staff recommend scoping restricted assets measured at current replacement cost out of the scope of the 'financially feasible use' aspect of an asset's highest and best use. The question for Board members on this issue is adjacent to paragraph Aus28.1.

legal in nature. For example, those constituents noted that if an entity holds a parcel of land that has been used as a garbage tip, the risk of methane emissions might limit the land's potential uses (eg to only being suitable for conversion to parkland). They argued that using that land as a tip creates a physical restriction on that land affecting the highest and best use that market participants would take into account when pricing that land, regardless of any legal restrictions on the use of the land (ie zoning restrictions) or on the prices that can be charged for using that land. Legal restrictions are the subject of paragraph 28(b) of AASB 13.

~~BC27~~BC51 The Board noted that using that land as a tip affects the physical characteristics of the land that market participants would take into account when pricing the land (ie would limit the use of the land that is physically possible, as referred to in paragraph 28(a) of AASB 13). Therefore, the Board concluded it is unnecessary to modify paragraph 28(a) of AASB 13 to also refer to 'physical restrictions'.

Legal restrictions on the use of an asset (paragraph 28(b))

~~BC28~~BC52 The Board was asked by constituents to provide guidance clarifying whether, in applying paragraph 28(b) of AASB 13, legal restrictions might in some circumstances be treated differently at a parent entity level (e.g. State Government level), compared with an individual entity (e.g. government department) level, when those restrictions were imposed by the parent entity.

~~BC29~~BC53 If a law or regulation imposes a restriction on the use of an asset held by a government department, and this restriction would transfer to any market participant buyer of the asset, paragraph 28(b) of AASB 13 states that the asset's highest and best use would take into account the restriction if market participant buyers would take it into account when pricing the asset. The Board considered whether the restriction should be treated as non-legally binding at the whole-of-government level if the government can rescind the law or regulation. This issue is unique to the public sector, because private sector entities cannot rescind laws.

~~BC30~~BC54 The Board considered that, if a restriction had been imposed by a law that can only be rescinded by parliament (and has yet to be rescinded), the existing legal requirement should be treated as legally binding at the whole-of-government level in addition to being treated as legally binding for the controlled entity (reflecting that the government does not control parliament). In this regard, if a rescission of a restriction has been approved by one House of Parliament but requires approval by another House of Parliament, or requires Royal Assent, the restriction is treated as still requiring rescission by parliament (ie presently legally binding).

~~BC31~~BC55 However, if the existing legal restriction can be rescinded without parliamentary approval, the Board concluded that the restriction should be treated as non-legally binding at the parent entity (e.g. whole-of-government) level, because:

(a) the parent entity has the unilateral capacity to remove the restriction; and, consequently,

(b) the restriction is in effect a self-imposed restriction (even if it was formalised in legislation or a regulation).

~~BC32~~BC56 That is, the measurement of the asset's fair value at the parent entity level should not assume that the restriction would definitely transfer to the market participant buyer in a hypothetical sale at the measurement date if it could be rescinded without parliamentary approval. The measurement of the asset's fair value should reflect the present existence of the restriction but also the parent's option to rescind the restriction. Therefore, the fair value measurement of the parent entity's asset should in principle include the estimated enhancement in value from rescinding the restriction, reduced by the effects of:

(a) the risk that the parent is unable to rescind the restriction. For example, if land is zoned as a park by government regulation and the government has the power to change that zoning (e.g. to allow the land to be used for a freeway extension) without parliamentary approval, it might face strong community opposition to that change in zoning; and

(b) the current cost (if any) of rescinding the restriction, if it could be rescinded. The Board considers that it is appropriate to deduct those costs in measuring the asset's fair value because those costs are analogous to costs of transporting an asset to its marketplace (which are deducted when determining an asset's fair value, in accordance with paragraph 26 of AASB 13).

~~BC33~~BC57 The Board noted arguments that financial reporting should reflect laws currently effective or substantively enacted, regardless of the probability that particular laws will change in the future. Some commentators have argued that treating an existing legal restriction as non-legally binding at the parent entity level would be inconsistent with the treatment of sovereign powers in the IPSASB's *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. The IPSASB Conceptual Framework specifies that a government's sovereign power (ie its general ability to establish a power through a statute) only gives rise to an asset when the power is exercised and creates rights to receive resources (paragraph 5.13)[11]. The Board observed that:

(a) as advised to it by professional valuers in outreach activities, current valuation practice in estimating the fair value of land takes into account any material potential that the land will be rezoned for a higher and better use, with any estimated net enhancement reduced for the risk that such rezoning will not occur and the time value of the period until such rezoning is expected to occur (weighted for the different possible periods until rezoning occurs). This practice is consistent with the comments in paragraphs IE7 – IE8 of the IASB's Illustrative Examples accompanying IFRS 13 and paragraphs BC68 – BC69 of the IASB's Basis for Conclusions on IFRS 13 that potential changes in zoning restrictions that market participants would take into account when pricing a property should be considered in the property's fair value measurement unless the alternative use is legally prohibited; and

(b) anticipating rescission of a law or regulation when measuring an asset's fair value does not imply disagreement with the IPSASB's view about anticipating the exercise of a government's sovereign powers. The IPSASB's view about sovereign powers is concerned with the identification and recognition of assets and liabilities—not measurement.

~~BC34~~BC58 In practice, the reliability with which the parent's option could be measured would largely depend on the ability to estimate the probability that the restriction could be rescinded. In some instances in which an existing legal restriction can be rescinded without parliamentary approval, the risk of being unable to rescind the restriction would be very low and could be ignored in the measurement of fair value, on materiality grounds. However, if there is a significant risk of being unable to rescind a restriction and the risk cannot be estimated reliably, the restriction should be wholly taken into account in the fair value measurement because rescission of a restriction should not be assumed if there is significant doubt that it will occur.

~~BC35~~BC59 The Board noted that, if a restriction is considered to be legally binding only at a controlled entity level, different fair value measurements of the asset would be made at the controlled entity and group level, requiring a consolidation adjustment when preparing the consolidated financial statements for the group. The Board observed that precedent exists in Australian Accounting Standards for the need for consolidation adjustments in relation to the same asset. For example, paragraph 15 of AASB 140 *Investment Property* stipulates that, in some circumstances, a property that is investment property of a controlled entity is classified as owner-occupied property from the perspective of the group. Similarly, paragraph 6.3.5 of AASB 9 *Financial Instruments* states that hedge accounting applied at a controlled entity level for transactions between entities in the same group might not be appropriate in the consolidated financial statements of the group.

Current Replacement Cost ~~approach~~ (paragraphs B8–B9)

Nature of costs included in the current replacement cost of a self-constructed facility

Commented [JP23]: This section has been edited for consistency with the Board's decisions on this issue at its June 2019 meeting.

~~BC36~~BC60 The Board was asked to clarify which costs should be included in the current replacement cost of a self-constructed ~~asset~~ facility (eg a road and the land under the road, whether reported jointly or separately)~~when measuring its fair value using the cost approach~~ held by a not-for-profit entity. (This issue excludes consideration of borrowing costs and other finance costs, which are discussed in paragraphs BC82~~BC57~~82 – BC86~~BC66~~86.) The following comments refer to any measurement of such an asset at current replacement cost, whether under the cost approach in paragraphs B8–B9 of AASB 13 or under proposed paragraph Aus31.1 of AASB 116.

~~BC37~~BC61 Some commentators have argued that:

(a) ~~an asset's~~ a self-constructed facility's current replacement cost should be estimated by assuming that the ~~asset~~ facility presently does not ~~presently~~ exist and needs to be replaced from scratch; and

(b) therefore, it is appropriate to base the estimates of current replacement cost on the conditions that existed when the ~~asset~~ facility was initially constructed. Therefore, they argue, it would be inappropriate to include in ~~an asset's~~ a facility's current replacement cost the ~~costs of repairing damage to other~~ make-good costs for surrounding facilities of another entity disturbed when the entity's facility is replaced (eg drainage works disturbed when replacing a road) if those surrounding facilities did not exist when the asset was initially constructed.

~~BC38~~BC62 Other commentators argue that the current replacement cost of a self-constructed ~~asset~~ facility should exclude any components of the ~~asset~~ facility that will not require replacement in the future because

[11] The IPSASB Conceptual Framework also states that a government's sovereign power to make, amend or repeal legal provisions, which potentially allows governments to repudiate obligations to other entities, should not be taken into account in determining whether those obligations should be identified as liabilities of the government. That is, the IPSASB concluded that the existence of a liability should be identified by reference to the legal position existing at the reporting date (paragraphs 5.22 and BC5.35).

their service potential does not expire over time. For example, in relation to a self-constructed road, they argue an estimate of its current replacement cost should exclude the cost of land, design work, earthworks and formation costs because those components do not wear out or become otherwise obsolete, and therefore do not require replacement in the future.

~~BC39~~BC63 In relation to these arguments, the Board observed that:

(a) paragraphs B8 and B9 of AASB 13 state that the cost approach to measuring an asset's fair value reflects the amount that would be required currently to replace the asset's service capacity. From the perspective of the market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence; and

(b) paragraph BC30 of the IASB's Basis for Conclusions on IFRS 13 *Fair Value Measurement* states that the definition of fair value in AASB 13 (IFRS 13) assumes a hypothetical exchange transaction. Therefore, the components of replacement cost included in an asset's fair value are not limited to *actual* replacement transactions expected to occur in the future.

~~BC40~~BC64 Therefore, the Board concluded that the current replacement cost of assets composing a self-constructed facility includes all necessary costs intrinsically linked to acquiring the facility at the measurement date. This is because a market participant buyer of the entity's facility would need to incur those costs when it acquires the facility, whether that buyer acquires the facility from the entity or constructs the facility itself. Consequently, in estimating the current replacement cost of a self-constructed ~~asset~~ facility, it should be assumed that:

(a) the facility presently does not exist (ie the market participant buyer does not presently possess the ~~asset~~ facility and needs to acquire it from scratch). Because the definition of fair value in AASB 13 assumes a hypothetical exchange transaction, the components of replacement cost included in ~~an asset's~~ a facility's fair value are not limited to *actual* replacement transactions expected to occur in the future; and

(b) ~~the hypothetical replacement of the asset occurs at the measurement date, reflecting the economic environment of the asset existing at that date. Therefore, it would be appropriate to include in an asset's current replacement cost the costs of repairing damage to other facilities if those facilities exist at the measurement date. In this regard, it is irrelevant whether those other facilities existed when the asset was initially constructed.~~the facility requires replacing in its current environment, taking into account any make-good costs that must be incurred for surrounding facilities of another entity disturbed when the entity's facility is replaced (eg drainage works disturbed when replacing a road). However, this assumption does not preclude reconfiguring a facility to a more optimal configuration upon replacement.

BC65 Consequently, the current replacement cost of a facility (whether presented as a part of a single line item or deconstructed into different line items, eg roads and land under roads) would include costs for land or permanent works despite those components not being expected to be replaced. Current replacement cost assumes hypothetical replacement of the facility being measured, and is not limited to costs of replacements actually expected to be incurred in the future.

BC66 In relation to paragraph BC64~~BC64~~(b), the Board concluded that when replacing a facility necessarily disturbs other facilities that are also controlled by the entity, in applying the principle set out in paragraph BC64~~BC64~~(a), make-good costs for those other facilities are excluded from the facility's current replacement cost. Thus, the sum of the current replacement costs of each of the entity's facilities would exclude any additional make-good costs relating to the entity's own facilities. Including any make-good costs in those current replacement costs would involve double-counting costs.

Commented [JP24]: Paragraph added in response to request for clarification in point 3 on page 5 of the ACAG letter dated 23/9/2019.

~~BC41~~BC67 Further to the argument set out in paragraph BC61~~BC61~~(b), another reason ~~S~~some commentators contend~~ed~~ why it would be inappropriate to include ~~the costs of repairing damage to other~~ make-good costs for another entity's surrounding facilities in the current replacement cost of ~~an asset~~ a facility is because those ~~repairs~~ make-good costs do not enhance the service capacity of the ~~asset~~ facility. The Board disagreed with that contention, because ~~repairs to other assets~~ make-good costs for another entity's surrounding facilities necessarily incurred as a result of acquiring or constructing an asset would be included in the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility (as referred to in paragraph B9 of AASB 13). ~~The Board considers that the costs of repairing damage to other facilities are similar to costs to install pollution abatement equipment in a production process in accordance with new legislation. Although the pollution abatement equipment is not expected to generate increased net cash inflows or services from using the asset, a market participant buyer would include the cost of that equipment in the price it would bid for the asset, because that cost is necessarily incurred to obtain access to the net cash inflows, or services, that the asset is expected to generate. It is implicit in~~ If using the cost approach ~~to measure an asset's~~ provides the best estimate of a facility's fair value (selling price), that conclusion indicates the market participant buyer would be prepared to pay ~~each~~ all of the costs included in ~~an asset's~~ the facility's current replacement cost, provided that current replacement costs exclude any costs resulting from avoidable inefficiencies (eg additional costs resulting from lacking modern technology readily available to market participants). ~~In other words, if an asset's current replacement cost provides the best estimate of the asset's fair value (selling price), that conclusion indicates that a market participant buyer would be prepared to pay all of the costs included in an asset's current replacement cost.~~

~~BC42~~BC68 Some commentators expressed concern that, if ~~the~~ make-good costs ~~of repairing damage to other~~ for another entity's surrounding facilities were included in the current replacement cost of ~~an asset~~ a facility without having been incurred during the ~~asset's~~ facility's initial construction, the ~~asset's~~ facility's current replacement cost would increase simply because of a change in the ~~asset's~~ facility's operating environment (ie without the entity having improved the ~~asset~~ facility). They argued that recognition of such an increase in the ~~asset's~~ facility's fair value through comprehensive income would not faithfully represent the entity's performance, especially since the entity has yet to incur any costs on the surrounding facilities of another entity). The Board observed that:

(a) this concern is similar to the contention discussed in paragraph BC67~~BC4167~~, but extended in relation to effects on comprehensive income. The Board disagrees with this concern for the same reason it disagreed with the contention in paragraph BC67~~BC4167~~: a market participant buyer would be willing to pay more for ~~an asset~~ a facility due to the change in the asset's operating environment, despite the asset's capacity to produce outputs not having been improved, because that additional cost is necessarily incurred to obtain access to the net cash inflows, or services, that the asset is expected to generate; ~~and~~

(b) measurement of an asset's fair value under AASB 13 is unaffected by the impacts of resulting remeasurement changes on an entity's comprehensive income; and

~~(b)~~(c) the costs of a facility for which a market participant buyer would be prepared to pay are the costs currently avoided by possessing the asset: these costs are not limited to those already incurred by the entity.

~~BC43~~BC69 The Board noted that the IPSASB Consultation Paper *Measurement* (April 2019) includes draft application guidance on replacement cost measurement stating that, regarding site preparation, "Work that may have been undertaken to prepare the actual site for occupation might not need to be carried out on an assumed equivalent site. An entity might therefore assume that the site being valued is level and serviced and ready for development" (paragraph D37). Arguably, this view is consistent with that outlined in paragraph BC62~~BC3862~~ and rejected by the Board in paragraph BC64~~BC4064~~(a). However, to the extent that replacement of an asset's service capacity would occur in a more efficient manner (e.g. by relocating a cutting through a hill to where the earth is more stable)—thus avoiding some costs incurred in the existing location of the asset—the statement that "Work that may have been undertaken to prepare the actual site for occupation might not need to be carried out on an assumed equivalent site" might be compatible with the Board's view in paragraph BC64~~BC4064~~(a). The Board considers that excluding some costs of acquiring or constructing the asset being measured at fair value would clearly be inconsistent with the principles of ~~fair value~~ current replacement cost in paragraphs B8 – B9 of AASB 13, and noted that, in the IPSASB Consultation Paper, replacement cost is not proposed to be used as a measure of fair value.

Economic obsolescence

~~BC44~~BC70 Paragraph B9 of AASB 13 states that obsolescence incorporated in an asset's current replacement cost includes 'external (economic) obsolescence'. Paragraph IE12(b) of IFRS 13 gives an example of economic obsolescence of a machine held for use as "conditions external to the condition of the machine such as a decline in the market demand for similar machines". An equivalent notion of economic obsolescence of an asset or facility held by a not-for-profit ~~public sector~~ entity is a decline in demand for the services provided by the asset or facility, such as a school. The Board was asked to provide guidance on when to identify economic obsolescence of assets measured at fair value using the cost approach, in light of uncertainty and diverse interpretations. In particular, the Board was asked to clarify whether an entity should identify economic obsolescence of a facility that has suffered a reduction in demand for its services before a formal decision has been made to reduce the facility's physical capacity, including a plan for when that decision will be implemented. The following comments refer to any measurement of a non-financial asset of a not-for-profit entity at current replacement cost, whether under the cost approach in paragraphs B8–B9 of AASB 13 or under proposed paragraph Aus31.1 of AASB 116.

~~BC45~~BC71 Some commentators have argued that an entity should not identify economic obsolescence of a facility before a formal decision has been made to reduce the facility's physical capacity because, until then, it is highly unlikely to be clear whether—and to what extent—economic obsolescence exists. The Board noted that the primary consideration in assessing when to identify economic obsolescence is whether market participant buyers would deduct such an amount from the asset's replacement cost when pricing the asset. This consideration depends on the entity's circumstances, and is not dependent on whether a formal decision has been made to reduce the asset's physical capacity. In some instances, it might be clear that market participant buyers would deduct an amount for economic obsolescence when pricing an asset, even if a formal decision has not been made. Deferring inclusion of economic obsolescence in the measurement of the asset's current replacement cost until a formal decision is made would not result in a faithful representation of the adjustment for obsolescence required by paragraph B9 of AASB 13. In addition, such deferral would not result in the best estimate of the price that market participant buyers would pay for the asset, and therefore would be inconsistent with the requirement in paragraph 22 of AASB 13 to measure an asset's fair value using the assumptions that market participants would use when pricing the asset. The Board observed that its conclusion on this issue is consistent with the guidance on the measurement of replacement cost in the IPSASB's Conceptual Framework (paragraph 7.41 of which states that an asset's replacement cost reflects reductions in required service capacity, without mentioning a need to formally decide to reduce the asset's capacity).

~~BC46~~BC72 The Board noted that part of the debate about when to identify economic obsolescence stemmed from perceptions that AASB 13 does not have regard to the temporary or cyclical nature of shortfalls in demand for services rendered by an asset when determining whether economic obsolescence exists. Therefore, the Board decided to clarify that economic obsolescence should not be identified for a facility with a current apparent overcapacity if there is more than an insignificant chance that future increases in the demand for its services will largely eliminate that overcapacity within the foreseeable future. Such an illusory overcapacity might be created to cater for expected increases in future demand for the facility's services. Increases in demand that eliminate an apparent, but illusory, overcapacity need not be long-term in nature. For example, a school in a mining town might presently appear to have overcapacity but require a higher service capacity than indicated by present enrolments, because its enrolments are cyclical due to booms and busts in mining activity. Such apparent overcapacity is similar to standby assets held by entities in either the for-profit or not-for-profit sector to cope with peaks in demand (eg electricity suppliers): such standby assets are not affected by economic obsolescence simply because they are presently inactive. The Board observed that this is consistent with the guidance in:

(a) the IPSASB Conceptual Framework, paragraph 7.41 of which states that the appropriate service potential included in measuring an asset's replacement cost "is that which the entity is capable of using or expects to use, having regard to the need to hold sufficient service capacity to deal with contingencies"; and

(b) the New Zealand Accounting Standard for Public Benefit Entities entitled PBE IPSAS 17 *Property, Plant and Equipment*. Paragraph AG21 of the Application Guidance included in PBE IPSAS 17[12] states that: "No obsolescence adjustment is made in respect of surplus capacity that, while rarely or never used, is necessary for stand-by or safety purposes."

Measuring the current replacement cost of real property forming part of a group of ~~non-cash-generating~~ non-financial assets held for their service capacity

~~BC47~~BC73 The issue relates to ~~non-cash-generating~~ real property held by a not-for-profit ~~public sector~~ entity for its service capacity and measured at current replacement cost by reference to observable market prices of comparable property. Examples of such real property are:

(a) land that is part of a facility such as a public school or public hospital; and

(b) a lessee's right of use asset to occupy an office premises.

~~BC48~~BC74 The Board was asked to clarify whether the location of the real property being valued should necessarily be the property's current location. For example, if a facility or right to use an office premises could deliver its services equally well in a nearby location with cheaper property, should it be assumed that "the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility" (as referred to in paragraph B9 of AASB 13) reflects the price of the property in the cheaper location? The following comments refer to any measurement of an asset described in paragraph BC73~~BC73~~ at current replacement cost, whether under the cost approach in paragraphs B8–B9 of AASB 13 or under proposed paragraph Aus31.1 of AASB 116.

~~BC49~~BC75 Some commentators have argued that the property's market value estimate should reflect the price of suitable property in a cheaper feasible location because paragraph B8 of AASB 13 describes the current replacement cost of an asset as "the amount that would be required currently to replace the service capacity of an asset". They argue that, if the facility or right to use office premises could deliver its services equally well in a nearby location with cheaper property, the service capacity of the entity's land or right to use office premises could be acquired by a market participant buyer at the price of property in the cheaper nearby location. In other words, they argue, applying the generally accepted principle that an asset's current replacement cost is measured on an optimised basis by reference to the price of a modern equivalent asset adjusted for differences in service capacity, the modern equivalent asset to refer to is nearby property in a

12 That Application Guidance was created by the New Zealand Accounting Standards Board and is additional to the text of IPSAS 17.

cheaper location. The market value premium of property in its current location over a suitable alternative location is a commercial element superfluous to the entity's not-for-profit (service delivery) objectives. They note that their view is consistent with the following text of The Royal Institution of Chartered Surveyors' Guidance Note *Depreciated replacement cost method of valuation for financial reporting* (November 2018)[13]:

> "Although the ultimate objective of the DRC method is to produce a valuation of the actual property in its actual location, the initial stage of estimating the gross replacement cost should reflect the cost of a site suitable for a modern equivalent facility. While this may be a site of a similar size and in a similar location to the actual site, if the actual site is clearly one that a prudent buyer would no longer consider appropriate because it would be commercially wasteful or would be an inappropriate use of resources, the modern equivalent site is assumed to have the appropriate characteristics to deliver the required service potential. The fundamental principle is that the hypothetical buyer for a modern equivalent asset would purchase the least expensive site that would realistically be suitable and appropriate for its proposed operations and the envisaged modern equivalent facility. …" (paragraph 7.1)

> "… An example could be a hospital that was originally constructed in the centre of a city that might now be better situated in the suburbs because of changes in the transport infrastructure or in the migration of the population it served." (paragraph 7.2)

~~BC50~~BC76 The IPSASB proposed a similar view to that of The Royal Institution of Chartered Surveyors in its Consultation Paper *Measurement* (April 2019), stating that:

> "If there is no locational requirement for the asset, the asset's replacement cost may assume that the notional replacement will be situated on an alternative site which can provide the same service potential in a more cost effective way. However, the location of an asset may impact its replacement cost in situations where a social policy decision has been made requiring the asset to be located in a specific location." (paragraph D4)

> "For example, hospitals and schools will ideally be located within the communities they serve; and local authority offices will be easily accessible to all citizens. The land on which these schools, hospitals or offices are built might be in expensive inner-city sites or in town and city centers. Where a social policy decision has been made requiring the asset be located in a specific location, the replacement cost of the land is based on the current value of the existing site, rather than on cheaper land located further away from the communities they serve." (paragraph D5)

~~BC51~~BC77 In contrast, some argue that the ~~fair value~~ current replacement cost of real property should always reflect the property's current location (rather than the price of land in a cheaper feasible site). This is because the land's characteristics include its location, and the price premium for the existing site (compared with a cheaper feasible site) could be realised through sale and reinvested in other assets used to provide services. For example, the Application Guidance included in the New Zealand Accounting Standard for Public Benefit Entities entitled PBE IPSAS 17 *Property, Plant and Equipment* states that:

> "If depreciated replacement cost is used to measure the fair value of property, plant and equipment: (a) The value of the land shall reflect the fair value of the land held, in terms of both its size and location; …" (paragraph AG2)

> "In instances where land is underutilised, the fair value of the land shall be determined by reference to the highest and best use of such land. For example, in a case where specialised facilities are located in a prime central business district site but the operation would be able to run from a smaller sized and/or less valuable alternative site offering the same service potential, the fair value of the land would be the market value of the entire central business district-located site." (paragraph AG9)

~~BC52~~BC78 The Board concluded that the current replacement cost of land forming part of a facility held by a not-for-profit entity for its service capacity would typically be measured by assuming it is replaced in its present location. ~~it will depend on the facts and circumstances whether the fair value of real property should reflect the property's current location when a cheaper alternative site exists. The Board considers that in making this assessment, the key principle to apply is that if land has improvements (eg facilities) on it, its fair value reflects the higher of the following:~~However, consistent with a facility's current replacement cost being measured using the optimal (most cost-efficient) configuration of all resources composing that facility, in the rare instances in which each of the following criteria is satisfied, the land's current replacement cost would be measured assuming its replacement in a cheaper alternative location:

Commented [JP25]: Paragraphs BC78 – BC79 reflect the Board's decisions on this issue at its June 2019 meeting.

Commented [JP26]: **Issue:** One Board member commented out of session that the principle of optimisation of resource use that underpins the measurement of current replacement cost (CRC) was not captured accurately in the thought process underpinning paragraph BC78. The Board member argued that:

- It would be sub-optimal (ie not economically rational) to save money by relocating to cheaper land if that saving was exceeded by the CRC of the buildings and other improvements on the existing site scrapped upon relocation. However, this sub-optimal outcome could be implicit in the result of applying paragraph BC78 in particular circumstances. This is illustrated in "Extra Example 6" in the Illustrative Examples. The Board member argued that relocation should only be considered if it results in a net saving of current costs; and
- The service potential assumed to be replaced in a CRC measurement (in the for-profit or NFP sector) is the sum of the capacity to provide services and the ability to generate net sales proceeds from selling land at the end of the useful life of the improvements on the land. In this context, the current market price of land is the best estimate of the present value of the land's future selling price. It is unnecessary to unlock or realise that cash-generating potential immediately, because CRC does not assume immediate realisation of the asset.

Staff:

- Agree with the reasoning that the value of the land component would not be less than the net selling price of the land in its present location. The amount another NFP entity market participant buyer, stepping into the shoes of the NFP entity holding the asset, would be prepared to pay for the land component of a property is its net selling price in its existing location;
- Observe that the bundle of services embodied in improvements on land is not unlocked or realised immediately. Therefore, it should not be necessary for the net selling price of the land to be unlocked or realised immediately; and
- Think an important implication of this reasoning is that the CRC of land should never be measured in an alternative location. For example, if the value of land in an alternative location were higher, measuring the existing property on that basis would measure an asset the entity does not have (it would overstate the asset).

Question for Board members

Q9 Board members are requested to consider whether they agree with this reasoning and, consequently, whether the ED should propose specifying that the land component of a facility should always be measured in its present location.

[13] This Guidance Note is not explicitly identified as applying to fair value measurements, or non-fair value measurements, using depreciated replacement cost. However, paragraphs 2.1 and 2.2 of the Guidance Note refer to depreciated replacement cost being used in relation to the 'cost approach' to valuation, and to the market and income approaches as the other principal approaches to valuation, implying the Guidance Note would be relevant to fair value measurements (even if not exclusively).

(a) management is aware of a cheaper location that might be a suitable alternative for the facility's land component, and is considering whether the facility's service potential can be replaced in that cheaper alternative location;

(b) replacing the facility in that cheaper alternative location is feasible, ie both legally permissible and compatible with the entity's operational requirements for that facility (eg relocation could only be assumed if the facility would provide the necessary accessibility of services to beneficiaries);

(c) the entity can identify the land's feasible alternative location within a reasonable range of estimates (ie there must not exist a number of feasible alternative locations with significantly different market buying prices of the land); and

the current replacement cost of the facility determined on the basis of that alternative location is not exceeded by the price a market participant buyer of the facility would be prepared to pay to remove the buildings and other improvements from the existing facility's site and then sell the property as a vacant site for an alternative use (if such a course of action is legally permissible).

~~(a) the price a market participant buyer would be prepared to pay to remove the improvements and then sell the property as a vacant site for an alternative use – reflecting the land's existing location; and~~

~~(b) the price a market participant buyer would be prepared to pay to replace the service capacity of the land and improvements in the most economical manner for the purpose of continuing to provide the same services as those currently provided using the property. The amount this market participant buyer would be prepared to pay for the land would be determined as follows:~~

~~(c) if the property needs to remain in its present location due to legal restrictions or operational requirements, the land's current replacement cost should reflect the market price of land in that existing location[14]; and~~

(d) ~~if the property does not need to remain in its present location, the land's current replacement cost should reflect the market price of land in a suitable cheaper alternative site (because the market participant buyer's alternative course of action to buying the property being measured would be to build a modern equivalent facility in that alternative cheaper site).~~

~~BC53 This key principle in paragraph BC52 reflects the following supporting principles:~~

~~(a) an asset's fair value can never be less than the price for which that asset could be sold at the measurement date (excluding transaction costs) – however, the unit of account for applying this principle might be a group of assets: see (b) below; and~~

BC79 Regarding paragraph BC78~~BC78~~(d), if the current replacement cost of a property measured on the basis of its existing use is exceeded by the price a market participant buyer of the property would be prepared to pay to remove the buildings and other improvements from the existing property's site and then sell the property as a vacant site for an alternative use (if such a course of action is legally permissible), the higher amount would represent the property's fair value. ~~i~~If real property is part of an interdependent group of assets for which the highest and best use is ~~to be used (and therefore sold) as a group of assets~~ that alternative use, it is essential to use consistent assumptions about the highest and best use of each asset in that group of assets (consistent with paragraph 31(a) of AASB 13). For example, it would be inconsistent with paragraph 31(a)(iii) of AASB 13 to measure the fair value of land based on its sale for a use other than continued operation of its existing facilities, and measure the fair value of the buildings and other specialised improvements on that land at their current replacement cost (reflecting an assumption of their continued operation).

BC80 The criterion in paragraph BC78~~BC78~~(a) is designed to avoid not-for-profit entities incurring the cost and effort of having to continually assess whether a market participant buyer might only be prepared to pay the price of land in an alternative location. This is particularly important when an entity possesses a range of properties that conceivably might be replaced in different locations, without any investigation of those alternative locations having been undertaken.

~~BC54~~BC81 The criterion in paragraph BC78~~BC78~~(c) is designed to clarify that not-for-profit entities should not use an estimated price for land in a feasible alternative location when a reasonable estimate cannot be made.

~~BC55 If a parcel of land has no improvements on it, its fair value should always be measured on the basis of its existing site, because there are no improvements that would be sacrificed in realising its market price.~~

~~BC56 In relation to the principle in paragraph BC53(a), although the asset is held by a not-for-profit public sector entity not primarily to generate net cash inflows, if a for-profit entity has a higher and better use for an asset than any not-for-profit public sector entity, the fair value of the asset will reflect the higher and better use for that for-profit entity.~~

~~14 The Board's conclusion on this issue is consistent with the IPSASB's proposal in paragraph D4 of its Consultation Paper *Measurement* (quoted in paragraph BC50).~~

~~BC57 For example, if a public hospital controlled by a Health Department is located in a prime inner city location and:~~

~~(a) there are no legal restrictions on the use of the land that would transfer to a market participant buyer;~~

~~(b) the hospital would not currently be built in that prime location by the hospital's management if it did not already exist; but~~

~~(c) a for-profit operator of private hospitals is willing to pay the premium for land reflected in the hospital's current location (because it can generate increased revenues in that location),~~

~~the fair value of the land should be estimated based on the existing site of the hospital. The for-profit entity has a higher and better use for the hospital in its current location because it can generate increased revenues in the private health system. Measuring the fair value of the land based on its existing location in this circumstance reflects that the service capacity of an asset (as referred to in paragraph B8 of AASB 13) can include the asset's capacity to be sold for a price exceeding the price of land in a needed location and reinvested in other facilities rendering services.~~

Borrowing costs and other finance costs

~~BC58~~BC82 The Board was asked to provide guidance to not-for-profit ~~public sector~~ entities (particularly those in the public sector) on whether they should include borrowing costs in the fair value of a self-constructed asset measured at current replacement cost under the cost approach (eg whether the current replacement cost of a self-constructed freeway should include borrowing costs incurred during construction). This issue relates to all self-constructed assets of such entities measured at current replacement cost, regardless of whether that ~~the cost approach to measuring fair value~~ measurement basis is adopted in accordance with proposed paragraph Aus66.1 of AASB 13 or in applying paragraphs B8 – B9 of AASB 13 to specialised ~~cash-generating~~ assets held primarily for their ability to generate net cash inflows. The issue raised is distinct from the question of whether not-for-profit public sector entities should capitalise borrowing costs into the cost of qualifying self-constructed assets, which is addressed in AASB 123 *Borrowing Costs*.

~~BC59~~BC83 The Board observed that the treatment of borrowing costs and other finance costs when measuring the current replacement cost of a self-constructed asset is not specific to not-for-profit entities in the public or private sector. It concluded that, in light of AASB 13 not specifying the treatment of those costs for fair value measurements by for-profit entities, it would be inappropriate to mandate a particular treatment for not-for-profit ~~public sector~~ entities applying AASB 13.[15]

~~BC60 Nevertheless, the Board decided to note some views and key arguments regarding this issue expressed by commentators in relation to not-for-profit public sector entities, to assist entities in reaching their own conclusions on this issue after consulting, where appropriate, with their professional valuers.~~

~~**View 1**~~

~~BC61~~BC84 The Board considers that a not-for-profit entity, in deciding whether it should include borrowing costs in the current replacement cost of a self-constructed asset, should consider whether a market participant buyer of the asset would include borrowing costs in its pricing decisions about the asset.

~~BC62~~ The Board noted that ~~S~~some commentators argue that a not-for-profit public sector entity should ~~be required to~~ exclude borrowing costs from the current replacement cost of a self-constructed asset if that entity elects, under paragraph Aus8.1 of AASB 123 *Borrowing Costs*, not to capitalise borrowing costs into the cost of qualifying assets. ~~This is because:~~ The Board considers that the accounting policy choice for borrowing costs made by an entity under AASB 123 is irrelevant to how those costs should be treated when measuring a self-constructed asset's fair value. The price that market participant buyers would pay for an asset is unaffected by accounting policies adopted in respect of that asset. The recognition of costs and the measurement of current value are fundamentally different processes. Therefore, there should be no presumption that the treatment of borrowing costs should be consistent for both.

~~BC63 under Government Finance Statistics, borrowing costs are not capitalised into the cost of qualifying assets – it would be inconsistent and confusing to their financial statement users for public sector entities to adopt different policies for borrowing costs on initial recognition and in subsequent revaluations;~~

~~BC64 current replacement cost is, in principle, a current measure of the costs included in the measurement of an asset on initial acquisition. Therefore, the treatment of borrowing costs should be the same when measuring the asset's historical cost (on initial recognition) and current replacement cost (on revaluation);~~

[15] The AASB has provided guidance on the treatment of borrowing costs when measuring an asset's current replacement cost, in paragraphs IE8 and IE17-IE21 of the Illustrative Examples in AASB 1059 *Service Concession Arrangements: Grantors*. However, this guidance applies to a much narrower range of entities than AASB 13 and does not give rise to a risk of inadvertent or inappropriate use of additional guidance by publicly accountable for-profit entities that may result in non-IFRS compliance (in the context of the AASB's Not-for-Profit Entity Standard-Setting Framework, May 2018, paragraph 32(c)).

Commented [JP27]: This issue's discussion has been amended to reflect the Board's decision in June 2019 that the ED's coverage of this issue should be limited to explaining the following in its Basis for Conclusions:

1. A NFP public sector entity's decision regarding whether to include borrowing costs in the current replacement cost of a self-constructed asset:

- does not depend on the accounting policy choice made by the entity (under paragraph 8.1 of AASB 123) regarding whether to capitalise borrowing costs into the asset's cost on initial recognition; and
- should consider whether a market participant buyer of the asset would include borrowing costs in its pricing decisions about the asset.

2. A comment noting the International Valuation Standards Committee's support for including borrowing costs in the fair value of property, plant and equipment (see para. BC63).

Consequently, the previous draft discussion of this issue has been shortened considerably.

~~BC65 some not-for-profit public sector entities self-construct assets using their own funds, in which cases it would be inappropriate to attribute borrowing costs to the current replacement cost of those assets; and~~

~~BC66 due to the complexity of funding arrangements in the public sector, identifying borrowing costs attributable to particular self-constructed assets is complex, time-consuming and potentially unreliable. These practical problems were acknowledged by the Board when it provided not-for-profit public sector entities the option not to capitalise borrowing costs into the cost of qualifying assets, under paragraph Aus8.1 of AASB 123.~~

~~BC67 The IPSASB's Consultation Paper *Measurement* (April 2019) proposes that all borrowing costs should be expensed rather than capitalised, with no exception for borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset (paragraph 3.28). Similarly[16] to View 1, the IPSASB's Consultation Paper also proposes that in determining an asset's replacement cost, it is assumed that all construction occurs 'instantly' and, consequently, no financing costs are to be included in the valuation (paragraph D38). The Royal Institution of Chartered Surveyors' Guidance Note *Depreciated replacement cost method of valuation for financial reporting* (November 2018) states that:~~

~~BC68 "In assessing the cost of the replacement asset, due account should be taken of all the costs that would be incurred by a potential buyer on the valuation date unless there is application direction to the contrary, such as the instant build (or 'overnight') concept as prescribed for much of the UK public sector. Examples of costs that may be expected to be incurred in replacing the asset include … finance costs, taking into account the likely pattern of payment." (paragraph 6.3)~~

~~BC69 **View 2**~~

~~BC70 Others argue that borrowing costs should always be included in the current replacement cost of a self-constructed asset held by a not-for-profit public sector entity. This is because:~~

~~BC71 market participant sellers of an asset constructed over a period of time would demand a return on the capital tied up in that asset during the construction period (in other words, borrowing costs are simply another cost of the asset on which a return would be sought). Market participant buyers would be prepared to compensate the seller for those borrowing costs, because they would need to incur those costs if they (instead of the entity) self-constructed the asset. Evidence of this market participant behaviour is found with the renegotiation of construction contract prices due to delays in completion that give rise to additional financing costs. Therefore, it is necessary to include borrowing costs in the measurement of current replacement cost if that measure is to faithfully represent the price that would be received to sell the asset at the measurement date;~~

~~BC72~~BC85 ~~the accounting policy choice for borrowing costs made by an entity under AASB 123 is irrelevant to how those costs should be treated when measuring a self-constructed asset's fair value. The price that market participant buyers would pay for an asset is unaffected by accounting policies adopted in respect of that asset. The recognition of costs and the measurement of current value are fundamentally different processes. Therefore, there should be no presumption that the treatment of borrowing costs should be consistent for both;~~

~~(a) current replacement cost is not merely the asset's recognised acquisition cost updated for changes in the prices of the inputs to that cost, because current replacement cost is used to estimate the price that would be received to sell the asset at the measurement date. Therefore, an asset's current replacement cost should include all current costs that the vendor would seek to recover, regardless of whether each type of cost was included in the measurement of the asset's historical cost; and~~

~~(b) regarding the complexity of funding arrangements in the public sector, some argue that (unlike with applying AASB 123 to capitalise borrowing costs into the cost of a qualifying asset) it is unnecessary to identify borrowings directly attributable to the construction of the qualifying asset. This is because:~~

~~(i) costs included in the current replacement cost of an asset (as a measure of fair value) are those that would currently be incurred by a typical market participant. Therefore, it is unnecessary to 'look through' centralised borrowing arrangements in the public sector jurisdiction to attribute borrowings to a particular not-for-profit public sector entity during the period while it self-constructs an asset. Instead, the entity needs to identify the period of financing of construction activity, and the pattern of drawdowns of finance, for a typical market participant – which might not necessarily be a not-for-profit public sector entity; and~~

~~(ii) market participant sellers of an asset constructed over a period of time would demand a return on all the capital tied up in that asset during the construction period. Therefore, to the extent that construction is not financed by borrowings, a return on equity capital tied up in the asset's construction would be sought by the market participant seller; a market participant buyer~~

~~[16] It should be borne in mind that the IPSASB Consultation Paper proposes measuring replacement cost as an entity-specific current value (paragraph D25), in contrast with the concept of fair value in AASB 13 (which measures current value from the perspective of market participants).~~

~~should be willing to pay for that opportunity cost of finance as well[17]. A practical step for not-for-profit public sector entities would be to assume that the construction project is entirely funded by borrowings and apply the entity's own borrowing rate[18] for the period of financing during construction (notwithstanding that, in principle, the entity's own borrowing rate should not be used in preference to the rate demanded by, and paid to, a typical market participant).~~

~~BC73 The AASB has indicated that borrowing costs should be included in the current replacement cost of a non-financial asset held by a public sector grantor in a service concession arrangement:~~

> ~~Paragraphs IE8 and IE17-IE21 of the Illustrative Examples in AASB 1059 *Service Concession Arrangements: Grantors* indicate that the current replacement cost of a public sector grantor's self-constructed asset includes borrowing costs incurred during the construction period, notwithstanding that the entity's accounting policy is to expense borrowing costs. Specifically, paragraph IE8 states that the current replacement cost of a self-constructed road includes "implied funding costs due to the extended construction period". Table 6.2 under paragraph IE21 states that the asset is revalued to include the funding cost in measuring the service concession asset at current replacement cost in year 2, since the grantor's accounting policy is to expense borrowing costs.~~

~~BC74 Some commentators argue that the position in AASB 1059 would also be appropriate for not-for-profit public sector entities in measuring the current replacement cost of any self-constructed assets.~~

~~BC75~~BC86 The International Valuation Standards Committee (IVSC) has indicated that consideration should be given to including borrowing costs and equity costs in the fair value of property, plant and equipment. International Valuation Standard IVS ~~500~~105 *Valuation Approaches and Methods* includes:

> "The cost elements *may* differ depending on the type of the asset and *should* include the direct and indirect costs that would be required to replace/recreate the asset as of the valuation date. Some common items to consider include: (a) direct costs … (b) indirect costs: … 7. finance costs (eg, interest on debt financing), and 8. profit margin/entrepreneurial profit to the creator of the asset (eg, return to investors)." (paragraph 70.11)

~~BC76 In outreach activities, professional valuers have advised that practice is mixed regarding whether borrowing costs are included in valuations of the current replacement cost of self-constructed assets held by not-for-profit public sector entities.~~

Right-of-use assets under concessionary leases

Commented [JP28]: This new section, and Illustrative Examples 7 and 8, are the subject of Question 3 in the Cover Memo.

More specific questions are asked adjacent to paragraph BC95.

Introduction

BC87 AASB 16 *Leases* is effective for annual reporting periods beginning on or after 1 January 2019, and replaces the former distinction between operating leases and finance leases for lessees. Subject to an optional practical expedient, under AASB 16, lessees recognise a right-of-use asset and a lease liability for all leases.

BC88 AASB 1058 *Income of Not-for-Profit Entities*, also effective for annual reporting periods beginning on or after 1 January 2019, originally required not-for-profit entity lessees to measure right-of-use assets at fair value on initial recognition, in respect of leases with significantly below-market terms and conditions principally to enable the entity to further its objectives. Such leases were referred to as 'concessionary leases' in the Board's Basis for Conclusions on AASB 2018-8 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities* (see paragraph BC89~~BC89~~): that term is used in this Exposure Draft.

BC89 In response to comments from constituents that they are encountering difficulties in determining the fair value of right-of-use assets in concessionary leases, the Board issued AASB 2018-8 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities* in December 2018 to provide a temporary option for not-for-profit entities to elect to measure these right-of-use assets at initial recognition either at cost or at fair value, with that election made for each class of right-of-use assets. Constituents had encountered difficulties in determining how to take into account the effect on fair value of:

(a) restrictions on the right to use the assets underlying the lease; and

(b) the specialised nature of many underlying assets.

BC90 This Exposure Draft proposes guidance to assist not-for-profit entity lessees in measuring the fair value of right-of-use assets under concessionary leases. The Board will consider comments on this Exposure Draft as part of its process of deciding whether to convert the temporary relief provided through AASB 2018-8 into a

~~17 This view is supported by the reference to finance costs and entrepreneurial profit in paragraph 70.11 of International Valuation Standard IVS 500 *Valuation Approaches and Methods*, quoted in paragraph BC65.~~
~~18 Or, where that rate is unknown, the government's borrowing rate.~~

permanent option for not-for-profit entity lessees to elect to measure right-of-use assets under concessionary leases on initial recognition either at cost or at fair value.

BC91 The Board's considerations underlying this Exposure Draft's proposed guidance on concessionary leases are discussed separately below in relation to:

(a) the fundamental principles for measuring the fair value of the above-mentioned right-of-use assets (see paragraphs BC92~~BC92~~ – BC96~~BC96~~); and

(b) specific issues in respect of measuring right-of-use assets under concessionary leases, including the distinction between right-of-use assets and the underlying asset, and the effect of restrictions and the specialised nature of underlying assets (see paragraphs BC97~~BC97~~ – BC106~~BC106~~).

Fundamental principles for measuring the fair value of right-of-use assets under concessionary leases (paragraphs Aus66.1 – Aus66.2 and F3 – F4)

BC92 As noted in paragraph BC88~~BC88~~, concessionary leases of not-for-profit entities are leases with significantly below-market terms and conditions principally to enable the not-for-profit entity to further its not-for-profit objectives. Right-of-use assets under concessionary leases are often subject to lessor-imposed restrictions on those rights, which, at the very least, require the asset to be used for the lessee's service-delivery objectives. Even where not-for-profit entity lessees hold unrestricted right-of-use assets under concessionary leases, those assets almost invariably are held for their service capacity rather than for their ability to generate net cash inflows. Consequently, not-for-profit entity lessees' right-of-use assets under concessionary leases are, almost invariably, assets that are held for their service capacity rather than their ability to generate net cash inflows.

BC93 In light of the nature of not-for-profit entity lessees' right-of-use assets under concessionary leases, the Board tentatively concluded that the fundamental principles for measuring the fair value of not-for-profit entities' other non-financial assets held for their service capacity should also apply to those entities' right-of-use assets as lessees under concessionary leases. In reaching this tentative conclusion, the Board considered that, although the fair value of right-of-use assets will differ from the fair value of the assets underlying those rights (see paragraph BC98~~BC98~~), the principles for measuring the fair value of owned assets and leased assets (rights of use) should be the same.

BC94 Accordingly, the Board proposes, consistent with paragraphs Aus66.1 – Aus66.2 of the [draft] Standard and paragraphs F3 – F4 of the proposed Application Guidance, requiring the following for a not-for-profit entity lessee's right-of-use asset under a concessionary lease:

(a) if the right-of-use asset is held primarily for its ability to generate net cash inflows, its fair value is measured using whichever of the market approach, cost approach or income approach (or a combination of them) is the most appropriate in the circumstances. This is an unmodified requirement of AASB 13. An example is donated leased space that becomes surplus to the not-for-profit entity lessee's operational requirements and is sub-leased by that not-for-profit entity;

(b) if the right-of-use asset is held for its service capacity, and the asset has neither a legally restricted use nor is subject to a legal restriction on the prices that may be charged for using it, its fair value is measured using whichever of the market approach, cost approach or income approach (or a combination of them) is the most appropriate in the circumstances. This is also an unmodified requirement of AASB 13. An example is a lessor's surplus office space leased without charge to a charity, where either:

(i) the charity's uses of the leased space are unrestricted; or

(ii) the lease terms restrict the charity from using the office space for another purpose than its charitable purposes but the restriction would not transfer to a market participant buyer of that right-of-use asset (ie under AASB 13.28(b), the restriction is not a restriction that would be taken into account when measuring the fair value of the right-of-use asset); and

(c) if the right-of-use asset is held for its service capacity, and the asset has a legally restricted use or is subject to a legal restriction on the prices that may be charged for using it (and either restriction is asset-specific, ie it would transfer to a market participant buyer):

(i) if an equivalent restricted right-of-use asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence (which would impound the discount resulting from the restriction), the asset is measured at fair value based on the available market evidence for the equivalent restricted asset. Typically, the resulting fair value estimate would be calculated as the present value of the market rentals for the restricted asset, discounted at a market-based asset-specific rate of discount. This is illustrated in Illustrative Example 7; and

(ii) if an equivalent restricted right-of-use asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is (subject to a 'reliable measurement' criterion: see paragraph BC95~~BC95~~) measured at its current replacement cost. The asset's current replacement cost is determined consistently with paragraphs B8 – B9 of AASB 13, without a discount to the current market buying price of an equivalent but unrestricted right-of-use asset. For example, a community centre is granted a concessionary lease for the real property on which it operates, which may only be used by it, or any acquirer of its right-of-use asset (eg sub-lessee), to provide community services. There is no observable evidence of market rentals for similarly restricted rights of use within the vicinity of the community centre. Consequently, the community centre measures its right-of-use asset at current replacement cost, which is calculated using a market comparison approach for leases of unrestricted real property in the vicinity. Current replacement cost would, for these restricted right-of-use assets, be estimated as the present value of market rentals (this is illustrated in Illustrative Example 8). The reason this measure is termed 'current replacement cost' is that, to replace the service capacity embodied in the right-of-use asset, the entity would need to acquire a right-of-use to an unrestricted underlying asset—the Board considered that it is unclear whether the resulting measurement would conform to the principles in IFRS 13 for measuring the fair value of the right-of-use asset, and consequently proposes requiring the right-of-use asset measured at current replacement cost to be presented separately from right-of-use assets (and other assets) measured at fair value.

BC95 In relation to paragraph BC94~~BC94~~, the Board also proposes that, if neither the fair value nor the current replacement cost of a right-of-use asset can be measured reliably (eg this might occur when the underlying asset is highly specialised), the right-of-use asset should be measured by discounting the contractual lease payments to their present value using a current market-determined rate of discount (see paragraphs Aus66.2 and F4). The Board decided upon this proposal because it is consistent with the stipulation in AASB 116.31 that an item of property, plant and equipment shall be carried at a revalued amount only when its fair value can be measured reliably. The Board considers that a 'reliable measurement' criterion should also apply to the measurement of an asset at current replacement cost. The 'reliable measurement' criterion is specified explicitly only in relation to using current replacement cost to measure the right-of-use asset, because (under paragraphs Aus66.1(a) and F3(c)(i)) fair value is used to measure such an asset only when its price is supported by observable market evidence (ie the 'reliable measurement' criterion is implicit in paragraphs Aus66.1(a) and F3(c)(i)).

Commented [JP29]:
Questions for Board members

Q10 Do Board members agree with specifying a 'reliable measurement' criterion for measuring NFP entity lessees' right-of-use assets under concessionary leases at either fair value (implicit criterion in paragraph Aus66.1(a)) or current replacement cost (explicit criterion in paragraph Aus66.2)?

Q11 Do Board members agree with the draft proposal that if neither the fair value nor the current replacement cost of a right-of-use asset can be measured reliably, the right-of-use asset should be measured by discounting the contractual lease payments to their present value using a current market-determined rate of discount? That is, measuring a peppercorn lease based on its peppercorn rent, as would have occurred before the issuance of AASB 1058 *Income of Not-for-Profit Entities*?

BC96 In applying the fundamental principles referred to in paragraph BC94~~BC94~~, where market rentals are used to estimate the value of the right-of-use asset, it is important to:

(a) factor in any rent-free periods typically offered for the type of asset as a lease inducement; and

(b) use a discount rate that is asset-specific. For example, for a public sector entity lessee, it would be inappropriate to use the government's incremental borrowing rate for the government in the entity's jurisdiction;

Specific issues in respect of measuring right-of-use assets under concessionary leases

BC97 Paragraphs BC98~~BC98~~ – BC106~~BC106~~ set out the Board's response to various issues raised by not-for-profit entity constituents regarding measuring the fair value (or current replacement cost) of right-of-use assets under concessionary leases.

BC98 The fair value of a right-of-use asset will, in principle, differ from the fair value of the underlying asset that is the subject of the lease, because:

(a) the term of the lease typically will be shorter than the economic life of the asset underlying the lease; and

(b) ownership of an underlying asset conveys rights additional to the right to use the asset, including:

(i) the right to sell the asset and the right to pledge the asset as security for a loan; and/or

(ii) when the asset is leased out, the right to benefit from the asset's residual value and the right to charge third parties for other rights to use the same underlying asset (where leased-out asset has separate mutually compatible uses).

Consequently, it is often necessary for a fair value estimate of a right-of-use asset to be calculated as the present value of the market rentals for using the underlying asset, discounted at a market-based asset-specific rate of discount.

Legal restrictions

BC99 When a not-for-profit entity lessee has a right-of-use asset with a legally restricted use or a legal restriction over the prices that may be charged for using that asset, the Board concluded that the existence of the restriction (if asset-specific) should be dealt with as follows in measuring the right-of-use asset:

(a) if the right-of-use asset is held primarily for its ability to generate net cash inflows, its fair value is measured using whichever of the market approach, cost approach or income approach (or a combination of them) is the most appropriate in the circumstances (see paragraph BC94~~BC94~~(a)). To the extent that the restriction reduces the net cash inflows market participant buyers of the right-of-use asset would expect to generate from the asset, it would reduce the asset's fair value (either directly, where the market approach or income approach is used, or indirectly by applying market approach or income approach estimates as a cross-check under paragraph 63 of AASB 13 to an estimate developed under the cost approach);

(b) if the right-of-use asset is held for its service capacity, and an equivalent restricted right-of-use asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is measured at fair value based on the available market evidence for the equivalent restricted asset. To the extent that the restriction reduces the estimated market price of the right-of-use asset, it would reduce the asset's fair value (see paragraph BC94~~BC94~~(c)(i)); and

(c) if an equivalent restricted right-of-use asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence, the asset is measured at its current replacement cost. The asset's current replacement cost is determined without a discount to the current market buying price of an equivalent but unrestricted right-of-use asset, ie the restriction does not reduce the value of the right-of-use asset (see paragraph BC94~~BC94~~(c)(ii)).

Specialised right-of-use asset

BC100 A not-for-profit entity lessee may possess a right-of-use asset that is specialised because its use is legally restricted. In such instances, the ramifications of being specialised are reflected in paragraph BC99~~BC99~~'s description of how restrictions are taken into account when measuring the fair value or current replacement cost of a right-of-use asset under a concessionary lease. The other main ramification of a right-of-use asset under a concessionary lease being specialised (whether legally restricted or not) is that the availability of market evidence for estimating the asset's fair value or current replacement cost might be limited significantly. In rare instances, neither the fair value nor current replacement cost of a specialised right-of-use asset will be capable of reliable measurement. The Board concluded that, in such a case, the asset should be measured using the contractual lease payments (if any) in the concessionary lease (see paragraph BC95~~BC95~~).

BC101 For some highly specialised right-of-use assets held for their service capacity, determining a reliable measure of their current replacement cost might be achievable by measuring the underlying asset, if the lease term is materially the same as the entire estimated economic life of the underlying asset. An example is where a government agency constructs an infant health clinic in a remote area and grants a right to use that clinic for its entire estimated economic life to another not-for-profit entity under a concessionary lease. If the clinic (and, therefore, the not-for-profit entity lessee's right-of-use asset) has no alternative use, the current replacement cost of the clinic would be a reasonable estimate of the current replacement cost of the lessee's right-of-use asset.

Right-of-use asset is measured as a resource

BC102 The Board observed that the ability to measure reliably the fair value or current replacement cost of a right-of-use asset (an input to a process) is different from the entity's ability to measure the value of the services or other outputs that the asset will produce. For example, if a not-for-profit research entity is a lessee of laboratory space under a concessionary lease, the value of its right-of-use asset is not determined by estimating the highly uncertain net cash inflows or other value that using the laboratory space will generate (ie the value created by conducting the research). Instead, the value of the space as an input (ie a resource) will depend on how market participant buyers price that space in its highest and best use.

Ability to pay

BC103 The Board observed that the fair value or current replacement cost of a right-of-use asset under a concessionary lease does not depend on the amount that the not-for-profit entity lessee would have been able, or prepared, to pay for that right if it had not been granted through a concessionary lease. The fair value of a right-of-use asset (eg a right to use office space acquired as a lessee under a lease) is not less than the price that a market participant buyer (eg a for-profit entity) is prepared to pay for that asset. A lesser amount that the reporting entity is willing to pay is a characteristic of that entity, and not of the asset. This is illustrated in Illustrative Example 8.

BC104 In this regard, the Board noted that the principle of fair value in AASB 13 assumes a hypothetical sale by the holder of the asset, even if its sale is legally prohibited (see paragraph BC30 of the IASB's Basis for Conclusions on IFRS 13). Under paragraph IE29 of the IASB's Illustrative Examples for IFRS 13, legal restrictions on an asset's uses (or on the prices that may be charged for using the asset) are limited to those that would transfer with the asset to the market participant buyer in the hypothetical sale transaction that is the subject of the fair value estimate. Therefore, an entity's being restricted in its ability to sell an asset, or inability to afford to pay the market price of an asset, does not affect the fair value of an asset it holds.

BC105 The Board observed that not-for-profit entities are inherently dependent on a degree of financial support in the form of transfers of financial and non-financial assets without giving equivalent value directly in return; it is representationally faithful to report the full value of the service potential they control, and of the financial support they receive (and rely on) to pursue their mission. The Board also concluded that this is equally the case for transfers of non-financial assets to those not-for-profit entities as it is for transfers of cash to those entities. It also concluded that there is no more of a case to take an entity's ability to pay into account when measuring a right-of-use asset under a concessionary lease than there is when measuring the current value of precious artworks bequeathed to a not-for-profit entity on the condition that those artworks are displayed to the public without charge.

BC106 Furthermore, the Board observed that measuring assets at the amount an entity is able to pay, when that amount differs from the amount that market participant buyers would be prepared to pay, would create generally insurmountable difficulties in reliably measuring those assets. This is because such an amount would depend on entity-specific circumstances, including the extent of financial support to the entity, which is inherently subjective and can be highly changeable.