Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	Fair Value Measurement for Not-for-Profit Public Sector Entities	**Meeting**	AASB December 2022 (M192)
Topic:	Analysis of stakeholders' comments on application of the Fatal-Flaw Review draft Standard	**Agenda Item:**	3.3
		Date of this agenda paper:	30 November 2022
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		Decision-Making:	High
		Project Status:	Consider ballot draft of amending Standard

Objectives of this paper

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

(a) **consider** comments received from stakeholders on application of the proposed modifications to AASB 13 *Fair Value Measurement* in the Fatal-Flaw Review (FFR) draft version of the proposed Standard;

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

(c) **decide** the actions to take in addressing stakeholders' comments.

2 Staff recommended changes to the FFR draft for the final Standard, including editorial changes, are marked-up in Agenda Paper 3.4 for Board members' consideration.

Introduction

3 In respect of fair value measurements of non-financial assets of not-for-profit public sector entities not held primarily for their ability to generate net cash inflows,[1] the FFR draft Standard proposed modifications to AASB 13 that would:

(a) specify that the asset's current use is presumed to be its highest and best use unless it is highly probable at the measurement date that the asset will be sold, distributed, or used for an alternative purpose to its current use;

(b) clarify that an asset's use is 'financially feasible' if market participants would be willing to invest in the asset's service capacity, considering both the capability of the asset to be used to provide needed goods or services to beneficiaries and the resulting cost of those goods or services;

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

(c) specify that, if both the market selling price of a comparable asset and some market participant data required to measure the fair value of the asset are not observable, an entity uses its own assumptions as a starting point and adjusts those assumptions to the extent that reasonably available information indicates that other market participants would use different data; and

(d) provides guidance on how the cost approach is to be applied to measure such an asset's fair value, including guidance on the nature of costs to include in the replacement cost of a reference asset and on the identification of economic obsolescence.

4 Two of the three submissions received on the FFR draft included comments related to application of the FFR draft principles. The two respondents are:

(a) the Australasian Council of Auditors-General (ACAG); and

(b) Liquid Pacific.

5 Because the submission from the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) does not propose any changes to the FFR draft, it is not discussed below.

6 Members of the Fair Value Project Advisory Panel (the Panel) also provided comments on application of the FFR draft principles during the Panel meeting held on 4 November 2022.

Further input from some ACAG members and Panel members

7 Prior to finalising the Agenda Papers for this meeting, on 18 November 2022, staff circulated a paper to ACAG members and Panel members for review. That paper included staff suggested revisions to the mandatory section of the amending Standard and to the Illustrative Examples in response to comments expressed in the ACAG submission and feedback provided by Panel members at the Panel meeting. Five ACAG jurisdictions and three Panel members responded to that review request.

8 Most comments by stakeholders did not express disagreement with the proposed principles in the FFR draft, but instead identified aspects of the examples and explanations they consider could be clarified. Staff considered each suggestion and included various proposed clarifications in the ballot draft of the Standard in Agenda Papers 3.4 and 3.5. Some suggestions by stakeholders were not supported by staff – in some cases, because the suggestion raised a matter within the province of detailed valuation assessments.

Structure of this paper and summary of staff recommendations

9 The table sets out the structure of this paper and includes a summary of staff recommendations.

Stakeholder comment	**Staff recommended actions**
Section 1: The presumption that an asset's current use is its highest and best use	
Stakeholder Comment 1: Clarify the criteria for determining whether it is highly probable that an asset will be used for an alternative purpose (paragraph Aus29.2)	Staff recommend amending paragraph Aus29.2(b) to: (a) combine sub-paragraphs (v) and (vi) to be consistent with AASB 5 paragraph 8; (b) amend the combined sub-paragraph in (a) to replace "the change in the asset's use is expected to be completed within one year from the measurement date" with "the

Stakeholder comment	Staff recommended actions
	asset's current use ceased by the measurement date"; and (c) omit sub-paragraph (iii) – that the asset is immediately available to be used for the alternative purpose in its present condition.
Stakeholder Comment 2: Clarify the references to 'distribution' in paragraphs Aus29.1 and Aus29.2, and query about transfers of assets	Staff recommend amending paragraphs Aus29.1 and Aus29.2 to clarify that: (a) 'distribution' refers to distribution to owners; and (b) an NFP public sector entity is not required to consider whether an asset's highest and best use differs from its current use unless the criteria in paragraph Aus29.2 are met. Staff recommend amending paragraph Aus93.2 to use text consistent with the revised paragraph Aus29.1. Staff recommend including a clarification in the Basis for Conclusions about a transfer of an asset that is neither a sale nor a distribution to owners.
Section 2: Financially feasible use	
Stakeholder Comment 3: Clarify the interaction between financially feasible use and functional obsolescence	Staff recommend editing paragraph Aus28.1 and adding explanations in the Basis for Conclusions.
Section 3: Market participant assumptions	
Stakeholder Comment 4: Concern about adequacy of relief when using own assumptions as the starting point for developing unobservable inputs (and potential inconsistency between paragraphs F5 and F6)	Staff recommend making no substantial changes but editing paragraph F6 for greater clarity.
Section 4: The overarching principle of the cost approach	
Stakeholder Comment 5: Queried examples of adjusting the reference asset's replacement cost	Staff recommend editing paragraph F9 and removing its reference to service concession arrangements.
Section 5: Estimating the replacement cost of a reference asset	
Stakeholder Comment 6: Perceived contradiction between paragraph F5 and paragraph F13(b)	Staff recommend no action.
Stakeholder Comment 7: Illustrative Example 4 may cause confusion regarding the measurement technique to use to measure the fair value of land	In respect of Stakeholder Comments 7–10, staff recommend: (a) removing the reference to decontamination costs from paragraph F13(a) and using site

Stakeholder comment	Staff recommended actions
Stakeholder Comment 8: Example 4 appears to allow an entity to make an accounting policy choice about the treatment of certain site preparation costs Stakeholder Comment 9: Other types of costs might be more appropriate to use than decontamination costs in Example 4 Stakeholder Comment 10: Illustrative Example 4 may reflect inappropriate treatment of costs specific to the circumstances of any entity's asset	levelling costs instead in Illustrative Example 4; (b) removing from the fact pattern in Illustrative Example 4 the reference to an entity making an accounting policy choice; (c) clarifying in Illustrative Example 4 that its simplifying assumption in the fact pattern and conclusion would not necessarily be appropriate in the facts and circumstances of particular entities; and (d) clarifying in the Basis for Conclusions that, in respect of consideration of site preparation costs, if there are no suitable alternative sites for a particular facility because the facility must be sited in its existing location, market participant buyers would be prepared to pay the location-specific costs of site preparation for that facility.
Stakeholder Comment 11: Illustrative Example 1 regarding 'brownfield' and 'greenfield' costs should be amended	Staff recommend no action.
Stakeholder Comment 12: Changing the assumed fact pattern in Illustrative Example 1	Staff recommend no action.
Stakeholder Comment 13: Changing the assumed fact pattern in Illustrative Example 2	Staff do not recommend changing the fact pattern for Illustrative Example 2, but have drafted an alternative example for the Board's consideration.
Stakeholder Comment 14: Illustrative Example 3 contradicts guidance on modern equivalent asset	Staff recommend no action.
Stakeholder Comment 15: Reference to no other market participants in Illustrative Example 3	Staff recommend no action.
Stakeholder Comment 16: Consistency of guidance on piecemeal replacement	Staff recommend no action.
Stakeholder Comment 17: Rationale for Board's conclusion on calibration of costs	Staff recommend omitting paragraph BC150 of the FFR draft from the Basis for Conclusions.
Section 6: Economic obsolescence	
Stakeholder Comment 18: Elaborate paragraph F19 regarding the adjustment for economic obsolescence	Staff recommend amending paragraph F19.
Stakeholder Comment 19: Perceived contradiction between paragraph F18 and Example 5	Staff recommend no action.

Stakeholder comment	Staff recommended actions
Stakeholder Comment 20: Elaborating the fact pattern in Illustrative Example 5	Staff recommend amending the fact pattern of Illustrative Example 5.

10 In each section, staff included extracts of the FFR draft Standard and staff suggested actions to take in addressing stakeholders' comments. To assist Board members' review, where relevant staff included:

(a) extracts of the FFR draft Standard in blue shaded boxes;

(b) staff recommended changes to the FFR draft included in the ballot draft, in unshaded boxes; and

(c) marked-up text, with new text underlined and deleted text struck through, to indicate recommended changes to the drafting of certain paragraphs.

Section 1: The presumption that an asset's current use is its highest and best use

The Board's decision in the FFR draft regarding the presumption that an asset's current use is its highest and best use

11 At its September 2022 meeting, the Board considered feedback received on ED 320. The Board noted that most ED respondents who commented on the highest and best use topic considered that the presumption that an asset's current use is its highest and best use (the current use presumption) should only be rebutted when all criteria in AASB 5 *Non-current Assets Held for Sale and Discontinued Operations* for the asset's classification as 'held for sale' are met.

12 Accordingly, the Board decided that the overarching principle for identifying a higher and better alternative use for an asset will be that the sale/distribution or alternative use must be 'highly probable' at the measurement date. Specifically, the FFR draft proposed that:

(a) for an asset subject to a future sale or distribution, the 'highly probable' test would be met when the asset meets the criteria for classification as 'held for sale' under AASB 5; and

(b) for an asset with a higher and better alternative use identified from a future redeployment (rather than a sale or distribution), the 'highly probable' test would be met when the asset meets criteria parallel those in AASB 5, but focusing on redeployment rather than sale. Accordingly, the Board adapted the AASB 5 criteria in drafting paragraph Aus29.2(b) in the FFR draft.

13 The FFR draft proposed adding paragraphs Aus29.1, Aus29.2 and Aus93.2 to AASB 13, which are reproduced below. Paragraphs 29 and 93 are not amended but are included for reference.

> 29 Highest and best use is determined from the perspective of market participants, even if the entity intends a different use. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.
>
> Aus29.1 Notwithstanding paragraph 29, for a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, the asset's current use is presumed to be its highest and best use unless at the measurement date it is highly probable that the asset will be sold, distributed, or used for an alternative purpose to its current use.
>
> Aus29.2 For the purposes of paragraph Aus29.1, it is highly probable that the asset will be:
>
> (a) sold or distributed when it is classified as held for sale or held for distribution in accordance with AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*; and
>
> (b) used for an alternative purpose to its current use when all of the following conditions are met:
>
> (i) the alternative purpose for the asset is physically possible, legally permissible and financially feasible in accordance with paragraphs 28 and Aus28.1;
>
> (ii) the appropriate level of management is committed to a plan to change the usage of the asset to that alternative purpose, and an active programme to complete the plan has been initiated;
>
> (iii) the asset is immediately available to be used for the alternative purpose in its present condition;
>
> (iv) any approvals required to change the asset's usage have been obtained;
>
> (v) actions required to complete the plan should indicate that

it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn; and

(vi) the change in the asset's use is expected to be completed within one year from the measurement date.

…

Disclosure

…

93 To meet the objectives in paragraph 91, an entity shall disclose, at a minimum, the following information for each class of assets and liabilities (see paragraph 94 for information on determining appropriate classes of assets and liabilities) measured at fair value (including measurements based on fair value within the scope of this Standard) in the statement of financial position after initial recognition:

(a) …

(i) for recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.

…

Aus93.2 For the purposes of paragraph 93(i), for a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, the asset's current use is presumed to be its highest and best use unless, in accordance with paragraphs Aus29.1 and Aus29.2, it is highly probable that the asset will be sold, distributed or used for an alternative purpose to its current use.

Stakeholder Comment 1: Clarify the criteria for determining whether it is highly probable that an asset will be used for an alternative purpose (paragraph Aus29.2(b))

14 In respect of assets that will be used for an alternative purpose (i.e. assets that will be redeployed), ACAG and some Panel members commented that the proposed paragraph Aus29.2(b)(vi) would benefit from clarification of the meaning of completion of an asset's change of use, in relation to "the change in the asset's use is expected to be completed within one year from the measurement date".

15 They noted that in some circumstances a change in an asset's use to the intended new use will take longer than one year to complete once the appropriate level of management commits to the planned change of use. In that context, they commented that it is unclear when the asset's change of use should be regarded as completed (and the fair value measurement of the asset should commence being based on the new intended use if that event is expected to occur within one year after the measurement date). For example, they asked whether completion of an asset's change of use occurs when:

(a) the entity ceases using the asset in its current use; or

(b) the asset will be put to the new intended use.

16 ACAG commented that in some cases the events in (a) and (b) might occur at significantly different times. ACAG illustrated this point with an example. To assist Board members' consideration of ACAG's example, in paragraph 17 below, staff elaborated ACAG's example of the planned decommissioning of a school to provide a hypothetical timeline.

Illustration of the application of paragraph Aus29.2(b) in the FFR draft

17 In this example, a State government entity (Entity A) decided in Year 1 to decommission a school and build a public hospital building on the site. It is assumed that in Year 1, the criteria in sub-paragraphs (i), (ii) and (iv) of paragraph Aus29.2(b) are met, that is:

- the intended use of the site as a hospital is physically possible, legally permissible and financially feasible in accordance with paragraphs 28 and Aus28.1;
- the appropriate level of management is committed to a plan to change the usage of the site to hospital use, and an active programme to complete the plan has been initiated; and
- any approvals required to change the site's usage have been obtained.

In addition, the following facts apply:

- in each of Years 1–6, actions required to complete the plan indicate it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn;
- in Year 1, at the measurement date, the entity expects all schooling activities will cease within one year;
- in Year 2, all schooling activities ceased, and at the measurement date the entity expects the demolition of the school to commence within one year;
- in Year 3, demolition of the school building commenced and was completed;
- in Year 4, land preparation works commenced but were not completed;
- in Year 5, construction of the hospital building commenced, and at the measurement date there is considerable uncertainty about when the construction of the hospital building will be completed; and
- in Year 6, construction of the hospital building was completed.

18 Because paragraph Aus29.2(b)(vi), as currently drafted in the FFR draft, requires "the change in the asset's use is expected to be completed within one year from the measurement date", in this example, Entity A would measure the fair value of the site as a school site until a higher and better use for the site, as hospital use, is identified in Year 6.

19 ACAG noted in its submission on the FFR draft that it considers that the criterion in Aus29.2(b)(vi) would be met at the Year 1 end-of-financial-year measurement date when the school becomes within one year of the expected cessation of schooling activities.

20 Staff obtained further input from Panel members and members of ACAG on this issue by requesting their review of an example with similar fact pattern to that in the example outlined in paragraph 17. Almost all respondents commented that continuing to measure the site for use as a school in the years subsequent to Year 2 would be inappropriate because cessation of schooling use is either imminent or has occurred. Staff broadly concur with this view and consider that, for an asset that will be redeployed, its current use should cease to be identified as its highest and best use before "the change to the new use is expected to be completed within one year from the measurement date" (unless the period to complete the transition to a new use is brief, i.e. where the same outcomes would occur regardless of whether Aus29.2(b)(vi) were amended). This is because staff consider 'completion' of the change of use could reasonably be interpreted as referring to commencement of the new use.

21 Therefore, staff consider that more adaptations to some AASB 5 'held for sale' criteria may be warranted for assets that will be redeployed.

Further adaptations to some AASB 5 criteria may be needed for assets that will be redeployed

22 To assist Board members' understanding of the staff recommendation, the remainder of this section of the paper is set out as follows:

(a) paragraphs 23 and 24 outline the changes staff recommend making to paragraph Aus29.2(b);

(b) paragraphs 25–37 provide the staff rationale for the recommended changes; and

(c) questions to Board members regarding the staff recommended changes.

Staff recommended changes to paragraph Aus29.2(b)

23 Staff recommend making the following changes to paragraph Aus29.2(b):

(a) combining sub-paragraphs (v) and (vi) to be consistent with AASB 5 paragraph 8;

(b) amending the combined sub-paragraph in (a) to replace "the change in the asset's use is expected to be completed within one year from the measurement date" with "the asset's current use ceased by the measurement date"; and

(c) omitting sub-paragraph (iii) – that the asset is immediately available to be used for the alternative purpose in its present condition.

24 That is, staff recommend amending Aus29.2(b) as follows:

Aus29.2	For the purposes of paragraph Aus29.1, it is highly probable that the asset will be:		
	(a)	…	
	(b)	used for an alternative purpose to its current use when all ~~of~~ the following conditions are met:	
		(i)	the alternative purpose for the asset is physically possible, legally permissible and financially feasible in accordance with paragraphs 28 and Aus28.1;
		(ii)	the appropriate level of management is committed to a plan to change the usage of the asset to that alternative purpose, and an active programme to complete the plan has been initiated;
		~~(iii)~~	~~the asset is immediately available to be used for the alternative purpose in its present condition;~~
		(~~iv~~iii)	any approvals required to change the asset's usage have been obtained; and
		(iv)	the asset's current use ceased by the measurement date, and actions required to complete the plan should indicate ~~that~~ it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn~~; and~~
		~~(vi)~~	~~the change in the asset's use is expected to be completed within one year from the measurement date~~.

Staff's rationale for recommending combining sub-paragraphs (v) and (vi)

25 Sub-paragraph (v) of paragraph Aus29.2(b) states: "actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn." Staff consider that in some situations involving redeployment of an

asset, it might not be very clear when this criterion would be satisfied when considered in isolation.

26 Using the example outlined in paragraph 17, it would be very subjective to determine whether this criterion is met some time in:

(a) Year 3, when demolition of the school building commenced; or

(b) Year 5, when construction of the hospital commenced.

27 In addition, staff observed that in AASB 5 paragraph 8, the equivalent criteria to those in sub-paragraphs (v) and (vi) are mentioned in one sentence, with the criterion in (v) seeming to be an explanation for the criterion in (vi) that an asset's sale is expected to be completed within one year, rather than as a separate criterion. AASB 5 paragraph 8 states "… the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except as permitted by paragraph 9, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn …".

28 Therefore, staff recommend combining sub-paragraphs (v) and (vi) in the final Standard.

Staff's rationale for recommending amending the combined paragraph described in paragraphs 25–28

29 As mentioned in paragraph 20, staff broadly concur with the view of ACAG and some Panel members that, for an asset that will be redeployed, its current use should cease to be identified as its highest and best use before "the change to the new use is expected to be completed within one year from the measurement date".

30 Moreover, after considering the additional input provided by ACAG and Panel members, staff think it is important for Board members to consider whether criterion (vi) in the FFR draft (i.e. completion of the change in the asset's use) should focus on:

(a) when the ***current use*** of the asset changes; rather than

(b) when the ***new intended use*** commences.

31 Among the respondents who provided comments on the staff paper circulated on 18 November 2022, mixed views were obtained regarding when the asset's highest and best use should be identified as changing for the purpose of rebutting the current use presumption. Based on the example in paragraph 17, mixed views were expressed about whether the change in the highest and best use of the site should be identified when (assuming all other criteria in paragraph Aus29.2(b) are met):

(a) [Option 1] the asset's current use ceased by the measurement date (at Year 2 in the example); or

(b) [Option 2] the asset's current use is expected to cease within one year of the measurement date (at Year 1 in the example).

32 In considering which of the Options 1 and 2 to adopt, staff observed that when developing the FFR draft, the Board identified that some problems could arising in relation to a change in the highest and best use based on the existence of a committed-to plan to sell the asset (as proposed in ED 320), which led to the Board deciding that the current use presumption should be rebutted for assets that will be sold when all AASB 5 'held for sale' criteria are met. Those problems are noted in paragraph BC45 of the FFR draft (which is reproduced as paragraph BC61 in Agenda Paper 3.4 and Agenda Paper 3.5).

33 The wording in Option 2 – the asset's current use is expected to cease within one year of the measurement date – better aligns with the text in AASB 5 paragraph 8 (quoted in paragraph 27). However, staff consider that Option 2 would likely give rise to similar problems to those

expressed by the respondents on ED 320 about a change in the highest and best use base on the existence of a committed-to plan to sell the asset. These problems, adapted for the context of assets that will be deployed, are:

(a) a significant risk of premature remeasurement because of the risk of future changes in plans to redeploy assets;

(b) a significant risk of information leakage (e.g. community consultation regarding the planned change of use might be incomplete or not yet even commenced);

(c) the potential need to seek information about decisions made by senior levels of government not yet communicated to the entity; and

(d) subjectivity in application because of difficulty in determining whether cessation of the asset's current use is expected to occur within one year of the measurement date.

34 To avoid those problems, staff recommend amending the criterion in sub-paragraph (vi) based on Option 1 – the asset's current use ceased by the measurement date.

Staff's rationale for recommending omitting the criterion in sub-paragraph (iii)

35 Sub-paragraph (iii) of paragraph Aus29.2(b) in the FFR draft states "the asset is immediately available to be used for the alternative purpose in its present condition." Staff observed that the point when the subject asset is immediately available to be used for the alternative purpose might not be as clearly identifiable compared with assets for which the entity will lose control. Staff note that the objective of AASB 5 for initially classifying an asset as 'held for sale' is to determine the point from which the asset's carrying amount will be recovered principally through a sale transaction rather than through continuing use (AASB 5, paragraph 6).

36 Moreover, in respect of an asset that will be redeployed, the asset becoming "immediately available to be used for the alternative purpose in its present condition" may sometimes occur after "the asset's current use ceased by the measurement date" (the staff recommended change to sub-paragraph (vi) described above). Using the example in paragraph 17, becoming "immediately available to be used for the alternative purpose in its present condition" might be considered to occur only in Year 5, when the land preparation works were completed and the site becomes fit-for-purpose to build a hospital. Staff do not consider it appropriate for an asset to be measured based on use that has ceased.

37 Therefore, staff recommend omitting the criterion in sub-paragraph (iii) from the final Standard.

Question for Board members
Q1: Do Board members agree with the staff recommended changes to paragraph Aus29.2(b) noted in paragraph 23, as presented in the box in paragraph 24?

Stakeholder Comment 2: Clarify the references to 'distribution' in paragraphs Aus29.1 and Aus29.2, and query about transfer of assets

Distribution to owners

38 ACAG commented that paragraphs Aus29.1 and Aus29.2 in the FFR draft refer to assets that will be 'distributed', whereas the references to 'distribution' in paragraphs 5A, 12A and 15A of AASB 5 refer to a distribution to owners. ACAG also commented that:

> "A distribution in the public sector can be a distribution within the wholly-owned group (e.g. whole-of-government) as well as transfers to entities outside the reporting entity or whole-of-government."

39 ACAG suggested the Board clarifies in the final Standard that 'distribution' referred to in paragraphs Aus29.1 and Aus29.2 are limited to distribution to owners. One ACAG jurisdiction commented that transfers to entities other than the entity's owners would be likely to be considered as a future redeployment of the asset, which is addressed in sub-paragraph (b) of Aus29.2.

40 Staff agree with ACAG's view, and therefore recommend amending paragraphs Aus29.1 and Aus29.2(a) as follows to state that 'distribution' refers to distribution to owners.

Transfers of assets

41 A stakeholder queried whether paragraph Aus29.2(b) would apply to assets that will be transferred to another entity in neither a sale nor a distribution to owners. Staff consider that, consistent with the Board's purpose to limit the circumstances in which an entity must consider whether an asset's highest and best use differs from its current use, paragraph Aus29.2(b) should be applicable to assets that will be transferred to another entity but are outside the scope of paragraph Aus29.2(a).

42 Another stakeholder commented that in some situations, such as a change in machinery of government, an asset continues to be used for its current use but its holder changes to another entity. Staff consider that in such a situation, an entity may determine that the asset's current use remains its highest and best use until the asset is transferred, which would occur if one or more criteria in paragraph Aus29.2(b) have not been met (eg if the asset's current use has not ceased by the measurement date and, therefore, sub-paragraph (iv) of paragraph Aus29.2(b) has not been met).

Staff observation – The drafting of paragraph Aus29.1 may require clarification

43 AASB 13 paragraph 29 states that "… an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or **other factors suggest that a different use by market participants would maximise the value of the asset**." (emphasis added) Staff consider that the Board's general intention of proposing paragraphs Aus29.1 and Aus29.2 in the FFR draft was to:

(a) provide guidance on essential conditions that must be met to conclude that, regarding paragraph 29 of AASB 13, factors suggest that a different use by market participants (including other not-for-profit (NFP) public sector entities) would maximise the value of the asset; and

(b) thereby limit the circumstances in which an NFP public sector entity would be required to ***assess*** whether an asset's highest and best differs from its current use.

44 However, staff consider that it should not be assumed that meeting the criteria in paragraphs Aus29.1 and Aus29.2 alone would necessarily indicate that a higher and better use than its current use has been identified – this would depend on the facts and circumstances. An entity needs to apply judgement to determine the asset's highest and best use.

45 Staff observed that the drafting of paragraphs Aus29.1 and Aus93.2 and some Basis for Conclusion paragraphs in the FFR draft may have inappropriately implied that a higher and better use than an asset's current use (whether a sale/distribution to owners or an alternative use) would necessarily be identified once the conditions in paragraphs Aus29.1 and Aus29.2 are met. Therefore, staff recommend revising the drafting of those paragraphs.

Staff recommendations

46 Staff recommend making the following amendments to the final Standard:

(a) amending paragraph Aus29.1 and Aus29.2 to clarify that 'distribution' refers to distribution to owners;

(b) amending paragraph Aus29.1 and Aus29.2 to clarify that an NFP public sector entity is not required to consider whether an asset's highest and best use differs from its current use unless the criteria in paragraph Aus29.2 are met (i.e. satisfying those criteria is likely to, but does not necessarily, result in identifying a change in an asset's highest and best use);

(c) amending paragraph Aus93.2 to use text consistent with the revised paragraph Aus29.1; and

(d) Clarifying the points discussed in paragraphs 41–45 in the Basis for Conclusions.

47 Staff suggested changes to paragraphs Aus29.1, Aus29.2(a) and Aus93.2 are outlined below.

Aus29.1	Notwithstanding paragraph 29, <u>a not-for-profit public sector entity is only required to consider whether,</u> for a non-financial asset ~~of a not-for-profit public sector entity~~ not held primarily for its ability to generate net cash inflows, <u>the asset's highest and best use differs from its current use when,</u> ~~the asset's current use is presumed to be its highest and best use unless~~ at the measurement date<u>,</u> it is highly probable that the asset will be sold, distributed <u>to owners</u> or used for an alternative purpose to its current use<u>, in accordance with paragraph Aus29.2</u>.
Aus29.2	For the purposes of paragraph Aus29.1, it is highly probable that the asset will be: (a) sold or distributed <u>to owners</u> when it is classified as held for sale or held for distribution <u>to owners</u> in accordance with AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*; ~~and~~ <u>or</u> (b) …
Aus93.2	<u>For a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, the information in</u> ~~For the purposes of~~ paragraph 93(i)~~, for a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, the asset's current use is presumed to be its highest and best use unless,~~ <u>is only required to be disclosed if the entity has determined that the asset's highest and best use differs from its current use. Such an entity is only required to consider whether this difference exists when,</u> in accordance with paragraphs Aus29.1 and Aus29.2, <u>at the measurement date</u> it is highly probable that the asset will be sold, distributed <u>to owners</u> or used for an alternative purpose to its current use.

Questions for Board members

Q2: Do Board members agree with the staff proposed changes to paragraphs Aus29.1, Aus29.2(a) and Aus93.2?

Q3: Do Board members agree with the staff recommendation to clarify the points discussed in paragraphs 41–45 in the Basis for Conclusions (please refer to paragraphs BC68, BC76 and BC77 in Agenda Paper 3.4/3.5)?

Section 2: Financially feasible use

48 The FFR draft proposed adding paragraph Aus28.1 to AASB 13 to clarify that an asset's use is 'financially feasible' if market participants would be willing to invest in the asset's service capacity, considering both the capability of the asset to be used to provide needed goods or services to beneficiaries and the resulting cost of those goods or services. That paragraph is reproduced below.

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

Stakeholder Comment 3: Clarify the interaction between financially feasible use and functional obsolescence

49 A Panel member commented that, with the introduction of a new financially feasible use concept in paragraph Aus28.1 to consider the cost of providing goods/services (as well as the capability of the asset to be used to provide needed goods or services to beneficiaries), when the subject asset has excess operating costs compared with a modern equivalent reference asset (and therefore is affected by functional obsolescence: see paragraph 50), it is unclear whether a use of the asset would be considered 'financially feasible'.

50 Paragraph 80.6 of the International Valuation Standard IVS 105 *Valuation Approaches and Methods* explains the two forms of functional obsolescence. It states:

"There are two forms of functional obsolescence:

(a) excess capital cost, which can be caused by changes in design, materials of construction, technology or manufacturing techniques resulting in the availability of modern equivalent *assets* with lower capital costs than the subject *asset*, and

(b) excess operating cost, which can be caused by improvements in design or excess capacity resulting in the availability of modern equivalent *assets* with lower operating costs than the subject *asset*."

51 The Panel member provided the example of where LED lights are more cost effective to operate than halogen lights (because they consume less electricity); if the subject asset has in-built halogen lights and the modern equivalent reference asset has in-built LED lights, this is an indicator of the subject asset having functional obsolescence compared with the modern equivalent reference asset. In this case, the fair value of the subject asset should be adjusted down to reflect the excess operating costs. The Panel member commented that it may raise questions among valuers if the fair value of the subject asset after such adjustments resulted in a small value, whether the asset's use could still be considered 'financially feasible' under the new proposed paragraph Aus28.1 that would require consideration of costs of providing goods/services.

Staff analysis and recommendation

52 In respect of the Panel member's comment noted in paragraph 49, staff considered that:

(a) as noted in paragraph BC47 in the draft Standard, the three aspects of highest and best use (physically possible, legally permissible and financially feasible use) would only need to be considered when the presumption that the asset's current use is its highest and best use is rebutted in accordance with paragraph Aus29.1 or Aus29.2. However, because that aspect is not specific to not-for-profit (NFP) entities, staff consider that AASB 13 should not be modified to state this explicitly; and

(b) under proposed paragraph Aus28.1, the cost of providing goods or services would be a consideration in determining whether market participants would be willing to invest in the asset's service capacity; the other consideration being the capability of the asset to be used to provide needed goods or services to beneficiaries.

53 Staff considered that even if the subject asset has a low fair value due to having higher operating costs than the reference asset, if it has been judged that market participants, including other not-for-profit public sector entities, would be willing to invest in the subject asset's service capacity considering also the capability of the asset to be used to provide needed goods or services to beneficiaries, then the asset's use would be considered financially feasible.

54 Staff recommend clarifying the points noted in paragraphs 52(b) and 53 in the Basis for Conclusions.

Question for Board members

Q4: Do Board members agree with the staff recommendation to explain the points noted in paragraphs 52(b) and 53 in the Basis for Conclusions (please refer to paragraphs BC93−BC94 in Agenda Papers 3.4 and 3.5)?

Section 3: Market participant assumptions

55 Paragraphs F2–F8 of the FFR draft provide guidance on the application of the market participant assumptions principles.

Market participant assumptions (paragraphs 22 and 23, 61 and 89)

F2 Paragraph 22 requires an entity to measure the fair value of an asset using the assumptions that market participants would use when pricing the asset, assuming that market participants act in their economic best interest. Paragraph 23 states that, in developing those assumptions, an entity need not identify specific market participants; and paragraph 89 states that (in relation to unobservable inputs for an asset) an entity need not undertake exhaustive efforts to obtain information about market participant assumptions.

F3	Unobservable inputs are defined as inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability. Paragraph 87 states that unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Paragraph 89 states that, in developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy).
F4	Various non-financial assets of not-for-profit public sector entities not held primarily for their ability to generate net cash inflows, especially some that are specialised, do not have observable market selling prices or other observable market data because entities seldom sell those assets until their economic life has expired (ie there is little market activity for the asset or comparable assets at the measurement date). Consequently, in applying the requirement of paragraph 61 for fair value estimates to maximise the use of relevant observable inputs, it may nonetheless be necessary to develop unobservable inputs to estimate their fair value. Moreover, for assets that are unique to a government, observable evidence of assumptions of other market participants, if any, is unlikely to differ from the entity's own assumptions.
F5	Accordingly, when applying the principles in paragraphs 61 and 62 to measure the fair value of a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, if both the market selling price of a comparable asset and some market participant data required to measure the fair value of the asset are not observable, the entity shall use its own assumptions as a starting point and adjust those assumptions to the extent that reasonably available information indicates that other market participants would use different data.
F6	For the purposes of paragraph F5, if no relevant information about other market participant assumptions is reasonably available, the entity shall use its own assumptions in measuring the fair value of the asset. Exhaustive efforts need not be undertaken to identify whether relevant information about other market participant assumptions is reasonably available or whether the entity's own data should be adjusted. However, when information about market participant assumptions is reasonably available, an entity cannot ignore that information.
F7	For the purposes of paragraph F5, for assets with various inputs to their fair value estimate, observable market data might be available for some inputs, in which instances unobservable inputs would only be used for the remainder of the asset's fair value estimate. For example, the land component of a self-constructed specialised facility might have comparable land with an observable market price, but entity-specific data might be needed to measure the fair value of some or all of the improvements on that land included in the fair value estimate for the facility.

Stakeholder Comment 4: Concern about adequacy of relief when using own assumptions as the starting point for developing unobservable inputs (and potential inconsistency between paragraphs F5 and F6)

56 ACAG noted that one of its jurisdictions commented that: "the proposed change has little effect on the current requirements and does not appear to achieve the intended relief from needing to determine hypothetical market participant inputs." Staff noted that the Board's intention is to assist in reducing the costs and effort required in identifying which market participant assumptions to use in fair value measurements of NFP public sector assets but not to omit the need to consider reasonably available information about market participant assumptions, because that is a fundamental principle of AASB 13.

57 That jurisdiction also recommended deleting the first sentence of paragraph F6 because it appears to contradict paragraph F5. Paragraph F6 states "<u>For the purposes of paragraph F5,</u> if no relevant information about other market participant assumptions is reasonably available" (emphasis added), whereas paragraph F5 refers to when 'some' of the market participant data are readily available. However, the majority of ACAG jurisdictions support paragraphs F5 and F6 of the FFR draft.

Staff recommendation

58 Staff consider that the first sentence of paragraph F6 can be re-located make the paragraph clearer. Staff recommend making the following changes to the proposed paragraph F6.

> F6 For the purposes of paragraph F5, ~~if no relevant information about other market participant assumptions is reasonably available, the entity shall use its own assumptions in measuring the fair value of the asset. Exhaustive~~ exhaustive efforts need not be undertaken to identify whether relevant information about other market participant assumptions is reasonably available or whether the entity's own data should be adjusted. However, when information about market participant assumptions is reasonably available, an entity cannot ignore that information. If no relevant information about other market participant assumptions is reasonably available, the entity shall use its own assumptions in measuring the fair value of the asset.

Question for Board members

Q5: Do Board members agree with the staff proposed changes to paragraph F6?

Section 4: The overarching principle of the cost approach

59 Paragraphs F8–F10 of the FFR draft outlined the overarching principle of the cost approach.

> ### Application of the cost approach (paragraphs B8 and B9)
>
> F8 Paragraphs B8 and B9 state that the cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost), based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.
>
> F9 Accordingly, when measuring the fair value of a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows (the subject asset) using the cost approach, an entity estimates the current replacement cost of the subject asset by estimating the cost currently required for a market participant buyer to acquire or construct a reference asset in accordance with paragraphs F11–F15, and:
>
> (a) adjusting that estimate for any differences between the current service capacity of the reference asset and the subject asset (for example, where the modern equivalent asset would be engineered to a higher standard than the subject asset, which might occur where the asset was self-constructed but its replacement by a modern equivalent is most likely to occur through a service concession arrangement whereby the reference asset is designed to provide services for an economic life longer than that of the subject asset); and
>
> (b) adjusting for any obsolescence.
>
> F10 A reference asset is a suitable alternative to the subject asset that the market participant buyer would consider in developing its pricing assumptions about the subject asset. Identifying the most appropriate reference asset involves the application of judgement and, on occasion, detailed valuation assessments in the circumstances of the subject asset. A reference asset could be a modern equivalent asset or a replica asset (where the utility offered by the subject asset could be provided only, or more cheaply, by a replica rather than a modern equivalent asset). A modern equivalent asset is an asset that provides similar function and equivalent utility to the subject asset, but is of a current design and constructed or made using current cost-effective materials and techniques.

Stakeholder Comment 5: Queried examples of adjusting the reference asset's replacement cost

60 ACAG commented that paragraph F9(a) should be amended to remove the reference to a service concession arrangement because it is very unlikely that an asset designed by a public sector entity (i.e. the grantor) subject to a service concession arrangement will be different from the same type of assets operated by the entity itself e.g. a road.

61 Staff note that mixed views have been received on this issue from stakeholders. Because the reference to a service concession arrangement was included only for illustrative purposes, staff consider that the appropriate response to ACAG's comment would be to omit that reference from paragraph F9(a).

62 In addition, regarding paragraph F9(a), ACAG commented that, "in practice, differences between the subject asset and the modern equivalent (apart from 'gold plating service potential') are related to building and construction standards, for example fire safety, the number of elevators etc". In response, staff suggest adding to paragraph F9(a) references to fire safety and the number of elevators as examples of where building and construction standards can differ between a modern equivalent asset and the subject asset.

Staff recommendation

63 Staff propose the following revised wording for paragraph F9. In addition to addressing the above ACAG comments, staff edited the drafting of that paragraph to improve understanding. Changes to the FFR draft wording are not marked up due to the extent of changes:

> F9 Accordingly, when measuring the fair value of a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows (the subject asset) using the cost approach, an entity shall:
>
> (a) estimate the cost currently required for a market participant buyer to acquire or construct a reference asset (ie the replacement cost of a reference asset) in accordance with paragraphs F11–F15; and
>
> (b) adjust the estimate in (a) for any:
>
> (i) differences between the current service capacity of the reference asset and the subject asset (for example, where the modern equivalent asset is engineered to a higher standard than the subject asset, such as where the subject asset is a building and the modern equivalent building has superior fire safety features and a greater number of lifts than the subject building); and
>
> (ii) obsolescence (physical deterioration, functional obsolescence and economic obsolescence).

Question for Board members

Q6: Do Board members agree with the staff proposed changes to paragraph F9?

Section 5: Estimating the replacement cost of a reference asset

64 Paragraphs F11–F15 of the FFR draft provide guidance on how to estimate the replacement cost of a reference asset.

> ### Estimating the replacement cost of a reference asset
>
> F11 For the purposes of paragraph F9, when estimating the cost currently required for a market participant buyer to acquire or construct a reference asset, an entity:
>
> (a) assumes the reference asset will be acquired or constructed at the subject asset's existing location; and
>
> (b) where paragraph F5 applies, shall use its own assumptions as a starting point in measuring the costs currently required to acquire or construct a reference asset and adjust those assumptions to the extent that reasonably available information indicates that other market participants would use different data.
>
> F12 When applying paragraphs F9 and F11, the entity shall, subject to paragraph F14, include the following costs (among other costs) in the reference asset's replacement cost if they would need to be incurred upon the hypothetical acquisition or construction of a reference asset with the same service capacity (including condition) as the subject asset at the measurement date:
>
> (a) costs required to restore another entity's asset, if the asset that would need restoration existed at the measurement date and would be disturbed in a hypothetical acquisition or construction of the reference asset. However, such costs are excluded if they relate to restoration of an asset of another entity included in the consolidated group (if any) to which the entity belongs;
>
> (b) other disruption costs that would hypothetically be incurred when acquiring or constructing the reference asset at the measurement date (eg costs of redirecting traffic when replacement of the asset, such as a drainage pipe, disrupts the operation of a road); and
>
> (c) if the subject asset is fixed to a parcel of land, site preparation costs for the reference parcel of land on which the reference asset would hypothetically be constructed, unless those site preparation costs are reflected (explicitly or implicitly) in the fair value measurement of the subject parcel of land.
>
> F13 For the purposes of paragraph F12(c), site preparation costs include, but are not limited to:
>
> (a) costs required to prepare the land (eg earthworks and decontamination) for the hypothetical construction of the reference asset; and
>
> (b) costs required to remove and dispose of any unwanted existing structures on the land to make way for the hypothetical construction of the reference asset.
>
> F14 An entity need not undertake exhaustive efforts to obtain information about the costs referred to in paragraphs F12 and F13. However, an entity shall include all such costs for which data are reasonably available.
>
> F15 When applying the cost approach in accordance with paragraph F9 to measure the fair value of a heritage asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, to the extent that its heritage features are an essential part of its service capacity, replacement cost generally means the cost of replicating those features of the subject asset (ie reproduction cost). Replication would assume reconstruction using modern cost-effective materials and processes, but sympathetic with the original heritage design and structure to the extent feasible.

Stakeholder Comment 6: Perceived contradiction between paragraph F5 and paragraph F13(b)

65 ACAG commented that "One jurisdiction believes that paragraph F13(b) is confusing and contradictory to the other proposed guidance, particularly when an entity uses its own assumptions. The costs to remove and dispose of existing structures are not an observable input and will therefore not be readily available. Consequently, under paragraph F5, an entity will use its own assumptions. This data should be consistent with paragraph F13(a) of the entity's cost in preparing the land. Therefore, if the land that existed prior to the construction was vacant, no additional costs would be added.".

66 Paragraph F5 of the FFR draft (reproduced in paragraph 25) states:

> "… if both the market selling price of a comparable asset and some market participant data required to measure the fair value of the asset are not observable, the entity shall use its own assumptions as a starting point and adjust those assumptions to the extent that reasonably available information indicates that other market participants would use different data."

Staff analysis

67 Staff observed that, under paragraph F5, an entity is required to consider whether there is reasonably available information that indicates that other market participants would use different data when pricing the asset. It should not be assumed that market participants' assumptions regarding the costs to remove and dispose of existing structures would always be the same as the entity's own assumptions. In addition, regarding the last sentence of paragraph 65, staff consider that it should be a matter for individual entities or the Treasury (or its equivalent) in the jurisdiction to determine the circumstances in which neither data of the entity nor of other market participants are reasonably available, because that issue pertains to factual circumstances rather than accounting policies. Therefore, staff disagree with the view of that ACAG jurisdiction and thus recommend no action.

Question for Board members

Q7: Do Board members agree with the staff view that no action is needed in respect of Stakeholder Comment 6? If not, which actions do you suggest?

Stakeholder Comment 7: Illustrative Example 4 may cause confusion regarding the measurement technique to use to measure the fair value of land

68 ACAG commented that one of its jurisdictions expressed the view that Example 4 seems to imply that the land had been valued using the cost approach. They also commented that "ACAG believes that the example should be updated to illustrate any differences that would arise between a current replacement cost and market approach valuation of the land, or otherwise confirm that the basis of valuing the related land is irrelevant to the outcome. The majority ACAG view is that land would generally be valued using the market approach as it is likely to have a reference point to the market."

Staff analysis

69 Staff note that Illustrative Example 4 in the FFR draft treated land decontamination costs as part of the fair value of the facility on the land because the proposed Standard does not provide guidance on the use of the market approach. Although Example 4 made no comment about using the cost approach to measure the fair value of the land, staff accept that Example 4 might be interpreted as implying that because:

(a) decontamination costs are explicitly adjusted for in the illustrative calculations; and

(b) the common assumption that land decontamination costs are reflected in the fair value of the land (e.g. the land generally should command a higher market price regardless of whether any improvements have been built on it).

Staff's response to this concern is discussed in paragraph 88.

Stakeholder Comment 8: Example 4 appears to allow an entity to make an accounting policy choice about the treatment of certain site preparation costs

70 ACAG commented that the FFR draft Standard did not include sufficient guidance to clarify whether certain site preparation costs e.g. decontamination costs should be reflected in the fair value of the land or the land improvements. Illustrative Example 4 in the FFR draft seems to

suggest that this is an accounting policy choice for an entity to make (Liquid Pacific expressed a similar concern, stating that an accounting policy is entity-specific and does not transfer with the property). ACAG is concerned that Illustrative Example 4 may lead to inconsistent recognition of site preparation costs.

71 ACAG also commented that:

> "Two jurisdictions noted that after decontamination, they would expect the land to be valued as decontaminated land and the expected $5 million decontamination costs adjusted against the surrounding contaminated land to arrive at an estimate of the fair value of the decontaminated land owned."
>
> "One of the two jurisdictions above, notes that the scenario is simplified in that the fair value of the decontaminated land will equal the fair value of contaminated land and an estimate of decontamination costs. However, this is unlikely in practice as contaminated land owned by other entities is subject to a large variation of possible decontamination costs and variations in the levels of contamination. This jurisdiction suggests that the AASB clarify as to what happens in practice when actual decontamination costs are different to the estimated costs."
>
> "… one of the simplifying facts specified in (c) is to remove the profit margin attributable to any site preparation costs for market participants. There is no explanation provided for why an adjustment should be made for the profit margin. The AASB should clarify that, if the profit margin is not ignored, it should be included, as this is what a market participant decontaminating land would pay. This is also an amount we expect the government would pay, as it is likely they will have to contract to the private sector to decontaminate land."

72 In addition, Liquid Pacific expressed concern that Example 4 conflicts with accepted market behaviour and typical transactions of real property assets, because a market participant would consider the building and the land it sits on as being one asset for purchase. Therefore, the illustrative example should reflect that, in the absence of market transactions for similar property, it is expected that the market participant would consider the market value of the land as it exists (which is uncontaminated) and the added value of improvements (assuming a cost approach) and summate both values to arrive at an estimate of fair value (market value) for the property.

73 Liquid Pacific expressed concern that Example 4 is inconsistent with the outcome that, if it is assumed that the fair value for the uncontaminated land is $20 million and the depreciated replacement cost of the building is $25 million:

(a) the market participant would only pay $45 million for the facility – there are no scenarios that would make this allocation of value change; and

(b) the fair value for the uncontaminated land being $20 million would indicate the value of the land when contaminated had a maximum value of $15 million.

Staff analysis

74 In respect of ACAG's comment about the lack of an explanation of why an adjustment might be made for the profit margin attributed to any site preparation costs by market participants when pricing the subject asset, staff consider that specific guidance should not be provided on whether or how such a profit margin should be taken into account in fair value measurements because it is a matter for detailed valuation assessments.

75 Staff consider that providing commentary on the relative outcomes of applying the cost approach or market approach to value land and a facility attached to the land would encroach on detailed valuation assessments.

76 Staff consider that attributing separate fair value estimates to the land and improvements is not in conflict with the assumption that the land and improvements would hypothetically be sold in a single transaction. Staff agree with Liquid Pacific's conclusion of a $45 million fair value estimate of the land and improvements under the assumed fact pattern provided by Liquid Pacific (note that Illustrative Example 4 contained no data about the value of the land).

77 However, the assumed facts in the three scenarios in Example 4 illustrated the implications of different circumstances regarding whether the reference parcel of land is contaminated; the comments by Liquid Pacific focus on the subject parcel of land being uncontaminated at the measurement date, without addressing whether differences between the subject parcel of land and the reference parcel of land would potentially affect the fair value measurement.

78 Under the assumed fact pattern of the revised Example 4 (see paragraph 88) those differences affect the measurement of the improvement on the land. Therefore, staff consider that the structure of the example should be retained.

79 Furthermore, Liquid Pacific expressed concern that the treatments in Scenarios A and C in Example 4 are susceptible to overvaluation because public sector entities often revalue their land holdings and buildings in separate financial years. That is, the improvement from the site preparation works (in the FFR draft: decontamination) could be included in both the land and building components. Staff consider that addressing this concern would be outside the scope of Accounting Standards, because it is a detailed implementation issue concerning valuation practice.

Stakeholder Comment 9: Other types of costs might be more appropriate to use than decontamination costs in Example 4

80 A Panel member commented that another type of costs than decontamination costs might be more appropriate to use in Illustrative Example 4 to illustrate how a particular entity treats site preparation costs in measuring an asset's fair value using the cost approach. This is because it is often difficult to quantify decontamination costs reliably (e.g. in situations where there is per- and poly-fluoroalkyl substances (PFASs) involved) and contamination is a widespread issue presenting huge valuation challenges. The Panel member also commented that in applying paragraph 31 of AASB 116 *Property, Plant and Equipment*, the reliable measurement criterion for fair value measurements often is not met.

Staff analysis

81 Staff agree that decontamination is only one type of site preparation costs an entity might need to consider in measuring the fair value of a site, and might be an unduly contentious example to include in an illustrative example.

Stakeholder Comment 10: Illustrative Example 4 may reflect inappropriate treatment of costs specific to the circumstances of any entity's asset

82 ACAG (in its submission on ED 320) and a Panel member (in outreach activities after the FFR draft) expressed concern about whether, in relation to using the cost approach to measure an NFP public sector asset, the focus in paragraph F9 on estimating the cost currently required for a market participant buyer to acquire or construct a *reference asset* might result in current replacement cost measurements failing to reflect the specific features of the subject asset for which market participant buyers would be prepared to pay when 'stepping into the shoes' of the entity holding the asset.

83 The Panel member also expressed concern that in a circumstance similar to that described in Scenario B of Illustrative Example 4 – where the entity incurred costs to decontaminate the site prior to constructing a facility on the site, but available land in the proximity of the subject site was uncontaminated. The example concluded that a market participant buyer could hypothetically purchase an uncontaminated site and therefore the decontamination costs

should not be included in the current replacement cost of the subject facility. The stakeholder was concerned that, if an entity incurred decontamination costs (that were capitalised in the facility's carrying amount), but in a subsequent measurement of the facility decontamination costs are excluded from the current replacement cost of the subject asset, the reduction in the asset's value would misleadingly indicate that the entity had made an economically unjustified decision in incurring the decontamination costs although those costs were necessarily incurred.

Staff analysis

84 In respect of the stakeholder's concern noted in paragraph 82, paragraphs B8 and B9 state that the cost approach reflects the amount that would be required currently to replace the service capacity of an asset, based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility (i.e. a reference asset), adjusted for obsolescence. Therefore, consistent with AASB 13 paragraphs B8 and B9, the costs that a market participant buyer would be prepared to pay to acquire or construct an asset would depend on the cost of acquiring or constructing a reference asset, after taking account of differences between the service capacity of the reference asset and the subject asset.

85 However, staff consider that there may be situations in which there might not be suitable alternative sites for a particular facility because the facility must be sited in its existing location. In those situations, market participant buyers would be prepared to pay the location-specific costs of site preparation for that facility. Staff recommend clarifying this point in the Basis for Conclusions.

86 In respect of the concern about the perception of an entity making economically unjustified decision described in paragraph 83, staff were informed by some stakeholders that, in many cases, if the market approach is applied to measure the value of the land under a facility, any site preparation works incurred would be reflected in the land's market value. In those cases, the aggregate fair value measurement of the land and facility would not indicate that the necessarily incurred site preparation costs are economically unjustified.

87 Staff recommend clarifying in Example 4 that the fact pattern in that example reflects a simplified assumption (that the value created by site preparation works affects the improvements rather than the land, to avoid going beyond illustrating application of the cost approach) and would not necessarily be appropriate in all situations.

Staff recommendation regarding stakeholder comments 7–10

88 In summary, in respect of the stakeholders' concerns noted in Stakeholder Comments 7–10, staff recommend:

(a) removing the reference to contamination costs from paragraph F13(a) and using site levelling costs instead in Illustrative Example 4;

(b) removing from the fact pattern in Illustrative Example 4 the reference to an entity making an accounting policy choice. Instead, the fact pattern should say that the entity "determined that site levelling costs are not reflected (explicitly or implicitly) in the fair value measurement of the land under the airstrip because market participants acquiring the land for other purposes would not require a level site", to be consistent with the text in the proposed paragraph F12(c). This should address the comment by Liquid Pacific noted in paragraph 72 which seems to be about their concerns on how the components of the aggregate fair value for the subject property should be allocated to the land and improvements;

(c) clarifying in Illustrative Example 4 that it assumes the value attributed by market participants to the site preparation is included in the estimated current replacement cost of the subject asset. That simplifying assumption would not necessarily be appropriate in all situations; and

(d) clarifying in the Basis for Conclusions that, in respect of consideration of site preparation costs, if there are no suitable alternative sites for a particular facility because the facility must be sited in its existing location, market participant buyers would be prepared to pay the location-specific costs of site preparation for that facility.

89 Staff suggested changes are included in the boxes below. Because of the extent of the changes made to Illustrative Example 4, the changes are not marked up.

F13 For the purposes of paragraph F12(c), site preparation costs include, but are not limited to:

(a) costs required to prepare the land (eg earthworks ~~and decontamination~~) for the hypothetical construction of the reference asset; and

(b) costs required to remove and dispose of any unwanted existing structures on the land to make way for the hypothetical construction of the reference asset.

Example 4 – Site preparation costs

Health Department C was transferred land on 1 July 20X0 to be used to construct a remote airstrip for airborne health services.

The subject asset is the airstrip, and the valuation of land under the airstrip is not addressed in this example.

Department C:

(a) recognises airstrips and land under airstrips as separate classes of asset;

(b) incurred $1.5 million (excluding any site preparation costs) to construct the airstrip. The construction was completed in June 20X1;

(c) measures the fair value of the airstrip at current replacement cost under the cost approach; and

(d) determined that site levelling costs are not reflected (explicitly or implicitly) in the fair value measurement of the land under the airstrip because market participants acquiring the land for other purposes would not require a level site.

As at 30 June 20X1, the fair value of the airstrip was estimated. For simplicity:

(a) it is assumed that the value of land in the proximity of the airstrip, and any site preparation costs, did not change between 1 July 20X0 and the measurement date of 30 June 20X1;

(b) the cost to construct the airstrip did not change since its construction;

(c) in relation to the requirements of paragraph F15, data are reasonably available for the site preparation costs and costs of constructing the airstrip; and

(d) any profit margin on the entity's own site preparation costs that would be demanded by external contractors and would increase the amount that not-for-profit public sector market participant buyers would be prepared to pay for the subject asset (as reflected in the asset's current replacement cost) is ignored.

The site preparation costs determined in accordance with paragraph F13(c) are analysed for the following three scenarios:

(a) Scenario A: The transferred land (airstrip site) was undulating, and Department C incurred $3 million to level the site. Available land in the proximity of the airstrip site was also undulating;

(b) Scenario B: The airstrip site was undulating, and Department C incurred $3 million to level the site. Available land in the proximity of the airstrip site was level; and

(c) Scenario C: The airstrip site was level. Available land in the proximity of the airstrip site was undulating.

Site preparation cost assessments as at 30 June 20X1

Scenario A

It would be expected that another market participant buyer would need to incur $3 million to level the airstrip site to be a fit-for-purpose site for the modern equivalent airstrip, since the only available land in the proximity is also undulating. Using the cost approach, Department C measures the replacement cost of a reference airstrip as at 30 June 20X1 as $4.5 million ($3 million site levelling cost and $1.5 million other construction cost).

Scenario B

It would be expected that another market participant buyer could hypothetically purchase a level site, in which case, it would not need to incur the $3 million site levelling cost. Using the cost approach, the replacement cost of a reference airstrip as at 30 June 20X1 is $1.5 million.

Scenario C

It would be expected that another market participant buyer, being unable to acquire a level site (to hypothetically construct a modern equivalent airstrip) as an alternative to acquiring Department C's airstrip, would be prepared to pay for the cost of site levelling when pricing the airstrip. Department C measures the replacement cost of a reference airstrip as at 30 June 20X1 as $4.5 million ($3 million site levelling cost and $1.5 million other construction cost), despite the fact that it did not actually incur any site levelling costs when the airstrip was constructed.

Including the $3 million site levelling cost in the fair value measurement of the airstrip represents the advantage for a market participant buyer to possess Department C's airstrip (ie would be considered by a market participant buyer when pricing the airstrip). The advantage to a market participant buyer of possessing Department C's airstrip would include that the buyer would avoid the need to incur site levelling costs to prepare an undulating parcel of land for the construction of a reference airstrip.

This example assumes the value attributed by market participants to the site levelling is included in the estimated current replacement cost of the airstrip. That simplifying assumption would not necessarily be appropriate in all situations. For example, a particular entity with circumstances similar to Scenario B might value the land under the airstrip using the market approach and the valuations before and after that site levelling might indicate that the site levelling increased the fair value of that parcel of land. Where the fair value of land incorporates the value attributed by market participants to site improvements, the cost of those improvements would, in accordance with paragraph F12(c), be excluded from the current replacement cost of improvements measured using the cost approach.

Questions for Board members

Q8: Do Board members agree with the staff proposed changes to paragraph F13(a) and the proposed revised Illustrative Example 4?

Q9: Do Board members agree with the staff recommendation to clarify in the Basis for Conclusions that, in respect of consideration of site preparation costs, if there are no suitable alternative sites for a particular facility because the facility must be sited in its existing location, market participant buyers would be prepared to pay the location-specific costs of site preparation for that facility?

Stakeholder Comment 11: Illustrative Example 1 regarding brownfield and greenfield costs

90 ACAG commented that:

> "Example 1 is a recent 'brownfield construction' valued in a brownfield environment. ACAG recommends that a more appropriate example is of a road constructed in a greenfield environment (with no traffic disruption costs) whose components will now need to be replaced in a brownfield scenario. For example, it could be expressed as an asset constructed several years ago that is now situated in a densely populated area, with relevant replacement cost estimates being provided by an independent valuer (ignoring the impact of any obsolescence).
>
> If the example is retained as a 'brownfield construction' then $2 million of removal costs and $1 million of disruption costs need to be included in the table of direct physical costs as they were part of the capital WIP project.
>
> ACAG also recommends that the AASB clarify in the example's fact pattern whether there are other market participants."

Staff analysis

91 In relation to the first comment by ACAG noted in paragraph 47, staff note that when developing ED 320, staff discussed two working examples with the Panel based on a road constructed in a greenfield environment that over time became a brownfield environment. At the time, some Panel members expressed concern that the assumed facts implied the entity ignored the opportunity to locate its road where its replacement would cause less disruption to other entities' services. In light of that concern, the examples were worded non-sequentially and thus involved different Councils. Staff consider that ACAG's suggestion does not indicate a fatal flaw in the FFR draft.

92 In response to the second comment by ACAG, staff propose to amend the heading above the list of costs totalling $22.2 million. Instead of implying the costs to remove unwanted existing structures and disruption costs are not direct physical costs, staff propose amending the above-mentioned heading to "Costs (excluding costs to remove unwanted existing structures and disruption costs)". [This proposed change has been incorporated in Example 1 in Agenda Papers 3.4 and 3.5]

93 Staff disagree with the ACAG suggestion to clarify in the example's fact pattern whether there are other market participants. As noted in paragraph 30, staff propose adding paragraph F3 to state that the assumptions of market participants for the subject asset include the assumptions of other not-for-profit public sector entities hypothetically acquiring the subject asset. Since it is unnecessary to identify particular market participants (instead, the assumptions that market participants would be likely to make are the focus), the example addresses the requirement of proposed paragraphs F5 and F6 of the FFR draft to consider (without undertaking exhaustive efforts) whether reasonably available information indicates that other market participants

would use different data from the entity's own assumptions. This would be a matter for a valuation expert to determine. Therefore, staff recommend no action.

Question for Board members
Q10: Do Board members agree with the staff view that no action is needed in respect of Stakeholder Comment 11? If not, which actions do you suggest?

Stakeholder Comment 12: Changing the assumed fact pattern in Illustrative Example 1

94 In relation to the assumed fact that there is no reasonably available information indicating that another market participant would construct a road at the same location during the daytime (at a lower cost), Liquid Pacific suggested reversing the assumption so that there is no evidence that another market participant would construct a road during the night time, i.e. no evidence that the entity would spend more than the minimum legally permitted amount.

95 Liquid Pacific also suggested that different amounts would be appropriate for Illustrative Example 1, including for example the additional costs of compulsory acquisition of properties acquired to build the road. They also suggest that the amounts for land and improvements are estimated jointly, with the amount for improvements being a residual after deducting the value of the land.

Staff analysis

96 Regarding the comment noted in paragraph 94, staff observe that:

(a) the purpose of this assumed fact of night time construction in the example is to demonstrate that sometimes market participants would necessarily incur more than the legally permitted amount (in the circumstances mentioned in paragraph BC155 of the FFR draft). Therefore, reversing the fact pattern would defeat the purpose of the example; and

(b) Liquid Pacific disagree with the Board's view, supported by a majority of stakeholders, that market participants would in some circumstances be willing to incur more than the cheapest legally permitted amount to currently acquire an asset.

97 Regarding the comment noted in paragraph 95, staff:

(a) note that the illustrative examples are meant to illustrate how to apply principles, not necessarily to reflect a particular or typical set of circumstances; and

(b) consider that illustrating how values are apportioned between land and improvements would be a matter of detailed valuation assessments, and might imply restrictions on how valuers apply the market, income or cost approach – which would contradict the Board's decision not to restrict the use of those valuation techniques.

98 Therefore, staff recommend noting the views of Liquid Pacific regarding this example in the Basis for Conclusions, but making no other changes to the FFR draft in respect of these comments.

Question for Board members
Q11: Do Board members agree with the staff view that no action is needed in respect of Stakeholder Comment 12? If not, which actions do you suggest?

Stakeholder Comment 13: Changing the assumed fact pattern in Illustrative Example 2

99 Liquid Pacific expressed concern that Example 2, by illustrating the inclusion of additional costs (compared with Example 1) for restoring another entity's assets, makes allowance for entity-specific circumstances.

100 ACAG commented that it may be more appropriate to include a new example that does not relate to the circumstances of Example 1, as it is not logical that the initial construction of the road would not disrupt the drainage works but the replacement of the components of the road will. A copy of Example 2 is set out below for ease of reference:

> **Example 2 – Difference in the asset's operating environment affecting the reference asset's replacement cost**
>
> In this example, the costs and circumstances set out in Example 1 also apply to another local government (Council B), and it is also assumed that:
>
> - as at 30 June 20X2 another entity's drainage works were situated under the road;
> - Council B determines that, if its road was to be replaced as at the measurement date of 30 June 20X2, the other entity's drainage works would be disrupted;
> - the current cost required to restore those drainage works disrupted during the hypothetical replacement of the components of Council B's road (ie another type of intrinsically linked disruption cost) is $2,500,000; and
> - Council B is not part of a group of entities that prepares consolidated financial statements.
>
> **Estimating the replacement cost of a reference road as at 30 June 20X2**
>
> *Restoration costs for disrupted assets of another entity*
>
> In addition to the replacement cost estimate of $25,200,000 (as per Example 1), Council B also includes in the reference road asset's replacement cost as at 30 June 20X2 the $2,500,000 restoration costs for the drainage works necessarily disrupted during hypothetical replacement of the road's components.
>
> This is because the cost to a market participant buyer to acquire or construct a substitute road at the current location would necessarily include those restoration costs. In addition, because Council B is not part of a group of entities that prepares consolidated financial statements, the 'same group' scope exclusion for such costs in paragraph F13(a) does not apply to Council B.
>
> Consequently, as at 30 June 20X2, Council B measures the replacement cost of the reference road asset as $27,700,000 (ie $25,200,000 + $2,500,000).

Staff analysis

101 In respect of Liquid Pacific's comment, staff note that the roads in Examples 1 and 2 of the FFR draft are not identical, and therefore should not be measured at identical amounts (i.e. market participant buyers would necessarily incur a higher cost to construct the road in Example 2). Therefore, staff disagree with the contention that the additional costs in Example 2 are entity-specific.

102 Staff also observe that, as noted in paragraph 7 of Agenda Paper 3.2, Liquid Pacific disagrees with the notion that hypothetical NFP public sector market participant buyers – who should be willing to pay for disruption costs necessarily incurred to acquire or construct a subject asset – exist for public sector entity assets.

103 Staff disagree with this concern expressed by ACAG (noted in paragraph 100). Example 2 was not intended to reflect changed circumstances over time for the same Council (Examples 1 and 2 have the same measurement date; the roads being measured by Councils A and B have many similarities but also some important differences). The key difference between the roads in the two examples are that Council B's road has drainage works of another entity situated below it, which would be disrupted upon replacement of the road. Staff were concerned that replacing Example 2 with an example of an entirely different asset would make the implications of the differences in fact patterns less obvious to the reader.

104 Nevertheless, staff circulated to Panel members and ACAG members an alternative to Example 2, numbered below as Example 2A. Mixed views were received from those stakeholders regarding which example they would prefer; a narrow majority would prefer Example 2A, which is worded as follows (please note that the below example has been drafted based on the staff's proposed revised paragraph F9 set out in paragraph 63 above). In view of feedback that the alternative example (2A below) is clearer than Example 2 in the FFR draft, staff recommend including it instead in the final Standard.

Example 2A – Difference in the asset's operating environment affecting the reference asset's replacement cost

A local government (Council B) applies the revaluation model after recognition of each class of property, plant and equipment, as referred to in paragraph 31 of AASB 116.

Council B recognises buildings and land under buildings as separate classes of assets. It measures the fair value of its buildings using the cost approach. The valuation of land is not addressed in this example.

As at 30 June 20X2, Council B uses the following assumptions in measuring one of its buildings at fair value:

(a) when the building was originally constructed by Council B (20 years ago), there were no internet cables underneath the site;

(b) ten years ago, another entity installed internet cables with protective pipes under the site where Council B's building is located;

(c) Council B determined that, if its building was to be replaced as at the measurement date of 30 June 20X2, the other entity's pipes that are protecting the internet cables would be disrupted;

(d) the current cost necessary to restore those pipes disrupted during the hypothetical replacement of the components of Council B's building is $500,000; and

(e) Council B is not part of a group of entities that prepares consolidated financial statements.

<u>Restoration costs for disrupted assets of another entity</u>

Since Council B determined that if its building was to be replaced as at 30 June 20X2 the other entity's pipes would be disrupted, when measuring the fair value of Council B's building under the cost approach in accordance with paragraphs F10(a) and F13(a), the reference building's replacement cost would include the $500,000 restoration cost for the pipes.

The restoration cost is included despite the fact that Council B did not incur those costs when it originally constructed the building. This is because fair value measurements consider the conditions of the asset as at the measurement date, and in its circumstances, Council B has determined that the cost to a market participant buyer to acquire or construct a substitute building at the current location would necessarily include those restoration costs. In addition, because Council B is not part of a group of entities that prepares consolidated financial statements, the 'same group' scope exclusion for such costs in paragraph F13(a) does not apply to Council B.

Question for Board members

Q12: Do Board members prefer retaining Illustrative Example 2 set out in the FFR draft or, as recommended by staff, replacing it with the alternative Example 2A outlined in paragraph 104?

Stakeholder Comment 14: Illustrative Example 3 contradicts guidance on modern equivalent asset

105 Liquid Pacific expressed concern that Example 3, illustrating the inclusion of additional costs to those legally required, depicts an entity-specific estimate of fair value and contradicts the principle in paragraph 22 of AASB 13 that market participants act in their economic best interest. In addition, they argued that the example:

(a) ignores the fact that there is no information to indicate a market participant would not acquire the railway tracks overseas, and therefore the analysis should reflect the cost minimisation objective of market participants;

(b) implies political motivation is a valuation input; and

(c) contradicts the guidance on modern equivalent asset in paragraph F10 of the FFR draft.

Staff analysis

106 Staff observe that Liquid Pacific disagreed with the Board's view, supported by a majority of stakeholders, that market participants would in some circumstances be willing to incur more than the cheapest legally permitted amount to acquire a subject asset – i.e. the Board's view that the cost minimisation objective of market participant buyers takes into account legal and other constraints on the actions of market participant buyers.

107 In this context, the political or regulatory environment is part of the market environment because (like laws) it can, for example, constrain the markets in which an asset might be acquired by market participant buyers. This is different from, for example, a hypothetical case of a politically motivated decision to disregard particular valuation inputs (e.g. restrictions that would transfer to market participant buyers) because the resulting measurement would otherwise be 'too low'.

108 Staff consider there is nothing in paragraph F10 of the FFR draft that contradicts (explicitly or implicitly) the Board's conclusion that market participants would in some circumstances be willing to incur more than the cheapest legally permitted amount to acquire a subject asset.

109 In addition, staff consider that the Board's analysis in Example 3 reflects the proposed implementation guidance in paragraphs F5–F7 of the FFR draft that, consistently with paragraph 89 of AASB 13, requires that, in the absence of observable market inputs, the entity uses its own assumptions unless reasonably available information indicates other market participants would use different data. Accordingly, staff disagree with the concerns of Liquid Pacific noted in paragraph 105 and thus recommend no action.

Question for Board members

Q13: Do Board members agree with the staff view that no action is needed in respect of Stakeholder Comment 14? If not, which actions do you suggest?

Stakeholder comment 15: Reference to no other market participants in Illustrative Example 3

110 ACAG commented that:

> "As noted by one jurisdiction in 'Market participant assumptions' (section of the submission letter), this illustrative example does not appear to support the intended relief in paragraphs F5, F6 and F11(b) for an entity to use its own costs. In this example, there are no other market participants, and it is only the department (controlled by the State Government) that would construct the railway tracks in that jurisdiction. Consequently, the decision to construct overseas or local, is not observable. This jurisdiction believes the example should be reworded to focus on the absence of other

market participants, the lack of observable inputs, and the need for the entity to use its own assumptions."

Staff analysis

111 Staff disagree with that jurisdiction's views. The comments do not identify any fatal flaws in the example, and no other stakeholder expressed similar concerns about the example. As noted in paragraph 50, proposed paragraphs F5 and F6 of the FFR draft would require an entity to consider (without undertaking exhaustive efforts) whether reasonably available information indicates that other market participants would use different data from the entity's own assumptions. If the need to consider that aspect is not mentioned in the example, there is a risk that the example might become a template for simply assuming that the entity's own assumptions should be used without considering the possibility they might need to be adjusted.

112 In addition, staff disagree with the comment that there are no other market participants. That assumption, even if made for illustrative purposes, would not acknowledge the proposed additional paragraph F3 that would state that the assumptions of market participants for the subject asset include the assumptions of other not-for-profit public sector entities hypothetically acquiring the subject asset. Therefore, staff recommend no action.

Question for Board members

Q14: Do Board members agree with the staff view that no action is needed in respect of Stakeholder Comment 15? If not, which actions do you suggest?

Stakeholder Comment 16: Consistency of guidance on piecemeal replacement

113 The ACAG submission stated that: "One jurisdiction notes that paragraph BC153 appears to contradict the requirements of paragraph F12(b). The typical scenario for a road replacement is for detours to occur at night rather than during the day or for one lane to be kept open so that the road can continue to be used. Paragraph F12(b) appears to concern part replacement and covering these extra brownfield costs (e.g., high road traffic control). However, paragraph BC153 indicates that the road is unavailable for months/years when it is initially constructed (which is akin to a greenfield cost environment – low traffic control as road is closed long-term). This jurisdiction believes that fair value information is useful if it aligns with capital expenditure budgets (i.e., with their expected actual future costs in stages rather than the cost of a full replacement approach that will never actually occur). Paragraph BC154 also underestimates the difficulty to implement paragraph BC153 as there is either no or very little data available (internal or external) for unplanned projects that have no or little historical precedent. This jurisdiction believes that the drafting could be interpreted as requiring, in the longer term, public sector entities to incur additional unnecessary costs to develop costs for such situations that are not planned."

Staff analysis

114 Regarding the concerns raised by that ACAG jurisdiction, staff consider that:

(a) where paragraph F12(b) refers to "other disruption costs … eg costs of redirecting traffic when replacement of the asset, such as a drainage pipe, disrupts the operation of a road", it is not referring to piecemeal replacement of an asset. Some types of disruption costs that would necessarily be incurred upon piecemeal replacement of an asset would also necessarily be incurred when replacing an asset in its entirety, because in either case the replacement activity interferes with the operation of other assets;

(b) because the hypothetical replacement transaction underpinning the current replacement cost estimate under the cost approach is assumed to occur at the measurement date, the amount of such disruption costs will be based on the disruption that the subject asset's replacement would create in that asset's environment at that measurement date. Over time, the amount of such disruption costs can change as the subject asset's environment changes. To reflect that potential for change, and because the terms 'greenfield' and 'brownfield' are interpreted differently by various stakeholders, the proposed Standard does not use those terms. Therefore, there is no conflict between paragraph F12(b) and its explanation in paragraph BC153; and

(c) there is no reference in paragraph BC153 to a road being unavailable for months/years when it is initially constructed.

115 In respect of that jurisdiction's view that fair value information is useful if it aligns with capital expenditure budgets based on actual replacement in stages rather than full replacement that will never actually occur, staff observed that:

(a) this view appears to reject the fundamental feature of fair value that it is based on an assumed hypothetical transaction for the subject asset, and not a part of the asset, at the measurement date, as noted in paragraph BC117 of the FFR draft;

(b) this view was rejected by the Board (as noted in in paragraphs BC125 and BC126 of the FRR draft); and

(c) applying the practical expedient in paragraph F14 of the FFR draft (that exhaustive efforts are not needed to obtain information about the costs to include in an asset's current replacement cost) should overcome the practical difficulty of estimating the cost to hypothetically replace an asset in its entirety compared with measurement based on piecemeal replacement. Paragraph BC154 of the FFR draft states that: "Where it is unclear whether some 'piecemeal costs' would differ if incurred as part of an entire replacement, when paragraph F5 applies, applying its principle to use the entity's own assumptions as a starting point and adjust them only to the extent that reasonably available information indicates that other market participants would use different data would generally mean that the entity's own costs would be used."

116 Therefore, staff disagree with the ACAG jurisdiction's comment that paragraph BC153 appears to contradict the requirements of paragraph F12(b), and consider there is no fatal flaw identified that requires amendment of either paragraph F12(b) or paragraphs BC153 and BC154. Staff recommend no action.

Question for Board members

Q15: Do Board members agree with the staff view that no action is needed in respect of Stakeholder Comment 16? If not, which actions do you suggest?

Stakeholder Comment 17: Rationale for Board's conclusion on calibration of costs

117 ACAG stated that one of its jurisdictions does not agree with the inclusion of paragraph BC150 of the FFR draft to justify not applying calibration to a 'day 2' valuation. In this regard, 'calibration' means the estimate of an asset's current replacement cost that includes unobservable inputs is calibrated to reflect actual transaction prices rather than hypothetical costs, under an interpretation of paragraph 64 of AASB 13. Paragraph BC150 stated that:

> "If AASB 13 paragraph 64 were to be applied to the situation described in paragraph BC148 – measuring those assets at their actual transaction price, which would be lower than its current replacement cost that includes unavoidable hypothetical costs as explained in paragraph BC116 – it would appear to nullify the aim of AASB 116 paragraph Aus15.1. That paragraph requires not-for-profit entities to initially measure the cost of an item of property, plant and equipment at fair value in accordance with AASB 13 where the consideration for the asset is significantly less than fair value principally to

enable the entity to further its objectives. The transaction price would apparently be the amount of consideration paid for the asset; by applying AASB 13 paragraph 64, fair value at initial recognition would equal the cost of acquisition (rendering AASB 116 paragraph Aus15.1 redundant)."

118 ACAG also stated that:

> "Two jurisdictions do not believe that the AASB's argument about paragraph Aus15.1 of AASB 116 *Property, Plant and Equipment* is relevant to the discussion on calibration. The aim of paragraph Aus15.1 of AASB 116 is to address situations where an entity receives an asset for free (e.g., via a gift or grant) or at a heavily discounted price, so the transaction price is definitely not fair value and therefore calibration is not relevant."
>
> " Hypothetically, if the AASB believed that calibration was appropriate, then it could include an Australian modification to correspond with the Australian modification in paragraph Aus15.1 of AASB 116."

Staff analysis

119 Staff interpret the comments of the two ACAG jurisdictions referred to in paragraph 118 as implying they would apply a threshold beyond which the 'donation/assistance' element of an acquisition is so significant that calibration is inappropriate – and therefore they consider the argument against calibration in paragraph BC150 of the FFR draft is irrelevant.

120 Because a significance threshold for calibration where a valuation technique uses unobservable inputs is not stipulated in AASB 13, staff are not aware of how the use of calibration of current replacement cost estimates to actual costs incurred might be constrained to prevent undermining paragraph Aus15.1 of AASB 116.

121 Despite that, because the reason in paragraph BC150 is not essential to support the Board's conclusion not to specify the use of calibration, and because the two jurisdictions' disagreement with paragraph BC150 seems to involve matters of degree, staff recommend:

(a) omitting paragraph BC150 from the Basis for Conclusions; but

(b) retaining the Board's conclusion on the inappropriateness of using calibration to remove the distinction between current replacement cost and acquisition cost. In this regard, staff consider that new reasons in favour of using calibration were not raised in the ACAG submission.

Question for Board members

Q16: Do Board members agree with the staff recommendation to omit paragraph BC150 from the Basis for Conclusions while retaining the Board's conclusion that it is inappropriate to use calibration to remove the distinction between current replacement cost and acquisition cost?

Section 6: Economic obsolescence

122 Paragraphs F16–F19 of the FFR draft provide the following guidance on economic obsolescence:

> ### Economic obsolescence
>
> F16 When a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows has suffered a reduction in demand for its services, the identification of 'economic (ie external) obsolescence' (referred to in paragraph B9) does not require a formal decision to have been made to reduce the physical capacity of that asset.

F17	When an asset described in paragraph F16 apparently has surplus capacity in view of current demand for its services, economic obsolescence is not identified for that asset if that 'surplus capacity' is necessary for stand-by or safety purposes (eg to deal with contingencies), even if it seldom or never is actively utilised. An example of an asset with stand-by capacity that is necessary for operational purposes, and would be replaced in full by a market participant buyer, is an electricity generation plant that maintains a generating capacity buffer that is typical of the industry to cater for periods of peak demand.
F18	An example of a strong indicator that economic obsolescence of assets would be identified when applying the principles in paragraphs F16 and F17 is a public school's buildings that have a capacity for 500 students but, due to demographic changes, a school for 100 students would meet current and reasonably foreseeable requirements, including a buffer needed for any temporary or underestimated student demand. In this example, based on these assumed facts alone (for simplicity), the school buildings' gross replacement cost would be based on the school's needed capacity (for 100 students), from which any other accumulated obsolescence related to the condition of the school buildings (eg physical obsolescence) would be deducted. Consistent with paragraph F16, the conclusion reached would not depend on whether a formal decision has been made to reduce the school buildings' capacity.
F19	Where an asset or a facility that is not held primarily for its ability to generate net cash inflows suffers a significant reduction in demand for its services, any economic obsolescence identified would not necessarily (and frequently would not) exhibit a linear relationship with that reduced level of demand. This is because some parts of an asset or a facility might need to be replaced in full, or almost in full, despite a significant fall in demand for the services provided by the asset or facility (eg in the school example, the administration office, cafeteria, toilet blocks, library and gymnasium might need replacing even for 100 students, although perhaps on a slightly smaller scale).

Stakeholder Comment 18: Elaborate paragraph F19 regarding the adjustment for economic obsolescence

123 ACAG commented that the final sentence of paragraph F19 should be amended "… to emphasise that construction costs are not linear relative to size and may vary due to economies of scale. For example, the construction costs for administration offices would be smaller than those needed for a 500 student school but would not be 20% of that of a 500 student school (a proportionate reduction from 500 to 100 students). ACAG also suggests changing 'cafeteria' to 'canteen' as this is the common term used in Australia."

Staff recommendation

124 Staff considered ACAG's comments and recommend amending paragraph F19 as follows:

F19	Where an asset or a facility that is not held primarily for its ability to generate net cash inflows suffers a significant reduction in demand for its services, any economic obsolescence identified would not necessarily (and frequently would not) exhibit a linear relationship with that reduced level of demand. This is due to economies of scale causing ~~because~~ some parts of an asset or a facility ~~might need to be replaced~~ potentially needing replacement in full, or almost in full, despite a significant fall in demand for the services provided by the asset or facility, in which cases the needed physical capacity of the asset or facility would not reduce linearly with the reduction in the level of demand for that asset's or facility's services. In ~~(eg in~~ the school example in paragraph F18, the administration office, ~~cafeteria~~ canteen, toilet blocks, library and gymnasium might need replacing even for 100 students, although perhaps on a slightly smaller scale~~)~~.

Question for Board members
Q17: Do Board members agree with the staff proposed changes to paragraph F19?

Stakeholder Comment 19: Perceived contradiction between paragraph F18 and Example 5

125 Liquid Pacific expressed concerns that:

(a) paragraph F18 and Illustrative Example 5 incorrectly assume a hierarchy of obsolescence exists; and

(b) the school example in paragraph F18 and Illustrative Example 5 appear to be inconsistent because:

(i) the school example in paragraph F18 appears to state that economic obsolescence is deducted from an asset's gross replacement cost before deducting all other obsolescence; whereas

(ii) Illustrative Example 5 appears to state that economic obsolescence is deducted from an asset's gross replacement cost after deducting all other obsolescence.

126 Liquid Pacific stated that, although these different apparent hierarchies of measuring economic and other obsolescence do not affect the fair value measurement of the asset, they result in different measurements of the monetary impact of each form of obsolescence, which may result in misleading interpretations of the reasons for obsolescence and the performance/riskiness of the subject asset.

Staff analysis

127 Staff note that, in the school example in paragraph F18, the gross replacement cost is indicated to be based on the needed capacity of the school at as the date of the fair value measurement, rather than the capacity of the school when it was constructed. Thus, economic obsolescence would be reflected in the gross replacement cost of the asset. This guidance responded to concerns that entities would need to perform two calculations of the school's gross replacement cost (based on the constructed and needed capacity), which would not be a simple arithmetic calculation (because the cost of the two capacities typically would not reflect a linear relationship). That guidance was supported by a majority of respondents to ED 320. Therefore, staff consider that paragraph F18 of the FFR draft should not be amended.

128 In the fact pattern of the kitchen example in Illustrative Example 5, "all forms of obsolescence other than economic obsolescence" are assumed to be reflected in the current cost measurement being tested for potential economic obsolescence. This is merely meant to indicate potential economic obsolescence has not been included in the measurement of obsolescence, rather than indicating economic obsolescence should be ranked below other forms of obsolescence. Therefore, staff consider that Example 5 of the FFR draft and the Basis for Conclusions should remain unchanged.

Question for Board members

Q18: Do Board members agree with the staff view that no action is needed in respect of Stakeholder Comment 19? If not, which actions do you suggest?

Stakeholder Comment 20: Elaborating the fact pattern in Illustrative Example 5

129 ACAG provided comments on Illustrative Example 5 that "As currently drafted, it appears that every situation where the physical asset is not being used to its full capacity (something very common in the public sector, and particularly for schools such as woodwork and metalwork classrooms) requires an assessment to rebut possible economic obsolescence. Economic obsolescence (per the International Valuation Standard 105) is any loss of utility caused by economic or locational factors external to the asset, none of which have occurred in the example".

130 ACAG suggested that Illustrative Example 5 could be amended to emphasise that:

(a) running of classes below the physical capacity of the kitchen was part of the original design;

(b) classes are still scheduled as intended;

(c) amount of equipment aligns with the intended number of students per class; and

(d) kitchen would be replaced by one with the same physical capacity.

Staff recommendation

131 Staff agree with ACAG's suggestions and recommend amending the fact pattern of Illustrative Example 5 as follows (the current replacement cost assessment has not been amended, but is retained for the Board's reference):

Example 5 – Kitchen with underutilised potential

A not-for-profit public sector institute (College A) measures the furniture and fittings in its college building at fair value using the cost approach. Its furniture and fittings include a kitchen of commercial standard necessary for training student chefs. ~~The current cost to replace the teaching kitchen with an identical capacity kitchen, less all forms of obsolescence other than any economic obsolescence, is estimated as at the measurement date (30 June 20X3) as $250,000. Based on College A's schedule of classes, the kitchen is used four hours per week.~~ The kitchen is an essential asset for College A to fulfil its teaching objectives, although it was planned not to be ~~is not~~ utilised outside the scheduled class times.

In this example, it is assumed that:

- the kitchen is scheduled to be used four hours per week;
- the amount of kitchen equipment aligns with the intended number of students per class;
- the current cost to replace the teaching kitchen with an identical capacity kitchen, less all forms of obsolescence other than any economic obsolescence, is estimated as at the measurement date (30 June 20X3) as $250,000; and
- if the kitchen requires replacing, College A would replace it with one that has the same physical capacity.

Current replacement cost assessment as at 30 June 20X3

College A assesses whether any economic obsolescence of its teaching kitchen has arisen as at the measurement date (30 June 20X3).

Although the teaching kitchen is operated with less intensity than physically possible, this does not indicate economic obsolescence has arisen. This is because the teaching kitchen is necessary for College A to fulfil its teaching objectives and is achieving the level of output planned. Another college 'stepping into the shoes' of College A would be willing to pay $250,000 to replace the kitchen's service capacity.

Therefore, no economic obsolescence is deducted from the amount of $250,000, which is the kitchen's current replacement cost as at 30 June 20X3.

Question for Board members

Q19: Do Board members agree with the staff proposed changes to the fact pattern in Illustrative Example 5?