Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Depreciated Replacement Cost**	**Meeting**	AASB February 2016 (M150)
Topic:	Stakeholder input on ED 269 on recoverable amount of non-cash generating specialised assets of NFPs	**Agenda Item:**	10.0
Contact(s):	Ahmad Hamidi ahamidi@aasb.gov.au (03) 9617 7643	**Date:**	9 February 2016
		Project Priority:	High
		Decision-Making:	High
		Project Status:	Redeliberation

Introduction and objective of this paper

1 The objective of this paper is to provide a summary of feedback received on ED 269 *Recoverable Amount of Non-cash-generating Specialised Assets of Not-for-profit Entities* and to seek decisions on preparing an amending Standard and Basis for Conclusions in regard to the ED 269 proposals.

2 The rest of this paper is structured as follows:

(a) Summary of staff recommendations (paragraph 3)

(b) Background (paragraphs 4 – 6)

(c) Due Process / Outreach Activity (paragraphs 7 – 9)

(d) Summary of Comments Received (paragraphs 10 – 44)

(e) Appendices:

Appendix 1 – IPSASB ED 57 - Proposals and Implications

Appendix 2 – Comment letters and outreach

Appendix 3 – Draft Basis for Conclusions

Link to project summary

http://www.aasb.gov.au/admin/file/content102/c3/Depreciated_Replacement_Cost_for_Not-for-Profit_Public_Sector_Entities_Project_Summary.pdf

Links to Comment letters (see Appendix 2)

Summary of staff recommendations

3 Staff recommend that the proposals in ED 269 to remove references to depreciated replacement cost (DRC) as a measure of value in use for not-for-profit entities (NFPs) be implemented with the following amendments:

(a) The amending standard should clarify that paragraph 5.1 only applies to specialised assets of NFPs and not specialised assets of for-profit entities (see paragraph 17).

(b) The Basis for Conclusions should clarify that:

(i) current replacement cost (CRC) under AASB 13 *Fair Value Measurement* is the CRC of the asset's remaining service capacity. Some commentators noted that CRC in AASB 13 might imply the current replacement cost of a new asset. A contributing factor to this view might be that the definition of DRC[1] in AASB 136 *Impairment of Assets* included the CRC reflecting a gross value. Staff also recommend that the perceived ambiguity[2] surrounding the meaning of CRC under AASB 13 be clarified in a staff article or an AASB Essay, preferably jointly authored with a member of the valuation industry (see paragraph 22).

(ii) NFP entities that revalue their specialised assets held for continuing use of their service capacity regularly would no longer need to test those assets for impairment (see paragraph 25), and

(iii) costs incurred to change the use of an asset from its existing use to its highest and best use should not be classified as disposal costs. They are costs incurred to change the target asset to a marketable asset; for example, rezoning costs. (see paragraph 30).

Next steps

Staff intend to implement necessary amendments arising from Board decisions at this meeting and prepare the draft Amending Standard for approval out of session.

Background

4 ED 269 proposes to:

(a) remove references to depreciated replacement cost (DRC) as a measure of value in use for not-for-profit entities (NFPs); and

(b) clarify that the recoverable amount of primarily non-cash generating assets of NFPs, which are typically specialised in nature and held for continuing use of their service capacity, should be measured at fair value determined under AASB 13.

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1 AASB 136 defines DRC as: "the current replacement cost of an asset less, where applicable, accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset".

2 A number of commentators noted that some continue to see CRC in terms of the depreciation-based valuation as might be implied by the DRC definition under AASB 136 and have not realised that the CRC under AASB 13 is not defined in these terms. These commentators generally agreed that this is an educational issue and would not need issuance of any specific guidance.

5 In deciding to issue ED 269, the Board noted that:

(a) with the publication of AASB 13, CRC plays a similar role to DRC for assets that are specialised in nature and are rarely sold, such as many assets held by public sector entities;

(b) some constituents have commented that considering the role of DRC as a measure of fair value under the superseded AASB 116 *Property, Plant and Equipment*,[3] its role as a measure of value in use of primarily non-cash-generating assets of NFPs under AASB 136 might be a source of confusion;

(c) targeted outreach indicated that NFPs and valuers typically do not differentiate between DRC as a measure of value in use under AASB 136 and CRC as a measure of fair value under AASB 13; and

(d) a number of constituents expressed the view that applying either measure to specialised assets would result in values that are materially the same.

6 IPSASB issued ED 57 *Impairment of Revalued Assets* in October 2015 proposing to amend its existing impairment standards IPSAS 21, *Impairment of Non-Cash-Generating Assets*, and IPSAS 26, *Impairment of Cash-Generating Assets* such that revalued assets are subject to an impairment test. Appendix 1 considers whether the ED 57 proposals have any implications for the Australian reporting environment.

Due Process / Outreach Activity

7 The ED 269 comment period closed on 16 November 2015. The AASB received seven comment letters.

8 Staff also conducted other outreach during the comment period in the form of face-to-face meetings and telephone meetings with key stakeholders.

9 A listing of ED 269 respondents and stakeholders consulted in other outreach is provided in Appendix 2 to this paper.

Summary of Comments Received – Specific Matters for Comment

<u>Removing references to DRC from AASB 136</u>

10 Comments received in staff outreach activities and most of the comment letters received were generally supportive of removing DRC as a measure of value in use from AASB 136. Many of them commented that this would help to reduce any confusion in relation to this term and how it compares to CRC under AASB 13.

11 One comment letter[4], while agreeing that applying either DRC under AASB 136 or CRC under AASB 13 would result in values that are materially the same, noted there may be circumstances where material differences could arise between the two methods on the basis that DRC uses entity-specific assumptions and the emphasis in AASB 13 is on using market-based assumptions.

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3 AASB 116 was revised to remove references to DRC when AASB 13 was made.

4 CPA Australia

12 Another comment letter[5], while agreeing with the proposal to remove references to DRC from AASB 136, noted that caution should be exercised in order to avoid a situation where entities in both NFP and for-profit sectors could effectively argue a case to avoid impairment of specialised assets.

13 Two commentators disagreed with the proposal to remove references to DRC from AASB 136. One commentator[6] noted the reason for disagreement was because the removal of this reference will effectively mean that there is no impairment test for NFP clients in the public sector with infrastructure assets measured at fair value. The other commentator[7] noted feedback received indicated that there may be circumstances where material differences could arise between valuations under CRC and DRC, particularly as the DRC method uses entity specific assumptions whilst AASB 13 requires market based assumptions.

<u>Sufficiency of clarification in proposed paragraph Aus5.1[8]</u>

14 Most comment letters agreed that proposed paragraph Aus5.1 clarifies the role of AASB 13 in determining the recoverable amount of primarily non-cash-generating specialised assets. They agreed that, under a continued use assumption, 'costs of disposal' are typically negligible and can therefore be ignored when determining 'fair value less costs of disposal' for recoverable amount calculations.

15 One comment letter[9] expressed the view that it is not sufficiently clear that paragraph Aus5.1 will apply only to NFP entities as it does not explicitly preclude application by for-profit entities. This lack of clarity may result in this paragraph being inappropriately applied by for-profit entities to their specialised assets, which they might maintain are held primarily for their service capacity and not the generation of cash inflows.

16 One commentator[10] who disagreed with removing references to DRC from AASB 136 commented that the proposed paragraph Aus5.1 only provides clarification to NFPs that carry their non-cash-generating specialised assets at cost but does not provide enough guidance to NFPs that fair value their non-cash-generating specialised assets.

17 **Staff are of the view** that paragraph Aus5.1 should be more clearly directed at specialised assets of NFPs. **Staff recommend** the following paragraph Aus5.2 be included in the Amending Standard after the proposed Aus5.1:

> Aus5.2 Paragraph Aus5.1 applies only to specialised assets of not-for-profit entities held for their service capacity. It does not apply to assets of for-profit entities whether or not held for their service capacity.

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5 ACAG

6 William Buck

7 CPA Australia

8 Paragraph Aus5.1 comments that many non-cash generating assets of not-for-profit entities are typically specialised assets held for continuing use of their service capacity and, given that these assets are rarely sold, their costs of disposal are typically negligible. Accordingly, the recoverable amount of such assets is expected to be materially the same as fair value, determined under AASB 13 *Fair Value Measurement*.

9 ACAG

10 William Buck

Question for the Bard: Does the Board agree to staff recommendation in paragraph 17 above?

CRC versus DRC

18 Valuation industry participants in staff outreach generally were of the view that the current valuers' practice of determining DRC as a measure of fair value is consistent with description of CRC in AASB 13 in that various types of obsolescence are deducted from the replacement cost or reproduction cost of a new equivalent asset and that the issue of overcapacity is taken care of to arrive at an optimised value.

19 One participant in staff outreach noted that DRC as a measure of value in use is based on entity-specific assumptions and is different from CRC as a measure of fair value under AASB 13. This commentator cited as an example a residential house used by a local hospital for patients to stay, for example, coming from out of town, or recuperating without having to use a hospital bed. In this situation the house had been modified, for example for disabled access and hand rails etc. A "usual" residential property purchaser would not pay for the extra fit-outs. However, another hospital would pay for the fit-outs to use the house in a similar way to the current hospital. The participant noted that in this example, the market participant was considered to be a similar hospital and the fit-outs would be included in the replacement cost.

Staff note that this example is consistent with fair value guidance in AASB 13 in that in valuing the asset in its existing use, the buyer would be standing in the shoes of the seller[11].

20 One comment letter [12]expressed the view that the 'pragmatic fix' proposed in ED 269 does not fully address the valuation issues that gave rise to the project. The commentator considers that the proposal's assumption that 'entry price' DRC valuations converge with 'exit price' CRC valuations holds true only for certain circumstances. The commentator considers that this convergence fails immediately as depreciation in DRC is not materially similar to obsolescence, according to paragraph B9 of AASB 13. This commentator also expresses the view that, the respective fair value measurement standards lack a precise definition of CRC when compared to the definition of DRC in AASB 136.The commentator is of the view that utilising the less well defined 'exit price' valuation methodology as a proxy for 'value in use' will result in preparers remaining wholly reliant on valuers for valuations, despite valuations not being required annually by paragraph 34 of AASB 116 *Property, Plant and Equipment.*

Confusion about CRC

21 Some valuation industry participants in staff outreach were of the view that, while they understand CRC under AASB 13 refers to current replacement cost of the asset being valued and not the gross replacement cost of a new asset, some others might be confused. These commentators noted some continue to see CRC in terms of the

11 Paragraph BC78 of the IASB's Basis for Conclusions on IFRS 13 states that, in relation to a specialised non-financial asset, "In effect, the market participant buyer steps into the shoes of the entity that holds that specialised asset".

12 A member of HoTARAC

depreciation-based valuation as might be implied by the DRC definition under AASB 136 and have not realised that the CRC under AASB 13 is not defined in these terms. These commentators generally agreed that this is an educational issue and would not need to be addressed through specific guidance.

22 **Staff recommend** that:

(a) the Basis for Conclusions to the Amending Standard clarify that the CRC under AASB 13 is the CRC of the remaining service capacity of the target asset. Paragraph BC21 in Appendix 3 to this paper provides tentative wording for this clarification; and

(b) as an educational tool, a staff article or AASB Essay, preferably jointly authored with a member of the valuation industry, would help clarify some of the confusion that might exist in relation to the meaning of CRC under AASB 13.

Question for the Board
Does the Board agree to staff recommendations in paragraph 22 above?

Impairment of revalued assets

23 Some participants in staff outreach commented that ED 269 is not clear as to whether it is exempting revalued assets from impairment or whether the NFP entity would still need to test for impairment if there were a trigger, although it would find there is no impairment as implied in paragraph BC17 of ED 269.

24 One comment letter [13]noted the ED only provides clarification to NFPs that carry their non- cash-generating specialised assets at cost. It does not provide enough guidance to NFPs that fair value their non-cash-generating specialised assets (such as roads and bridges) and as such, it does not allow for an impairment test under AASB 136 to be performed since the carrying amount (being fair value) will always equal the recoverable amount (also equalling fair value since costs of disposal are negligible). The commentator recommends that the AASB provide additional guidance to help NFPs that fair value their specialised assets determine an appropriate recoverable amount to enable an impairment test to be performed.

25 Staff note that ED 269, paragraph BC17, explains that NFP entities that revalue their primarily non-cash-generating specialised assets to fair value regularly would find the application of the impairment model under AASB 136 redundant. **<u>Staff recommend</u>** that the Basis for Conclusions to the Amending Standard clarify that NFP entities no longer need to test such assets for impairment. Paragraph BC25 in Appendix 3 to this paper provides tentative wording for this clarification.

Question for the Board:
Does the Board agree to staff recommendation in paragraph 25 above?

13 William Buck

Disposal costs associated with specialised assets

26 Some participants in staff outreach noted the costs of disposal might not be negligible in some cases where non-cash generating specialised assets are involved. Some noted, by way of example, that significant costs might need to be incurred to make public sector assets ready for sale[14]. Others had in mind a range of costs that they considered potentially material that could be associated with getting an asset to the stage where it could be sold separately. For example, those costs might include costs of rezoning land.

27 Some participants in staff outreach, however, did not think costs such as rezoning costs should be included in costs of disposal. They noted rezoning costs would change the nature of the relevant asset and a rezoned asset is a different asset that would be valued at its highest and best use in its rezoned state, while the target asset prior to rezoning would be valued in its existing use. The views of these commentators is consistent with the public sector valuation practice in some states where the valuer discounts the land's market value for the restrictions relating to any community service obligation (CSO) associated with the land. In these cases, the asset that is held is land with an associated CSO. If Government were to put the land in its current public sector zoning on the market, it would sell for less as buyers would subtract the estimated cost of rezoning the land and an amount reflecting the risks involved in buying an asset that is not yet rezoned for the entity's intended use. Governments generally prefer to incur the cost of rezoning themselves as the relevant assets can be more widely marketed for sale with a rezoned status. Therefore it can be argued rezoning costs are not in the nature of disposal costs for the asset in its existing state.

28 One participant in staff outreach noted that costs of disposal as defined in AASB 136 only encompasses 'normal' costs to sell the asset[15]. Thus costs associated with the sale process specific to an entity such as costs of tender and inviting expressions of interest are not seen as 'normal' costs to sell.

29 Most comment letters agreed that the disposal cost of non-cash generating specialised assets that are held for continued use are typically negligible. Some, however, included the following comments:

(a) where a specialised asset is sold (either separately or as part of a cash generating unit (CGU)), the costs of disposal may be significant due to the difficulty of their disposal, the lack of market participants, significant barriers to entry of potential market participants, the need to observe due process and probity in their sale, and the need to resolve issues with the associated workforce, customers and other stakeholders. For example: (i) disposal of electricity assets in several jurisdictions has been subject to multiple expressions of interest / calls for tender at great cost, and (ii) demolition and decommissioning of certain assets where contamination is a factor can be extremely costly to remove prior to disposal or

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14 AASB 136, paragraph 6 defines costs of disposal as incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense. AASB 136, paragraph 28, notes examples of costs of disposal as legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

15 AASB 136, paragraph 28, notes examples of costs of disposal as legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

reuse. The inclusion of an incorrect assumption regarding costs of disposal may see many NFP entities (and for-profit entities which carry specialised assets measured at CRC) ignore costs of disposal, even where they are significant[16].

(b) The term "negligible" is not defined and is therefore open to different interpretations. This may present challenges from an audit perspective as NFP entities are likely to conclude the costs of disposal are indeed "negligible" to avoid having to calculate impairment. If the term "negligible" proceeds to inclusion in the standard, it is recommended the AASB consider defining the term and include requirements for entities to disclose in the financial statements why selling costs are considered "negligible"[17].

(c) We question whether disposal cost is typically negligible as it could be possible that disposal cost is higher when selling specialised assets compared to actively traded assets[18].

30 **Staff are of the view** that costs incurred to change the use of an asset from its existing use to its highest and best use should not be classified as disposal cost. **Staff recommend** that the Basis for Conclusions to the Amending Standard clarify that a cost to change the target asset to a marketable asset (such as rezoning costs) are not disposal costs for the asset held in its existing use. Paragraph BC22 in Appendix 3 provides tentative wording for this clarification.

Question for the Board: Does the Board agree to staff recommendation in paragraph 30 above?

31 One comment letter notes[19] that the term 'specialised assets' requires a definition. The commentator considers that a defining feature of specialised assets is that they are rarely traded and there are few, if any, market participants, which does not sit comfortably with the fair value definition in AASB 13. **<u>Staff do not recommend</u>** that the term 'specialised assets' be defined, as the term 'specialised' has been used in AASB 13 and any attempt to define it might be seen as interpreting that Standard.

Question to the Board Does the Board agree with staff view in paragraph 31 above?

<u>Existence of regulatory or other issues</u>

32 Comment letters generally noted constituents are not aware of any regulatory or other issues affecting the implementation of proposals by NFPs.

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18 KPMG
19 ACAG

Proposals would result in financial statements that would be useful to users

33 Comment letters generally noted that constituents were of the view that the proposals would result in financial statements that would be useful to users.

34 One commentator did not agree that the proposals overall would result in useful financial statements for users citing the issues raised in paragraph 24 above [20].

35 Comment letters generally noted that constituents agreed that the proposals are in the best interests of the Australian economy.

36 One commentator did not believe the proposals were in the best interest of the Australian economy citing the issues raised in paragraph 24 above.[21]

Costs and benefits of the proposals relative to the current requirements

37 Most comment letters expressed a favourable view on the costs and benefits of the proposals as summarised below:

(a) There are no costs arising from the proposed changes. Benefits include removal of unnecessary duplicated information, simplification of reporting requirements and potential cost savings as there is no longer a requirement to value these assets using a different method and efficiencies may be gained when applying AASB 13[22].

(b) We expect the benefits of the proposals to outweigh any related costs. We do not anticipate that the proposals will increase the costs incurred by preparers of financial statements as it will reduce the need for them to consider two separate valuations, CRC and DRC, when measuring their non-cash-generating specialised assets[23].

(c) The proposals are likely to result in long term cost savings for both preparers and auditors. Longer term savings will be achieved as NFP entities that hold primarily non-cash-generating specialised assets will no longer be required to measure their value in use as DRC.[24]

(d) We do not consider that these proposals would result in additional or fewer costs of implementation.[25]

(e) While we do not have an expectation of significant costs and time involved in transitioning to the amendments [to] this standard, we are unable to comment to any estimated amounts[26].

38 One comment letter, however, noted that there may be additional costs involved in determining appropriate recoverable amounts for fair valued specialised assets[27].

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20 William Buck

21 William Buck

22 HoTARAC

23 PwC

24 ACAG

25 BDO

26 KPMG

Other concerns and suggestions

39 One comment letter[28] raised a potential issue with entities with specialised assets that are also subject to rate regulation. The commentator noted that the regulated asset base is a key input to calculating the allowed rate of return and expressed concern that, if a CRC calculation is interpreted as not requiring deduction of impairment, the asset base will be larger than it should be and may result in additional costs to consumers. **Staff note** that this concern seems to arise from the confusion about CRC noted in paragraph 21 above and the clarification of CRC in an article or AASB Essay proposed in paragraph 22 above would help alleviate this concern.

40 Another comment letter [29]proposes that guidance should be provided for NFPs in relation to when the application of AASB 13's cost approach is recommended and when an entity's cost to replace would equal the amount that a market participant would pay to acquire it (AASB 13, paragraph BC141), that is, when entity-specific assumptions effectively become market participant assumptions.

41 One other comment letter[30] recommends that the AASB provide additional guidance to help NFPs that fair value their specialised assets determine an appropriate recoverable amount to enable an impairment test to be performed.

42 One comment letter[31] has noted that the example in paragraph BC14 of ED 269 erroneously assumes the entity is the "most efficient operator in the industry". Due to the significant barriers of entry to the market, generally entities with specialised assets are the only operators (or one of very few similar operators) in the market. The commentator argues that there is no need for a sole operator in a market to deliver service efficiency, and monopoly theory would indicate they do not. Further, the capitalisation of borrowing costs assumed in that example is not common for NFP entities because the GFS/ABS Manual prohibits capitalisation of borrowing costs.

43 One comment letter[32] notes that the concern relates more to the current application of the CRC concept in AASB 13 than to the removal of the DRC concept from the AASB 136. The commentator raises some areas of concern in relation to AASB 13 and notes that, if the ED 269 proposals are implemented without amendment, it is strongly recommended that the AASB expand the guidance in AASB 13 to address the application of the CRC approach for specialised assets[33].

44 **Staff are of the view that** the issues raised in paragraphs 40, 41 and 43 are about fair value guidance in relation to requirements of AASB 13 and do not fall under depreciated replacement cost project. **Staff recommend that** any necessary guidance be provided as part of the fair value project.

Question for the Board:
Does the Board agree with staff recommendation in paragraph 44 above?

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27 William Buck

28 ACAG

29 KPMG

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Appendix 1: IPSASB ED 57 - Proposals and Implications

1.1 IPSAS 21 *Impairment of Non-Cash-Generating Assets* and IPSAS 26 *Impairment of Non-Cash-Generating Assets* scope out assets measured at revalued amounts under the revaluation model in IPSAS 17 *Property, Plant and Equipment*, and IPSAS 31 *Intangible Assets.*

1.2 The International Public Sector Accounting Standards Board (IPSASB) issued Exposure Draft ED 57 *Impairment of Revalued Assets* in October 2015 proposing to amend IPSAS 21 and IPSAS 26 so that assets measured at revalued amounts under IPSAS 17 and IPSAS 31 fall within the scope of those standards.

1.3 ED 57 responds to a concern raised by NZASB[34] that when assets are revalued by class, there is ambiguity when there is impairment of a single asset within the class, for example because of fire, as to what revaluation of all assets within that class requires in practice (see paragraph 36 of AASB 116 *Property, Plant and Equipment*)

1.4 ED 57 argues that a clarification that 'impairment of one asset within the class does not trigger revaluation of the whole class' would not suffice in dealing with the above concern. ED 57, therefore, proposes to resolve this issue by bringing revalued assets within the scope of its impairment standards. It is argued that impairments are distinct from revaluations and should be disclosed separately. A practical issue is that it is unclear what proportion of a change in value of a revalued asset relates to impairment unless an asset is tested for impairment.

1.5 The IPSASB's objective in clarifying the ambiguity was to ensure that impairment losses and reversals of impairment losses of a revalued asset did not, of themselves, trigger the need for an entity to revalue the entire class of assets to which that asset belongs.

1.6 In a paper to the AASB's October 2015 meeting (agenda item 21.1), AASB staff noted that IPSASB ED 57 is moving away from the substance of paragraph Aus5.1 proposed by AASB ED 269. The Board noted Australian constituents had not raised issues regarding impairment of a single asset in a class causing significant revaluation issues. Accordingly, the IPSASB ED 57 proposals are unlikely to be relevant in Australia[35].

1.7 The issue covered in IPSASB ED 57 was raised with HoTARAC at its October 2015 meeting by a Board member. In response to the question as to whether in HoTARAC members' experience, impairment of a single asset within a class of revalued assets has been an issue in Australia, no HoTARAC member indicated a problem with this issue in practice.

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34 NZASB minutes, March 2015.

35 AASB minutes, October 2015.

Appendix 2: Comment letters and outreach

2.1 Comment letters on ED 269 were received from:

(a) Australasian Council of Auditors-General - 16 Nov 2015 - Download PDF - 414K;

(b) BDO Australia Limited - 17 Nov 2015 - Download PDF - 189K;

(c) CPA Australia - 25 Nov 2015 - Download PDF - 80K;

(d) Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) - 13 Nov 2015 - Download PDF - 177K;

(e) KPMG - 20 Nov 2015 - Download PDF - 38K;

(f) PwC - 16 Nov 2015 - Download PDF - 46K; and

(g) William buck - 19 Nov 2015 - Download PDF - 140K.

2.2 Participants in staff targeted outreach included staff of two private sector valuation firms engaged in NFP sector valuations, staff of one state's valuer-general's office, staff of two state audit offices, staff of one large accountancy firm with NFP clients and one independent accounting professional with experience in regard to the NFP sector.

Appendix 3: Basis for Conclusions to the Amending Standard

(The mark ups present changes to the draft Basis for Conclusions included in ED 269.)

[DRAFT] BASIS FOR CONCLUSIONS

This Basis for Conclusions accompanies, but is not part of, AASB 2015-X.

~~Background~~

BC1 This Basis for Conclusions summarises the Australian Accounting Standards Board's considerations in reaching the conclusions in ~~the~~Amending Standard AASB 2015-X. Individual Board members gave greater weight to some factors than to others.

Background

BC2 Under AASB 136 *Impairment of Assets*, an impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount. The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use. AASB 136 also has not-for-profit (NFP) specific requirements, included as Aus paragraphs, to cater for measuring impairment of assets that are not held primarily for their ability to generate net cash inflows.

BC3 AASB 136, paragraph Aus32.1, requires NFP entities to determine the value in use of an asset as its depreciated replacement cost (DRC), when the future economic benefits of the asset are not primarily dependent on the asset's ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits.

BC4 AASB 136, paragraph Aus6.2, defines DRC as "the current replacement cost of an asset less, where applicable, accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset". Paragraph Aus32.2 of AASB 136 explains that "The current replacement cost of an asset is its cost measured by reference to the lowest cost at which the gross future economic benefits of that asset could currently be obtained in the normal course of business".

BC5 The AASB previously concluded that the Aus paragraphs were needed in AASB 136 to help ensure that impairments are not recognised for non-cash-generating assets held by NFP entities when they still embody future economic benefits of a value equal to, or greater than, their carrying amounts. This was based on the view that entities might inappropriately recognise impairments due to the focus of IAS 36, which is incorporated in AASB 136, on cash generating assets. This was because the value in use of non-cash-generating assets based on cash flows would be zero or close to zero and net fair value of the asset could be regarded as relating to a scrap value for a specialised asset.

~~Significant Issues~~ The Need to Issue AASB 2015-X

BC6 Clarifications were sought by some constituents about the interaction between the notion of DRC for determining the value in use of assets held by NFP entities in the circumstances described in paragraph BC3 and the notion of current replacement cost (CRC) as a measure of the fair value of an asset under AASB 13 *Fair Value Measurement*. AASB 13 (paragraphs B8 and B9) identifies the cost approach as a valuation technique for measuring fair value. Under AASB 13, the cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as CRC).

BC7 Some commentators argued that, consistent with the role of CRC as a measure of fair value under AASB 13 (reflecting the assumptions that market participants would use when pricing the asset), DRC should not be an entity-specific measure of recoverable amount under AASB 136. These commentators supported the objective of the existing requirements of AASB 136 of not basing the recoverable amount of non-cash-generating assets held by NFP entities on discounted cash flows. They also noted that when DRC was introduced under the superseded AASB 116 *Property, Plant and Equipment*, there was ambiguity as to whether it was a measure of fair value or a measure of value in use and that with the publication of AASB 13 and its exposition of the cost approach, it became clear that DRC under AASB 116 was a measure of fair value as is CRC under AASB 13. Accordingly, they argued that, for such assets, DRC should be used to determine fair value as a measure of recoverable amount and note that its designation as a measure of value in use under AASB 136 might be a source of confusion.

BC8 Other commentators argue that DRC was identified as a measure of fair value in the superseded AASB 116, paragraph 33, in cases where there was no market-based evidence of fair value because of the specialised nature of the asset and the item was rarely sold, except as part of a continuing business. They noted that, with the publication of AASB 13, the cost approach plays a similar role as a measure of fair value when the market and income approaches to valuation are not applicable due to the specialised nature of the asset.

BC9 ~~The Board considered various fact patterns that illustrate the possible interactions between DRC as a measure of value in use under AASB 136 of assets held by NFP entities and the CRC of the service capacity of an asset under AASB 13.~~ Further comments on interaction between DRC under AASB 136 and CRC under AASB 13 were sought in AASB outreach with key stakeholders, such as preparers and auditors, and valuers of NFP entities' assets, particularly in regard to assets held by public sector entities.~~The Board also considered the results of further staff outreach with key stakeholders, such as preparers and auditors, and valuers of NFP entities' assets, particularly in regard to assets held by public sector entities~~.

~~Constituents' Feedback on Targeted Outreach~~

~~BC9~~BC10 Comments from some preparers in the public sector that participated in the outreach indicated that separate evaluations of CRC as a measure of fair value under AASB 13 and DRC as a measure of value in use under AASB 136 were not usually performed. These commentators noted that, although CRC as a measure of fair value under AASB 13 and DRC as a measure of value in use under AASB 136 ~~are~~ were different in concept, for specialised assets~~,~~ where the market is typically inactive, the highest and best use is generally their current use. Accordingly, in their view the CRC of such assets under AASB 13 and their DRC under AASB 136 are, in practice, interchangeable. Some noted one reason for this outcome might be that highest and best use requires consideration of reasonably possible uses, not every possible use.

~~BC10~~BC11 Some valuers participating in staff outreach noted:

(a) in the case of a NFP entity where the fair value of a specialised asset is based on the cost approach, the entity acts as the 'buyer' and is competing with other market participants in order to acquire the asset. They argue that this means CRC under AASB 13 should not be different from DRC under AASB 136;

(b) CRC under AASB 13 and DRC under AASB 136 are regarded as similar measures of fair value and the existing use or alternative uses are considered and assessed on a case-by-case basis; and

(c) The highest and best use of an asset determines its fair value, but restrictions (such as legal restrictions) on the use of an asset often mean that the highest and best use of an asset is its current use.

~~AASB Decisions~~The AASB's Initial Deliberations

~~BC11~~BC12 The AASB noted that DRC is~~was~~ identified as a measure of fair value in the superseded AASB 116, paragraph 33, in cases where there is~~was~~ no market-based evidence of fair value because of the specialised nature of the asset and the item was rarely sold, except as part of a continuing business. The AASB also noted that, with the publication of AASB 13, CRC plays a similar role for assets that are specialised in nature and are rarely sold, such as many assets held by public sector entities. The AASB further noted that the cost of disposal of such assets is not expected to be material.

~~BC12~~BC13 The AASB noted that CRC as a measure of fair value under AASB 13 is an exit price and, therefore, is conceptually different from DRC as a measure of value in use under AASB 136, being an entry price. The AASB, however, noted that:

(a) the description of the cost approach in AASB 13 indicates that CRC incorporates obsolescence as does the definition of DRC under AASB 136, where accumulated depreciation encompasses obsolescence;

(b) valuers use similar approaches in determining DRC and CRC. Factors such as physical obsolescence, functional obsolescence and external and economic obsolescence are all considered in determining either measure; and

(c) valuers' practice involves considering as a starting point whether the valuation is of a specialised asset in its current use or an alternative use and whether there are any restrictions on the use of the asset.

~~BC13~~BC14 The AASB ~~tentatively~~ concluded that DRC as a measure of value in use of specialised assets that are rarely sold is unlikely to be different from DRC (or CRC) as a measure of fair value of such assets. This is because, for non-cash-generating specialised assets, the market is typically inactive and the current uses of the assets rather than their sale would generally be their highest and best uses, resulting in CRC of such assets being not materially different from their DRC, as the following example shows:

Example:

An entity self-constructs a specialised facility. Because the entity is the most efficient operator in its industry, it can construct the facility for $8.5 million (including borrowing costs), whereas the cost of construction of the facility to any other market participant would be $10 million (including borrowing costs). As the construction of the facility has just been completed, there is no obsolescence or depreciation.

The issues are: (a) whether the CRC of the facility should be measured at $10 million or $8.5m under AASB 13; and (b) whether the DRC of the facility should be measured at $10m or $8.5m under AASB 136.

Analysis

AASB 13, paragraph B9, states that "a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset". The implication of that statement depends on whether the market participant buyer includes, or has the attributes of, the vendor. Paragraph BC78 of the IASB's Basis for Conclusions on IFRS 13 states that, in relation to a specialised non-financial asset, In effect, the market participant buyer *steps into the shoes of the entity* that holds that specialised asset" (emphasis added). Based on that comment, it seems appropriate in the above example to regard the market participant buyer as being capable of self-constructing the asset for $8.5 million, in which case CRC should be measured at $8.5 million under AASB 13. Because value in use is an entity-specific measure, the DRC of the facility would also be measured at $8.5 million under AASB 136.

~~BC14~~BC15 The AASB noted that, when AASB 136's impairment model (as per IAS 36) is applied to non-cash-generating specialised assets that are rarely sold, the value in use of the asset is typically less than its net fair value because the asset is generally held for continuing use of its service capacity, not the generation of cash inflows. Further, because these assets are rarely sold, their cost of disposal is typically negligible. The ~~Board~~ AASB concluded that in such circumstances, the recoverable amount of the asset would be materially the same as fair value determined under AASB 13.

~~BC15~~BC16 The AASB noted that AASB 13 has addressed the concerns noted in paragraph BC5 above that the net fair value of an asset could be regarded as relating to a scrap value for a specialised asset leading to an inappropriate recognition of impairment. Paragraph BC78 of the IASB's Basis for Conclusions on IFRS 13 refers to the concerns that an exit price would be based on the scrap value (particularly given the requirement to maximise the use of observable inputs, such as market prices) and would not reflect the value that an entity expects to generate by using the asset in its operations. It notes that, in such circumstances, the scrap value for an individual asset would be irrelevant because an exit price reflects the sale of the asset to a market participant that has, or can obtain, the complementary assets and the associated liabilities needed to use the specialised asset in its own operations. In effect, the market participant buyer steps into the shoes of the entity that holds that specialised asset.

~~BC16 The AASB noted that the conclusion in paragraph BC16 has implications for assets held both under the revaluation model and under the cost model as outlined below.~~

~~***Revaluation model***~~

~~BC17 NFP entities that revalue their primarily non-cash-generating specialised assets to fair value regularly would find the application of the impairment model under AASB 136 redundant.~~

~~***Cost model***~~

~~NFP entities applying the cost model to their primarily non-cash-generating specialised assets would need to determine their recoverable amounts at fair value to establish whether there is a need to recognise impairment.~~

~~BC18~~BC17 The AASB noted that, with the issuance of AASB 13, the fair value of non-financial assets is determined under that Standard. Accordingly, with the CRC measure being available under AASB 13, the notion of DRC introduced by the superseded AASB 116 would no longer be applicable in estimating the fair value of specialised non-financial assets.

ED 269 Proposals

BC18 The AASB decided to publish ED 269 proposing that:

(a) references to DRC as a measure of value in use in AASB 136 be deleted from that Standard and explaining the rationale for this decision; and

(b) an Aus paragraph be included in AASB 136 to clarify that, because non-cash-generating specialised assets held for continuing use of their service capacity are rarely sold, their cost of disposal is typically negligible and, accordingly, the recoverable amount of such assets is expected to be materially the same as fair value, determined under AASB 13.

BC19 The AASB noted that the proposals set out in paragarph BC18 have implications for assets held both under the revaluation model and under the cost model as outlined below.

Revaluation model

NFP entities that regularly revalue their primarily non-cash-generating specialised assets to fair value would find the application of the impairment model under AASB 136 redundant.

Cost model

If there are indicators of impairment, NFP entities applying the cost model to their primarily non-cash-generating specialised assets would need to determine their recoverable amounts at fair value to establish whether there is a need to recognise impairment.

~~BC19 The AASB decided to publish ED 269 proposing that references to DRC as a measure of value in use in AASB 136 be deleted from that Standard and explaining the rationale for this decision. The AASB also decided an Aus paragraph should clarify that, because non-cash-generating specialised assets held for continuing use of their service capacity are rarely sold, their cost of disposal is typically negligible and, accordingly, the recoverable amount of such assets is expected to be materially the same as fair value, determined under AASB 13.~~

Redeliberation of ED 269 Proposals

BC20 The AASB considered comments on the ED 269 proposals received via submissions and further AASB targeted outreach. The AASB noted that commentators were generally supportive of ED 269 proposals and discussed concerns raised about some aspects of the proposals.

Confusion about CRC

BC21 Some valuation industry participants consulted in AASB outreach were of the view that some continue to see CRC under AASB 13 as the gross replacement cost of a new asset and have not realised that the CRC under AASB 13 is the CRC of the remaining service capacity of the target asset. The AASB observed that:

(a) paragraph B8 of AASB 13 describes CRC as the amount that would be required currently to replace the service capacity of an asset. This is a reference to replacement cost of the service capacity of the target asset and not a new asset; and

(b) paragraph B9 of AASB 13 further clarifies that the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence and that obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence.

The AASB concluded that the description of CRC in AASB 13 is clear and CRC is not a gross value reflecting the replacement cost of a new asset, rather it is replacement cost of the remaining service capacity of the target asset.

Disposal costs associated with specialised assets

BC22 Some participants in AASB outreach noted the costs of disposal might not be negligible in some cases where non-cash generating specialised assets are involved. Some noted, by way of example, that significant costs might need to be incurred to make public sector assets ready for sale[36]. Others had in mind a range of costs that they considered potentially material that could be associated with getting an asset to the stage where it could be sold separately. For example, those costs might include costs of rezoning land.

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36 AASB 136, paragraph 6, defines costs of disposal as incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense. AASB 136, paragraph 28, notes examples of costs of disposal as legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

The AASB concluded that costs incurred to change the use of an asset from its existing use to its highest and best use should not be classified as disposal costs. Such costs (for example, rezoning costs) change the nature of the target asset to a marketable asset rather than being incurred as part of the disposal of the marketable asset.

Impairment of revalued assets

BC23 Some participants in AASB outreach commented that ED 269 is not clear as to whether it is exempting revalued assets from impairment or whether the NFP entity would still need to test for impairment if there were a trigger, although it would find there is no impairment.

BC24 The AASB noted that the removal of DRC from AASB 136 and calculation of recoverable amount as fair value is intended to reduce financial reporting costs to the NFP entities holding specialised assets that are held for their continued service capacity.

BC25 The AASB decided to clarify that when non-cash generating specialised assets of NFP entities are revalued regularly, the entity would no longer need to perform an impairment test in respect of these assets.

~~BC20~~BC26 The AASB decided to proceed with ED 269 proposals subject to conclusions and decisions noted in paragraphs BC21, BC22 and BC25.