



Staff Paper

April 2011, AASB Agenda Paper 3.5 / FRSB Agenda Paper BX.X

Key Issues Arising from IVSC Exposure Draft *Proposed Technical Information Paper 2 (TIP 2) 'Depreciated Replacement Cost'*

Purpose of this Paper

1 This paper notes issues in IVSC ED TIP 2 *Depreciated Replacement Cost* regarding the use of depreciated replacement cost (DRC) to estimate an asset's fair value, with a view to the Board providing staff with directions for developing a Board submission on ED TIP 2. Key issues discussed below relate to:

- (a) the context and authority of the proposed IVSC TIP;
- (b) compatibility with forthcoming IFRS 13 *Fair Value Measurement* regarding the use of DRC to estimate an asset's fair value; and
- (c) the proposed guidance on finance costs in ED TIP 2. A potential concern the AASB and FRSB may wish to raise in their submissions on ED TIP 2 is whether finance costs included in DRC should be those of the entity or those of the typical market participant (see paragraphs 8 – 12 below).

2 It is intended that these issues are discussed at the forthcoming Board meeting. Non-key issues identified by staff are not included in this paper. These non-key issues include the 'Questions to Respondents' on page 3 of ED TIP 2. Staff propose having the non-key issues considered by a Board Subcommittee.

Context and Authority of the Proposed IVSC TIP

3 The context and objective of using DRC as a valuation methodology reflected in ED TIP 2 need clarifying. Question 1 on page 3 of ED TIP 2 says that, unlike the Guidance Note it is replacing, the TIP will not be limited to use of the cost approach for financial reporting purposes. Except for the matter discussed in paragraphs 6 – 7 below, staff are unaware of inconsistencies between ED TIP 2 and how they expect IFRS 13 to be applied when using

the cost approach to estimating fair value. Nevertheless, staff are concerned that the TIP may be intended to provide guidance for purposes inconsistent with measuring fair value as defined in IFRS 13. Therefore, staff think the IVSC should address and assess the consistency of the guidance in the TIP and the guidance on the cost approach to measuring fair value under IFRS 13 once IFRS 13 is issued.

- 4 Staff views are mixed on whether the non-mandatory status of the proposed TIP should be challenged. Some are concerned that reliance may be placed on professional valuations of DRC that do not conform to the guidance in the TIP. Given the widespread use of DRC in measuring the fair value of various items of property, plant and equipment, they argue that best practice guidance on DRC should be part of International Valuation Standards and therefore mandatory for professional valuers. Others argue it is beyond the remit of the Boards to comment on the authority of documents issued by others, and that proposing mandatory status for the TIP would be a *de facto* endorsement of the TIP by the Boards.

Questions for Board members

- Q1** Do you agree with recommending that any incompatibilities between the guidance in the TIP and the guidance on the cost approach to measuring fair value under IFRS 13 should be clearly identified by the IVSC?
- Q2** Do you think the non-mandatory status of the proposed TIP should be challenged in each Board's submission?

Compatibility with Forthcoming IFRS 13

- 5 Staff consider that ED TIP 2 is generally consistent with what they expect to be in IFRS 13 regarding the determination of an asset's DRC. Staff expect IFRS 13 to include guidance that:
- (a) the cost approach reflects the amount that would be required currently to replace the asset's service capacity (its current replacement cost);

- (b) 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. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence; and
 - (c) in many cases, the current replacement cost method is used to measure the fair value of tangible assets used in combination with other assets.
- 6 Some staff think ED TIP 2 contains an inconsistency with IFRSs (specifically, IAS 36 *Impairment of Assets*) that would seem to create a risk that valuations under the proposed TIP would be inconsistent with the outcome of correctly applying IFRSs. The perceived inconsistency is that, in determining the DRC of assets within a group of assets, ED TIP 2 proposes economic obsolescence should normally be allocated to intangible assets before tangible assets (this is set out in the ‘Illustrative examples of economic obsolescence’, in the third paragraph on page 15 of ED TIP 2). In contrast, IAS 36 allocates impairment losses for a cash-generating unit firstly to any goodwill, and then to all other assets on a *pro rata* basis (paragraph 104).
- 7 Staff consider that this principle in IAS 36 is also appropriate for determining fair value under IFRS 13, for the following reasons. The ED TIP 2 proposal seems to be based on an arbitrary assumption that intangible assets suffer economic obsolescence before tangible assets—staff disagree. Sometimes intangible assets can be sold or redeployed more readily than tangible assets, which may be fixed in location. And businesses customarily use tangible and intangible assets to jointly generate net cash inflows, with the result that net cash inflows [whether used to estimate recoverable amount or fair value] can only arbitrarily be assigned to particular assets within cash-generating units (such as identifiable intangible assets).

Questions for Board members

- Q3** Do you agree with recommending in each Board’s submission that, in determining the DRC of assets within a group of assets, economic obsolescence should not normally be allocated to intangible assets before tangible assets?

Q4 Do you consider there are any other incompatibilities between ED TIP 2 and IFRSs that should be raised in each Board's submission on that ED?

Finance Costs

Those of the entity or typical market participants?

- 8 In relation to self-constructed assets, paragraphs 16 – 17 of ED TIP 2 say replacement costs include interest during construction, based on the cost of debt and other factors (e.g., construction period and draw-down schedule) for typical market participants. In addition, paragraph 18 of ED TIP 2 says that, for some assets, an 'entrepreneurial profit margin' would be included, representing the economic benefit required to motivate the asset owner to create the asset.
- 9 In relation to both the amount of interest included in DRC and the inclusion of an entrepreneurial profit margin, ED TIP 2 proposes measuring DRC by reference to circumstances that may differ from the replacement cost that would presently be incurred by the reporting entity if it were to replace the self-constructed asset. The issue is whether, in applying IFRS 13, this is the appropriate way to measure DRC. Staff have mixed views on this issue. Arguments for each view are set out in paragraphs 10 – 12.
- 10 Some staff argue that the position in ED TIP 2 is appropriate because it focuses on the costs and a margin on cost that would sum to the price at which market participants would exchange the asset. Therefore, they argue, the cost of interest used in a DRC estimate of fair value should reflect the cost of interest of typical market participants. Current PBE guidance in NZ IAS 16 *Property, Plant and Equipment* says any borrowing costs included in DRC should be those of a typical market participant (paragraph NZ 33.14).
- 11 Other staff note that DRC represents the market buying price(s) faced by the reporting entity in replacing the service potential embodied in the subject asset. Those market buying prices reflect the circumstances of the reporting entity. They argue that it would be inconsistent to measure the current (replacement) cost of materials, transportation, duties and employee services from the viewpoint of the reporting entity but to measure the current cost of finance from the viewpoint of other market participants. The resulting

measure would be a hybrid that lacks a coherent economic principle. They also argue that the discussion of the ‘cost approach’ expected to be included in IFRS 13 implicitly supports this analysis, because it focuses on the cost to replace the asset’s service capacity or utility, which reflects the circumstances of the reporting entity.

- 12 These other staff referred to in paragraph 11 argue that if the cost approach (DRC) is used under IFRS 13 to measure an asset’s fair value, it has already been decided that DRC represents the asset’s fair value more faithfully than measures obtained using either the market approach or the income approach. In other words, DRC has passed the hurdle that there are no known significant differences between DRC and fair value. Therefore, in those circumstances, there seems little purpose in incurring the cost and effort of obtaining and verifying information about the financing profile of other market participants (in the manner detailed in paragraph 17 of ED TIP 2).

Question for Board members

- Q5** In measuring the interest component of the replacement cost (as a fair value estimate) of self-constructed assets, do you think interest should be based on:
- (a) the cost of debt and other factors for typical market participants? or
 - (b) the cost of debt and other factors for the reporting entity?

Scope of finance costs included

- 13 A related issue is that, under the approach referred to in Question 5(a), the costs and a margin on cost that would sum to the price at which market participants would exchange a self-constructed asset should include all costs of finance, not just interest. This is because a constructor would seek a market rate of return on all costs incurred in constructing the asset, including the cost of non-debt finance tied up in the project. This may be covered by the reference in paragraph 18 of the IVSC ED to an ‘entrepreneurial profit margin’, but this is not clear. If the IVSC retains its proposed approach to measuring DRC, staff think the IVSC should clarify the treatment of non-debt finance costs.

Question for Board members

Q6 Do you agree that, if the IVSC retains its proposed approach to measuring DRC using interest costs of typical market participants, it should clarify the treatment of non-debt finance costs?

Other Possible Key Issues

Question for Board members

Q7 Are there any key issues with ED TIP 2 not identified above? If so, please identify them and how you think ED TIP 2 should be amended.

Review of draft Submission

Question for Board members

Q8 Do all Board members wish to consider out of session the draft submission on ED TIP 2, or should the draft be reviewed by a Subcommittee?