AASB Staff Issues Paper: The Relationship between Current Replacement Cost as a Measure of Fair Value and Depreciated Replacement Cost as a Measure of Value in Use

Introduction

1 Enquiries have been received from three constituents relating to clarifying the relationship between:

(a) current replacement cost (CRC) as a measure of fair value, for any entity, under AASB 13 *Fair Value Measurement*; and

(b) depreciated replacement cost (DRC) as a measure of value in use, for not-for-profit entities (NFPs), of particular assets under AASB 136 *Impairment of Assets*. DRC is used to measure the value in use (as part of recoverable amount) of a NFP's asset when both of the following apply:

(i) the future economic benefits of the asset are not primarily dependent on the asset's ability to generate net cash inflows; and

(ii) the entity would, if deprived of the asset, replace its remaining future economic benefits (see paragraph A3(c) in the appendix to this paper).

None of the requests was a formal issue proposal for an Interpretation.

2 The Board previously noted the issue in paragraph 1 above at its June 2011 meeting, the minutes of which include:

> "In relation to NFPs, the Board confirmed its earlier decision not to include any modifications to IFRS 13 in AASB 13. However, the Board decided to consider clarifying AASB 136 *Impairment of Assets*, to address the fact that AASB 13 treats depreciated replacement cost as a measure of fair value whereas, for NFPs, AASB 136 treats depreciated replacement cost as a measure of value in use. It requested staff to review this difference and provide an analysis at a future AASB meeting in time for the issue to be resolved before IFRS 13 becomes mandatory."

As mentioned in Agenda Paper 16.1 for this Board meeting, staff resource constraints have precluded analysing this issue earlier.

3 The issue in paragraph 1 above arises in relation to Australian Accounting Standards but not IFRSs, because the reference to DRC in AASB 136 is a NFP modification of IAS 36. Therefore, any need for clarification of this issue (e.g. through Board guidance) is a domestic issue.

4 AASB staff think it is potentially unclear whether the references to 'CRC' in AASB 13 and 'DRC' in AASB 136 are meant to be different, in the absence of specific guidance (e.g. there is no explanation in a Basis for Conclusions).

5 This paper is structured as follows:

(a) technical considerations related to this issue are discussed in paragraphs 6 – 35 below; and

(b) possible actions to address this issue are discussed in paragraphs 36 – 51 below.

Technical Considerations Regarding the Relationship between CRC under AASB 13 and DRC as a Measure of Value in Use for NFPs under AASB 136

6 Constituents asked three questions regarding the issue in paragraph 1 above.

Question 1

7 In its letter dated 8 July 2014 (see Agenda Paper 16.5[1]), Sydney Water asks whether the role of DRC (or CRC[2]) as a measure of value in use, for NFPs, of particular assets under AASB 136 precludes for-profit entities from using DRC as a measure of fair value under AASB 13. (The financial statements of Sydney Water indicate it is a for-profit entity.)

8 Sydney Water commented that: "AASB 136 Aus6.1 can be interpreted in two ways:

- One interpretation is that the particular Australian guidance limits the use of depreciated replacement cost (DRC) to only 'not-for-profit' entities as 'value in use' in a recoverable amount test (RAT) for impairment purposes, and therefore this option is not available to 'for-profit' entities.

- The other interpretation is not as limiting in its application, whereby AASB 136 Aus6.1 is only specifying how 'value in use' can be determined in a specific situation by not-for-profit entities, and thus is not intended to constrain 'for-profit' entities from using DRC as a measure of fair value under AASB 13."

9 Another constituent referred to in paragraph 1 above[3] commented that this question asked by Sydney Water is symptomatic of:

(a) a missed opportunity to previously clarify that DRC clearly represents fair value; and

(b) the confusion about the meaning of DRC (fair value) caused by the reference in AASB 136 to DRC as a measure of *value in use*. (As mentioned in paragraph 12 below in relation to Question 2, this submitter argues that the reference in AASB 136 to DRC as a measure of value in use should be omitted.)

1 This letter was previously provided to the Board as Agenda Paper 3.8 for its 16 – 17 July 2014 meeting (M139), within 'Other Business'.

2 This paper uses the terms 'DRC' and 'CRC' interchangeably, except where a narrower reading is indicated.

3 KPMG

10 In relation to paragraph 9(a) above, that submitter[4] commented that:

(a) prior to the issuance of AASB 13, the compatibility of DRC with fair value was less well understood. AASB 13 provides guidance on using DRC ('CRC') to measure fair value under the 'cost approach', and explains why DRC is compatible with the exit price principle underpinning fair value; and

(b) AASB 136 was issued before AASB 13; now that the compatibility of DRC with fair value is better understood, there is a strong case for revisiting AASB 136 in relation to its characterisation of DRC as a measure of value in use.

11 In view of that perspective, Board members are not asked to answer Question 1 until they consider Questions 2 and 3 below, the answers to which have implications for whether DRC should continue to be described as a measure of value in use for NFPs in the particular circumstances described in paragraph 1(b) above.

<u>Question 2</u>

12 The submitter referred to in paragraph 9 above:

(a) argues that, consistent with its role as 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;

(b) commented that the AASB previously (and appropriately) concluded that the recoverable amount of NFPs' assets described in paragraph 1(b) above should not be based on discounted cash flows, because using discounted cash flows to measure recoverable amount would result in the inappropriate recognition of impairments. Therefore, for NFPs' assets the future economic benefits of which are not primarily dependent on their ability to generate net cash inflows, DRC should be used to determine fair value as a measure of recoverable amount; and

(c) argues that, in view of the points in (a) – (b) above, the reference to 'DRC as a measure of value in use' in paragraph Aus6.1 of AASB 136 should be omitted because it is unnecessary and inappropriate.

13 **Question 2** is whether the reference in AASB 136 to DRC as a measure of value in use should be omitted.

14 The submitter referred to in paragraph 9 above considers that the answer to this question should essentially be the same as the answer to Question 1. However, because Sydney Water did not explicitly ask Question 2, that question is identified separately from Question 1 in this paper.

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[4] KPMG

Question 3

15 The other constituent referred to in paragraph 1 above[5] requests clarification of the relationship between DRC as a measure of fair value under AASB 13 and as a measure of value in use under AASB 136, and presumed CRC in AASB 13 has substantially the same meaning as DRC when it was contained in AASB 116. This request raises the same question as Question 2 above, except that it does not explicitly ask whether the reference in AASB 136 to DRC as a measure of value in use should be omitted.

16 The submitter referred to in paragraph 15 above fleshed out Question 3 by asking the following more specific (paraphrased) question regarding assets of NFPs for which value in use is measured at DRC:

> Given that:
>
> (a) the recoverable amount of an asset is defined as "the higher of its fair value less costs of disposal and its value in use"; and
>
> (b) DRC is a method for determining fair value,
>
> is the only difference between 'fair value less costs of disposal' and 'value in use' the costs of disposal? In other words, if value in use is measured at DRC under AASB 136 and DRC represents fair value under AASB 13, must recoverable amount always equal DRC (as a measure of value in use) in those circumstances because that amount, by definition, exceeds fair value less costs of disposal?

17 That submitter provided the following fact pattern to illustrate the issue:

> A NFP possesses two adjacent blocks of land, situated on each of which is a house built in the 1950s. Those houses are used as employee amenities. Under the 'market approach' to estimating the fair value of each property (i.e. house and block of land together), the market evidence is of transactions for sale of those properties jointly as a development site. If the properties were sold as a development site, the houses would be a blight on the site (they would need to be demolished, and therefore reduce the market price for such sale).

18 In relation to the fact pattern described in paragraph 17 above, that submitter argued the following:

(a) the market value of the houses is nil because the houses are a blight on the selling price of the properties;

(b) in properly determined estimates of fair value, the result of applying the 'market approach', 'income approach' and 'cost approach' should yield materially the same estimates of fair value. For example, under paragraph B9 of AASB 13, when applying the 'cost approach', the obsolescence reflected in an asset's CRC includes economic obsolescence as well as physical

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5 Martin Burns, Director, Liquid Pacific (Property and Environmental Consultants)

deterioration. Any material difference between the fair value estimates under those three approaches indicates at least one of those estimates has been mis-calculated;

(c) based on (a) and (b) above, the CRC of those houses under AASB 13 should be measured at nil;

(d) 'CRC' in AASB 13 is equivalent to DRC as previously used to measure the fair value of various assets (e.g. when revaluing property, plant and equipment under AASB 116 *Property, Plant and Equipment*); and

(e) an asset can only have one DRC[6]. Therefore:

(i) DRC in AASB 136 should have the same meaning as CRC in AASB 13; and, in turn,

(ii) the recoverable amount of the houses should be nil.

The submitter asks whether the outcome in (e)(ii) above is intended under AASB 136.

19 The submitter referred to in paragraph 15 above also argued that an asset's value in use cannot exceed the asset's fair value (which is based on the asset's highest and best use).

20 The submitter referred to in paragraph 9 above expressed a view that the AASB should not provide guidance on the specific fact pattern described in paragraph 17 above, because it is unnecessary in a principles-based Standards regime and would amount to interpreting IFRSs (with the risk of inadvertently contradicting IFRSs). Nevertheless, AASB staff think the fact pattern can be useful in illustrating Question 3, without the Board issuing guidance on it.

AASB staff analysis of technical considerations in Questions 1 – 3 above

21 This staff analysis focuses mainly on Question 3, because that question effectively subsumes most of the issues in the other two questions. It discusses, in the following order:

(a) how to determine the highest and best use of the houses in the example in paragraph 17 above (see paragraphs 22 – 26 below);

(b) the submitter's contention in paragraph 18(b) above that estimates of the fair value of an asset under the 'market approach', 'income approach' and 'cost approach' should, as a matter of principle, not differ materially (see paragraphs 27 – 32 below);

(c) regardless of whether an asset's CRC might differ materially from its fair value, whether an asset's DRC under AASB 136 has a different meaning than an asset's CRC as a measure of fair value under AASB 13 (see paragraphs 33 – 34 below); and

[6] This is also the view of the submitter referred to in paragraph 9 above.

(d) in light of the comments on (a) – (c) above, how Question 1 should be answered (see paragraph 35 below).

Estimating fair value under AASB 13

Highest and best use

22 Regarding the submitter's arguments set out in paragraphs 18(a) – 18(d) above, AASB staff think the first issue to consider is whether the highest and best use of the houses is:

(a) in combination with the land; or

(b) on a stand-alone basis[7].

23 AASB staff think the answer to this issue depends on whether the estimated future economic benefits that market participants holding complementary assets would expect to generate by using the properties as employee amenities exceed the estimated future economic benefits from selling the properties on a stand-alone basis (i.e. as land with buildings that need demolition to realise the properties' redevelopment potential).

24 AASB staff think the submitter's view described in paragraph 18(a) above does not consider the possibility that the estimated future economic benefits that market participants holding complementary assets would expect to generate by using the properties as employee amenities would exceed the estimated future economic benefits from selling the properties on a stand-alone basis, and therefore is potentially inconsistent with paragraph 31 of AASB 13. The valuation premise requirements in paragraph 31 of AASB 13 seem to reflect the importance of identifying which asset is being measured.

25 AASB staff think the buildings should not be regarded solely as a potential enhancement of the selling price of the land, but should also be regarded as potentially possessing separate service potential in the form of contributing to meeting the entity's objectives (e.g. generating cash flows) through use.

26 Another example of the point made in paragraphs 24 – 25 above is where the fact pattern in the submitter's example in paragraph 17 above is modified to assume that the houses are used for the entity's *primary* purpose. For example, assume that the houses are used by a NFP to provide counselling and other assistance to drug users who tend to congregate near the entity's properties (the present location of the houses is critical to achieving the entity's mission). In relation to applying the principle that "a fair value measurement assumes that the market participant already holds … complementary assets …" (AASB 13, paragraph 32), AASB staff think this means the market participant would hold complementary assets for the purposes for which the reporting entity uses the asset in question (provided that such use is the highest and best use of all those assets), even if those purposes are specific to the NFP. This view seems to be supported by the comment in paragraph BC78 of the IASB's Basis for Conclusions on IFRS 13 that, in relation to a specialised non-financial asset:

7 See paragraph 31 of AASB 13, quoted in paragraph A2(a) of the appendix to this paper.

"In effect, the market participant buyer *steps into the shoes of the entity* that holds that specialised asset." [emphasis added]

Different approaches to measuring fair value under AASB 13

27 AASB staff disagree with the submitter's contention in paragraph 18(b) above that estimates of the fair value of an asset under the 'market approach', 'income approach' and 'cost approach' should, as a matter of principle, not differ materially. AASB staff think each approach can generate different amounts; some of those amounts might be considered less faithful representations of fair value and thus be estimates that should not be used to estimate fair value. For example, in some circumstances, the CRC of an item of self-constructed equipment might be capable of being faithfully represented, but:

(a) due to a reduction in the price of the equipment's outputs, the CRC exceeds the amount market participants (including hypothetical market participants identical to the reporting entity) would be prepared to pay for the equipment (despite assuming they hold complementary assets). In other words, the reporting entity would not replace the asset's capacity to provide goods or services—at any scale—if deprived of the asset because any replacement expenditure would be uneconomic. Therefore, the equipment's CRC would exceed the equipment's fair value (which would probably be a scrap value), and thus would not faithfully represent the equipment's fair value; and

(b) other market participants are willing to pay more than CRC for the asset (because they can use the asset more efficiently). Arguably, the CRC for the asset should not be aligned to that exit price, because doing so would involve substituting a market exit price for a market entry price. Because other market participants are willing to pay more than CRC for the asset, the equipment's CRC would be less than the equipment's fair value, and thus would not faithfully represent the equipment's fair value.

28 In addition, the submitter's contention in paragraph 18(b) above that estimates of the fair value of an asset under the 'market approach', 'income approach' and 'cost approach' should, as a matter of principle, not differ materially seems inconsistent with the comment in paragraph BC79 of the IASB's Basis for Conclusions on IFRS 13 that, in relation to a specialised non-financial asset:

> "When a market price does not capture the characteristics of the asset (eg if that price represents the use of the asset on a stand-alone basis, not installed or otherwise configured for use, rather than in combination with other assets, installed and configured for use), that price will not represent fair value. In such a situation, an entity will need to measure fair value using another valuation technique (such as an income approach) or the cost to replace or recreate the asset (such as a cost approach) depending on the circumstances and the information available."

29 Therefore, even if the highest and best use of the properties referred to in paragraph 17 above is for sale on a stand-alone basis, and the houses' fair value were determined (by applying the 'market approach') to be nil, AASB staff think it would not necessarily follow that the houses' CRC would be nil (as is contended by one of the

submitters, in paragraph 18(c) above). In making that comment, AASB staff hold a different view of 'economic obsolescence' (as referred to in paragraph B9 of AASB 13[8] in relation to determining an asset's CRC) than that held by the submitter. That submitter considers the amount of the houses' economic obsolescence to equal their replacement cost (i.e. he regards the houses as completely obsolete).

30 In contrast, when market participants would not be willing to replace an asset if they were deprived of it, AASB staff think it is more logical to conclude that CRC does not represent the fair value of the houses. In other words, AASB staff think that treating an asset's current market entry price as the equal of the asset's current market exit price (determined on a stand-alone basis), by calculating obsolescence based on replacement cost in such a manner that it yields the same measure of both current market entry and exit prices, would be inconsistent with the fact that entry and exit markets for an asset are different.

31 AASB staff are unaware of any substantive differences between the meaning of 'CRC' in AASB 13 and 'DRC' as previously used to measure the fair value of various assets (e.g. when revaluing property, plant and equipment under AASB 116). In this regard:

(a) the context in which CRC is used, and DRC was used, to estimate fair value seems similar. Paragraph 33 of the version of AASB 116 superseded (by Accounting Standard AASB 2011-8) when AASB 13 became effective indicated that a DRC approach to estimating fair value might need to be applied to specialised items of property, plant and equipment. Similarly, paragraph B9 of Appendix B in AASB 13 says: "In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities." AASB staff understand that the highest and best use of specialised items of property, plant and equipment is often for use of those assets in combination with other assets or with other assets and liabilities; and

(b) AASB staff think the meaning of 'obsolescence' in the discussion of 'CRC' in paragraph B9 of AASB 13 is substantively the same as the meaning of 'depreciation' in the reference to 'DRC' in AASB 136. This is despite the comment in paragraph B9 of AASB 13 that: "Obsolescence … is broader than depreciation for financial reporting purposes (an allocation of historical cost)".[9] IFRS 13 is worded consistently with FASB Accounting Standards Codification Topic 820 *Fair Value Measurement*; depreciable assets generally are not revalued by entities applying FASB Statements.

32 As mentioned in paragraphs 27 and 28 above, AASB staff think an asset's CRC might differ materially from its fair value. Therefore, even if the highest and best use of the properties referred to in paragraph 17 above is for sale on a stand-alone basis, and the houses' fair value were determined (by applying the 'market approach') to be nil, AASB staff think it would not necessarily follow that the houses' CRC would be nil.

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[8] Quoted in paragraph A2(e) of the appendix to this paper.

[9] The concerns of AASB staff regarding this comment in AASB 13 are discussed in Agenda Paper 16.4 for this Board meeting.

Measuring value in use under AASB 136

33 If the staff view that an asset's CRC might differ materially from its fair value were not supported, staff nevertheless think an asset's DRC has a different meaning in the context of measuring value in use under AASB 136 than the meaning of CRC as a measure of fair value under AASB 13[10]. This is because:

(a) in paragraph Aus6.1 of AASB 136[11], DRC is explicitly referred to as a measure of value in use in the context of the deprival value notion (which, for NFPs, is invoked for each asset the future economic benefits of which are not primarily dependent on the asset's ability to generate net cash inflows). Therefore, when applying paragraph Aus6.1 of AASB 136, DRC should be read as a current market buying price. An asset's current market buying price differs from its current market selling price, because those prices are obtained in different markets for the asset, even though their amounts might by coincidence be the same for a particular asset; and

(b) it would be illogical to describe recoverable amount of particular assets of NFPs[12] as the higher of fair value and fair value less costs of disposal. If that meaning were intended, it would have been logical for the AASB to simply refer to 'fair value'. The use of a two-limbed notion of recoverable amount[13] implies the AASB did not intend that DRC as a measure of value in use would be indistinct from fair value.

34 Consequently, AASB staff think, when the value in use of a NFP's asset described in paragraph 1(b) above is measured at DRC under AASB 136, that asset's fair value could be measured at a different amount under AASB 13. This means that the AASB staff's answers to:

(a) the main part of Question 3 asked in paragraph 16 above is 'no' (although a particular asset's DRC and fair value less costs of disposal could, by coincidence, be equal in amount); and

(b) Question 2 asked in paragraph 13 above is 'no', in the context of staff's understanding of the AASB's intention when it developed AASB 136. Such an answer would not preclude the Board conducting a fundamental review of this aspect of AASB 136 (possible Board actions are discussed in paragraphs 36 – 51 below).

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10 This is despite AASB staff thinking that DRC and CRC have essentially the same meaning *when used to measure fair value*.

11 Quoted in paragraph A3(c) of the appendix to this paper.

12 i.e. those assets the future economic benefits of which: (1) are not primarily dependent on the assets' ability to generate net cash inflows; and (2) would be replaced if the entity were deprived of those assets.

13 See paragraph A3(a) of the appendix to this paper.

Question for Board members

Q1 Do you agree with the AASB staff views in paragraph 34 above that:

(a) when the value in use of a NFP's asset described in paragraph 1(b) above is measured at DRC under AASB 136, that asset's fair value could be measured at a different amount under AASB 13? and

(b) the reference in AASB 136 to DRC as a measure of value in use should be retained, at least until a fundamental review of this aspect of AASB 136?

Question asked by Sydney Water

35 In relation to Question 1 asked in paragraph 7 above, AASB staff think that, regardless of whether the Board agrees with the staff views in paragraph 34 above, the Board should agree with the 'other interpretation' quoted in paragraph 8 above. That is, AASB staff think the role of DRC as a measure of value in use, for NFPs, of particular assets under AASB 136 does not preclude for-profit entities from using DRC as a measure of fair value under AASB 13 (provided that DRC faithfully represents fair value in the circumstances). This view reflects the Board's policies that:

(a) Australian Accounting Standards adopt the requirements of IFRSs word-for-word as drafted by the IASB, without modifying the requirements of IFRSs for application by for-profit entities[14]; and, accordingly,

(b) any NFP-entity-specific modifications of IFRS text in an Australian Accounting Standard should not be read as affecting application of an IFRS by a for-profit entity.

Question for Board members

Q2 Do you agree with the AASB staff view in paragraph 35 above that the role of DRC as a measure of value in use (as part of recoverable amount), for NFPs, of particular assets under AASB 136 does not preclude for-profit entities from using DRC (or CRC) as a measure of fair value under AASB 13?

Possible Actions before a Post-Implementation Review of AASB 13

36 As indicated in paragraph 4 above, AASB staff think it is potentially unclear whether the references to 'CRC' in AASB 13 and 'DRC' in AASB 136 are meant to be different, in the absence of specific guidance. (This is despite the AASB staff view that – as discussed in paragraphs 33 – 34 above – in the context of those Standards, those amounts could differ.) This potential lack of clarity would, if not addressed by the Board sooner, seem likely to be addressed by the Board in a post-implementation review (PIR) of AASB 13. AASB 13 became effective on 1 January 2013, and therefore a PIR could be conducted as early as 2016 (concurrently with an IASB PIR of IFRS 13)[15].

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[14] *AASB Policies and Processes*, paragraphs 27, 29, 36 and 41(a).

[15] For most Australian entities, AASB 13 would (unless adopted early) be initially adopted for annual reporting periods that ended on 30 June 2014.

37 The key issues regarding possible actions the Board might take (discussed in paragraphs 39 – 51 below) are:

(a) whether the Board should respond to the issue in paragraph 1 above before it conducts a PIR of AASB 13; and, if so,

(b) which steps the Board might take.

38 The conclusions on the issues referred to in paragraph 37 above will depend, in part, on the overall priority the Board gives to addressing the issue in paragraph 1 above.

39 In assessing whether a need exists for the Board to respond to the issue in paragraph 1 above before a PIR of AASB 13, AASB staff note that indications to date are that uncertainty about how to apply AASB 13 and AASB 136 in relation to this issue is not isolated.

40 At this stage, the *Process for Modifying IFRSs for PBE/NFP* issued by the AASB and the NZASB's predecessor (the Financial Reporting Standards Board) in October 2009 is not planned to be invoked in relation to the issue in paragraph 1 above. This is because the issue relates to a NFP-specific modification of IAS 36 developed consistently with the principles later embodied in that *Process*. In that regard:

(a) paragraph 15(b) of that *Process* identifies 'non-cash-generating assets or units' as an example of a circumstance more prevalent among NFPs than among for-profit entities (which is one of the factors identified in paragraph 12 of that *Process* for considering whether an IFRS should be modified for application by NFPs); and

(b) paragraph 11 of the *Process* notes that a modification of an IFRS made in an IPSAS, based on one of the factors in paragraph 12 of the *Process*, would provide evidence of a NFP issue warranting modification of an IFRS incorporated in an Australian Accounting Standard. As mentioned in the IPSASB comparison in paragraphs A4 – A8 of the appendix to this paper, IPSASs state that DRC is used in measuring the recoverable amount of some assets and in measuring the fair value of some assets (i.e. they are broadly consistent with AASB 136 and the superseded text of AASB 116 regarding fair value measurement).

Whether the AASB should take action in response to this issue before a PIR of AASB 13

41 Although the issue in paragraph 1 above was most recently raised in the context of AASB 13, AASB staff think essentially the same issue already existed in the context of AASB 116 and AASB 136 (i.e. whether the references to 'DRC' in AASB 116 and AASB 136 were meant to be different). This is because, as mentioned in paragraph 31 above, AASB staff are unaware of any substantive differences between the meaning of 'CRC' in AASB 13 and 'DRC' as previously used in AASB 116. If essentially the same issue already existed in the context of AASB 116 and AASB 136, this would be an argument for concluding it is unnecessary to take urgent action in relation to the issue in paragraph 1 above, since the issue has existed for several years (the pertinent text in AASB 116 and AASB 136 has existed since those Standards came into effect for annual reporting periods beginning on or after 1 January 2005).

42 However, in view of having received multiple enquiries from constituents on the issue in paragraph 1 above and the priority given to this issue by the Board when it last considered it (in June 2011: see paragraph 2 above), AASB staff recommend that the Board should take action in response to this issue before a PIR of AASB 13.

Question for Board members

Q3 Do you agree with the AASB staff view that the Board should take action in response to the issue in paragraph 1 above before a PIR of AASB 13?

Options if the Board takes action in response to this issue before a PIR of AASB 13

43 The Board's options for taking action in response to this issue before a PIR of AASB 13 include:

(a) directing AASB staff to write an article on the issue, informed by Board members' input (using a process similar to that used for the two AASB staff papers that discuss accounting for the carbon tax, issued in 2013); and

(b) taking either of the following due process steps:

(i) undertaking the process for assessing whether an AASB Interpretation should be developed[16]; and

(ii) developing an Invitation to Comment that includes a proposed Board clarification of the issue identified in paragraph 1 above (e.g. proposed amendments to Australian Accounting Standards). If the Board decides to conduct a fundamental review of the aspect of AASB 136 affected by the issue in paragraph 1 (particularly, in the context of Question 2, a review of whether to retain the reference to DRC as a measure of value in use), this would involve a substantial new project. Prior to the Board holding an initial discussion of the issues in this paper, that possibility is not canvassed in detail in staff agenda papers.

These options are discussed in paragraphs 44 – 51 below.

<u>Option (a): AASB staff article</u>

44 This option should have the advantage that it facilitates the Board's consideration of input on the various issues affecting application of AASB 13 (including its interaction with other Australian Accounting Standards) in a more orderly, efficient and comprehensive fashion than if the Board were to undertake formal due process in the short term and then conduct a PIR on AASB 13 within a relatively short period thereafter (i.e. possibly as early as 2016).

45 The main disadvantages of AASB staff preparing an article, compared with undertaking formal due process in the short term, are that:

[16] Following the Board's *Interpretations and Improvements Model* (February 2012): see also paragraph 47 below.

(a) AASB staff articles are not authoritative and therefore might not significantly reduce the incidence of disagreements about how to apply AASB 13 and AASB 136. In this regard, if the Board formed a tentative view that either AASB 13 or AASB 136 should be amended in response to the issue in paragraph 1 above, an AASB staff article would be an ineffective response to the issue; and

(b) any significant practice issues that might be identified if formal due process were undertaken would remain unaddressed by the Board until a PIR on AASB 13 is conducted (which, as mentioned in paragraph 36 above, could occur as early as 2016). However, AASB staff think that if other practice issues than those discussed in this paper were identified, such issues might not be resolved much earlier than when a PIR is conducted.

Option (b)(i): Assess whether an AASB Interpretation should be developed

46 As mentioned in paragraph 3 above, the issue in paragraph 1 above is domestic because it relates to a NFP modification of IAS 36. Therefore, under the Board's *Interpretations and Improvements Model*[17]:

(a) the issue would not be referred to the IFRS Interpretations Committee for consideration; and

(b) the Board would make an agenda decision to either:

"(i) take no action and give reasons; or

(ii) add the issue to the work program and, if required, establish an Advisory Panel to prepare alternative views and recommendations for consideration by the AASB."[18]

47 From a resource commitment perspective, undertaking the process for assessing whether an AASB Interpretation should be developed in response to this issue before a PIR of AASB 13 is conducted would involve the following additional steps to the initial investigation of this issue already conducted, in application of the Board's *Interpretations and Improvements Model*:

(a) establishing an Advisory Panel (normally comprising between four and eight members, including the Chair and at least one other AASB member, drawn from preparer and user groups, accounting firms, the accounting bodies, relevant public sector and not-for-profit organisations, and academia) to prepare alternative views and recommendations for the Board's consideration, for which AASB staff would provide technical and administrative support;

(b) consideration of the Advisory Panel's views and recommendations by the Board, and the Board's development of either:

(i) a Proposed Interpretation, if the Board decides to propose an Interpretation; or

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17 Particularly, the 'Agenda Decisions' section on pages 2 – 3 thereof.

18 Quoted from paragraph (b) at the top of page 3 of the Board's *Interpretations and Improvements Model*.

(ii) a Proposed Agenda Decision not to add the issue to the AASB's agenda;

(c) publication of the Board's Proposed Interpretation or Proposed Agenda Decision (including reasons) on the AASB's website; and

(d) consideration of any comments received on the Board's Proposed Interpretation or Proposed Agenda Decision, and finalisation and publication of the Interpretation or Agenda Decision.

48 The main advantage of the Board undertaking the process for assessing whether a AASB Interpretation should be developed is that the Board can respond in a timely manner to any significant problems regarding the issue in paragraph 1 above, without necessarily spending the time and resources that would be associated with developing an Invitation to Comment including a proposed Board clarification of the issue.

49 The main disadvantage of this approach is that if, ultimately, the Board were to conclude that it should amend an Accounting Standard (or issue other non-interpretative guidance) in response to this issue, developing and communicating Board proposals would take longer than if the Board progressed directly to developing an Invitation to Comment.

Option (b)(ii): Develop a Due Process Document including proposed amendments to Standard(s) to clarify the issue

50 The main advantage and disadvantage of this approach are the reciprocal of the main advantage and disadvantage of Approach (b), as set out in paragraphs 48 – 49 above.

AASB staff recommendation

51 AASB staff think the advantage of an AASB staff article (as the only action before a PIR of AASB 13 is conducted) described in paragraph 44 above outweighs the disadvantages of that approach described in paragraph 45 above, particularly as a PIR could be conducted as early as 2016. Accordingly, AASB staff recommend that the only action before a PIR of AASB 13 is conducted is to direct AASB staff to prepare a staff article.

Question for Board members

Q4 Do you agree with the AASB staff recommendation that the only action the Board should take before a PIR of AASB 13 is to direct AASB staff to prepare a staff article?

APPENDIX

Extracts from Relevant Australian Accounting Standards and IPSASs

Relevant text of AASB 13 and AASB 136

A1 The relevant text of AASB 13 and AASB 136 is set out in paragraphs A2 and A3 below.

A2 AASB 13:

(a) states that: "The highest and best use of a non-financial asset establishes the valuation premise used to measure the fair value of the asset, as follows:

(a) The highest and best use of a non-financial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (eg a business).

(i) If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets or with other assets and liabilities and that those assets and liabilities (ie its complementary assets and the associated liabilities) would be available to market participants.

(ii) Liabilities associated with the asset and with the complementary assets include liabilities that fund working capital, but do not include liabilities used to fund assets other than those within the group of assets.

(iii) Assumptions about the highest and best use of a non-financial asset shall be consistent for all the assets (for which highest and best use is relevant) of the group or the group of assets and liabilities within which the asset would be used.

(b) The highest and best use of a non-financial asset might provide maximum value to market participants on a stand-alone basis. If the highest and best use of the asset is to use it on a stand-alone basis, the fair value of the asset is the price that would be received in a current transaction to sell the asset to market participants that would use the asset on a stand-alone basis." (paragraph 31);

(b) states that: "a fair value measurement assumes that the market participant already holds … complementary assets …" (paragraph 32);

(c) states that one of the valuation techniques for measuring fair value is the 'cost approach' (paragraph 62);

(d) defines the ‘cost approach’ as: “A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)” (Appendix A); and

(e) states that: “From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. … Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives). In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.” (Appendix B, paragraph B9)

A3 AASB 136:

(a) defines ‘recoverable amount’ as follows: “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” (paragraph 6);

(b) defines ‘value in use’ as “the present value of the future cash flows expected to be derived from an asset or a cash-generating unit” (paragraph 6);

(c) states that: “Notwithstanding paragraph 6, in respect of not-for-profit entities, value in use is depreciated replacement cost of an asset 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.” (paragraph Aus6.1);

(d) defines ‘depreciated replacement cost’ 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 Aus6.2); and

(e) states 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.” (paragraph Aus32.2)

IPSASB comparison

A4 Like AASB 116 and AASB 136, IPSASs state that DRC is used in measuring the recoverable amount of some assets and in measuring the fair value of some assets. Therefore, it would appear that applying IPSASs could give rise to similar questions to those set out in paragraphs 7, 13 and 15 – 16 above. This aspect is elaborated on in paragraphs A5 – A8 below.

A5 The IPSASB has yet to issue a Standard based on IFRS 13 *Fair Value Measurement*. IPSAS 17 *Property, Plant and Equipment* contains similar requirements for measuring the fair value of property, plant and equipment to those in the version of AASB 116 that was amended as a consequence of the issue of AASB 13. [In addition to referring to measuring the fair value of specialised non-financial assets at DRC, IPSAS 17 refers to measuring the fair value of such assets using the 'restoration cost' or 'service units' approaches. Those latter approaches were not mentioned in the superseded AASB 116 and are not discussed in this paper.] IPSAS 17 says:

(a) "The fair value of items of property, plant and equipment is usually their market value determined by appraisal." (paragraph 45);

(b) "For some public sector assets, it may be difficult to establish their market value because of the absence of market transactions for these assets." (paragraph 46);

(c) "In the case of specialized buildings and other man-made structures, fair value may be estimated using depreciated replacement cost, or the restoration cost or service units approaches …" (paragraph 47); and

(d) "If there is no market-based evidence of fair value because of the specialized nature of the item of plant, and equipment, an entity may need to estimate fair value using, for example, reproduction cost, depreciated replacement cost, or the restoration cost or service units approaches (see IPSAS 21). The depreciated replacement cost of an item of plant or equipment may be established by reference to the market buying price of components used to produce the asset or the indexed price for the same or a similar asset based on a price for a previous period. …" (paragraph 48).

A6 Requirements in IPSASs for measuring the recoverable amount of 'non-cash-generating assets' are set out in IPSAS 21 *Impairment of Non-cash-generating Assets* (see quotes in paragraph A7 below). Like AASB 136, IPSAS 21 states that, for assets the future economic benefits of which are not primarily dependent on the assets' ability to generate net cash inflows (which it terms 'non-cash-generating assets'[19]), value in use is determined as DRC (subject to the exceptions noted in (b) immediately below). The substantive differences between those Standards in this regard are that:

(a) unlike AASB 136, IPSAS 21 does not also specify that, to measure an asset's value in use as DRC, it is necessary that the entity would, if deprived of the asset, replace its remaining future economic benefits; and

(b) for 'non-cash-generating assets', IPSAS 21 also permits value in use to be measured using the 'restoration cost' or 'service units' approaches. It facilitates using DRC and these other two approaches by referring to value in use of a non-cash-generating asset, broadly, as "the present value of the asset's remaining service potential".

A7 In relation to the subject matter of paragraph A6 above, IPSAS 21 states that:

(a) "<u>Non-cash-generating assets</u> are assets other than cash-generating assets." (paragraph 14);

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[19] Under IPSAS 21, 'non-cash-generating assets' are assets not held with the primary objective of generating a commercial return: see paragraph A7 below.

(b) "Cash-generating assets are assets held with the primary objective of generating a commercial return." (paragraph 14);

(c) "Recoverable service amount is the higher of a non-cash-generating asset's fair value less costs to sell and its value in use." (paragraph 14);

(d) "Value in use of a non-cash-generating asset is the present value of the asset's remaining service potential." (paragraph 14);

(e) "The present value of the remaining service potential of the asset is determined using any one of the approaches identified in paragraphs 45 – 49, as appropriate." (paragraph 44); and

(f) "Under this approach [i.e. the depreciated replacement cost approach], the present value of the remaining service potential of an asset is determined as the depreciated replacement cost of the asset. The replacement cost of an asset is the cost to replace the asset's gross service potential. This cost is depreciated to reflect the asset in its used condition." (paragraph 45).

A8 To date, a post-implementation review (PIR) of IPSAS 21 has neither been conducted nor scheduled by the IPSASB. The IPSASB's Strategy Consultation Paper (March 2014) seeking views on projects to include in the IPSASB's work program for 2015 – 2019 does not identify a PIR of IPSAS 21 as a potential IPSASB project for that period.