Staff Issues Paper: Clarifying the Use of Depreciated Replacement Cost as a Measure of Value in Use

Purpose

1 The purpose of this paper is to provide an analysis of three sweep issues:

(a) whether there are situations in which depreciated replacement cost (DRC) as a measure of value in use under AASB 136 *Impairment of Assets* is expected to be the same as CRC as a measure of fair value under AASB 13 *Fair Value Measurement* (discussed in paragraphs 6 – 19);

(b) whether to amend AASB 136 to require the use of CRC determined under AASB 13 in place of DRC as input to the impairment model under AASB 136 (discussed in paragraphs 6 – 19); and

(c) whether there is a not-for-profit-specific reason to amend AASB 136 to exempt revalued assets of not-for-profit (NFP) entities from the scope of the impairment model under AASB 136 (discussed in paragraphs 20 – 26).

Background

2 At its September 2014 meeting, the Board discussed concerns raised by some constituents in regard to the interaction between the use of DRC in measuring value in use under AASB 136 and the use of CRC in measuring fair value under AASB 13. Constituents' comments considered at that meeting are reflected in Agenda paper 16.3 of AASB's September 2014 meeting.

3 At that meeting the Board noted that under AASB 136, DRC would be used to measure an asset's value in use only if the NFP entity would, if deprived of the asset, replace its remaining future economic benefits. The Board also noted that a non-financial asset's CRC under AASB 13 reflects the highest and best use of that asset by market participants, which is not necessarily the asset's existing use. Therefore, the Board decided to clarify that DRC as used in AASB 136 does not have the same meaning as CRC as used in AASB 13.

4 The Board decided to develop proposed amendments to AASB 136 in the form of additional or revised 'Aus' paragraphs to make this clarification.

Comments received post September 2014 meeting

5 Staff intended to draft an Exposure Draft to implement the Board's decision noted in paragraph 4 above. However, further comments received in targeted outreach after the September 2014 meeting indicated that there are a number of related issues that the Board needs to consider before an Exposure Draft could be prepared. These are discussed below.

Differentiation between DRC and CRC in practice

6 Comments received from Board members (in their capacity as preparers and auditors), valuers and other parties in staff's targeted outreach (see Appendix to this paper) have indicated that some NFP entities use CRC as a measure of fair value under AASB 13 and use the same measure under AASB 136 for measuring the value in use of

primarily non-cash generating assets where the entity would, if deprived of the asset, replace its remaining future economic benefits. That is, a separate measurement of DRC for input into the impairment model under AASB 136 is not performed. The issue is analysed below.

Is DRC the same as CRC?

7 Whether CRC under AASB 13 is the same as, or different from, DRC under AASB 136 depends on consideration of whether:

(a) replacement cost (RC) has a similar meaning as a measure of both fair value and value in use; and

(b) accumulated depreciation has the same meaning as obsolescence.

RC as a measure of both fair value and value in use

8 In this section we consider the question in paragraph 7(a) in the context of an argument that, in a similar manner to DRC under AASB 136, CRC under AASB 13 also has a deprival value connotation. Some parties who do not see a difference between DRC under AASB 136 and CRC under AASB 13 from a practical valuation perspective argue that CRC is fair value only if the entity would replace the asset if deprived of it. Paragraph B9 of AASB 13 states:

> B9 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. That is because *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*. 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. (emphasis added)

9 The following example shows how the deprival value notion could be argued to be implicit in paragraph B9 of AASB 13.

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, whereas the current market buying price of the facility to any other market participant would be $10 million.
>
> The issues are (a) whether the RC of the facility should be measured at $10 million or $8.5m under AASB 13 and (b) whether the RC of the facility should be measured at $10m or $8.5m under AASB 136.

10 AASB 13, paragraph B9 (quoted above) 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 RC should be measured at $8.5 million when estimating CRC under AASB 13. Because value in use is an entity-specific measure, the RC of the facility would be measured at $8.5 million when estimating DRC under AASB 136.

11 The above example shows the meaning of 'replacement cost' in DRC and CRC should not differ when CRC reflects fair value (ie is seen as having a deprival value connotation).

Accumulated depreciation and obsolescence

12 The other issue that would influence a comparison of DRC under AASB 136 and CRC under AASB 13 is whether depreciation has a different meaning from obsolescence. This is because accumulated depreciation is an element in the calculation of DRC while obsolescence is an element considered in arriving at a value for CRC. Staff are of the view that in the context of IFRS, depreciation and obsolescence can differ as discussed below.

13 For ease of reference we have quoted the definitions/descriptions of the two terms from accounting standards in the table below.

Accounting Standard	**Definition/description**
AASB 116.6	Depreciation is "the systematic allocation of the depreciable amount of an asset over its useful life"
AASB 116.56	Useful life is estimated having regard to expected usage, physical wear and tear, technical or commercial obsolescence and legal/similar limits on the use of the asset.
AASB 13.B9	Obsolescence "encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence …"

14 Staff note that, based on factors that affect useful life (such as expected usage, physical wear and tear and technical or commercial obsolescence), some might argue that depreciation and obsolescence represent the same phenomenon. However, the factors that are common to obsolescence and depreciation are treated differently. In the context of depreciation, the factors affecting useful life are accounted for prospectively[1] but in the context of obsolescence under AASB 13 they affect current value at a particular time. In other words, obsolescence as referred to in paragraph B9 of AASB 13 is a market-oriented measure[2], whereas depreciation under AASB 116 is an allocation that assumes a predetermined relationship (linear or otherwise) between the time or use and accumulated depreciation (except to the extent that an impairment loss is recognised in respect of the asset).

15 The above analysis shows that differences in accumulated depreciation and obsolescence can cause the DRC and CRC to differ even if CRC under AASB 13 is regarded as having a deprival value connotation.

16 Based on the comments received in targeted outreach, one explanation for using the CRC measure for DRC under AASB 136 is that in many cases, the highest and best use for the types of assets NFP entities hold is their existing use. This is based on the premise that highest and best use does not require consideration of every possible use, but reasonably possible uses. Another explanation from a valuation firm[3] notes that:

> "*We agree that in the case of a NFP entity [where] the valuation 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. As such the Fair Value (Current Replacement Cost) under AASB13 should be the same as the Depreciated Replacement Cost (Value in Use) under AASB136.*"

17 Staff think the issue of whether CRC has a deprival value connotation when it represents fair value warrants consideration by the Board.

Question for Board members:

1. Do you agree that CRC has a deprival value connotation when it represents fair value?

18 If the Board **agrees** that CRC has a deprival value connotation, enabling it to be used as a measure of value in use in place of DRC in AASB 136, then the clarification proposed at the September 2014 meeting would be replaced by a proposed amendment to AASB 136 to require the use of CRC as a measure of value in use in the impairment model for NFP entities under AASB 136.

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1 Paragraphs 51 and 61 of AASB 116 treat a change in useful life or depreciation method as a change in an accounting estimate that consequently is accounted for prospectively. Those requirements in AASB 116 do not discriminate between assets measured using the cost model or revaluation model when accounting for a change in useful life or depreciation method.

2 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.

3 *Miscellaneous Fair Value Issues*, For input to AASB Outreach Project (November 2014), APV, Valuers and Asset Management.

Question for Board members:

2. If Board members agree that CRC has a deprival value connotation when it represents fair value, do you agree to replace references to DRC under AASB 136 with references to CRC as measured under AASB 13?

19 If the Board **does not** agree that CRC has a deprival value connotation, then consistent with the Board's decision at the September 2014 meeting, staff would recommend that the Exposure Draft that amends AASB 136 should propose to clarify that:

> *Under AASB 136, DRC would be used to measure an asset's value in use only if the not-for-profit entity would, if deprived of the asset, replace its remaining future economic benefits. A non-financial asset's CRC under AASB 13 reflects the highest and best use of that asset by market participants, which is not necessarily the asset's existing use.*

Question for Board members:

3. If Board members do not agree that CRC has a deprival value connotation when it represents fair value, do you agree with including the proposed clarification in paragraph 19 in the forthcoming exposure draft?

Implications of revaluations by not-for-profit entities

20 Comments received in targeted outreach also indicated support for an exemption from the AASB 136 impairment model for revalued assets of NFP entities. It was argued by some that impairment is not required when valuations are kept up to date.

IASB requirements

21 AASB 136, paragraph 5 notes that the Standard applies to assets that are carried at revalued amount (i.e. fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses) in accordance with other Australian Accounting Standards, such as the revaluation models in AASB 116 *Property, Plant and Equipment* and AASB 138 *Intangible Assets*. AASB 136 further explains that in applying that Standard:

(a) if the disposal costs are negligible, the recoverable amount of the revalued asset is necessarily close to, or greater than, its revalued amount. In this case, after the revaluation requirements have been applied, it is unlikely that the revalued asset is impaired and recoverable amount need not be estimated; and

(b) if the disposal costs are not negligible, the fair value less costs of disposal of the revalued asset is necessarily less than its fair value. Therefore, the revalued asset will be impaired if its value in use is less than its revalued amount. In this case, after the revaluation requirements have been applied, an entity applies this Standard to determine whether the asset may be impaired.

Is there a NFP-specific reason for exemption?

22 In relation to the issue in paragraph 20, the question arises whether there is a NFP-specific reason for exempting assets of NFP entities revalued to fair value from the scope of AASB 136 impairment model. For the reasons in paragraphs 23 to 26, staff are of the view there is no NFP-specific reason under the *Process for Modifying IFRSs for PBE/NFP* (the *Process*) for this scope exemption.

23 Under the *Process*, in some cases, the context or increased or reduced prevalence of a transaction or event for NFP entities, as compared with for-profit entities, may require modifications to the relevant IFRS to ensure that user needs are met while considering the balance between costs and benefits. In such cases, requirements in an IFRS may be amended or a new standard may be developed to address the issue. The following factors would generally be reviewed when considering differences in user needs between the for-profit and NFP sectors:

(a) nature of transactions, events and circumstances and their impact on NFP;

(b) benefits to users of complying with the IFRS; and

(c) costs of complying with the IFRS (the *Process*, paragraph 12).

24 In relation to paragraph 23(a) above, paragraph 15(b) of the *Process* cites the following circumstance as warranting consideration:

> *"Non-cash generating assets or units, where the future economic benefits of an asset or unit are not primarily dependent on the activity's ability to generate net cash inflows. Although such activities can occur in the for-profit sector, they are usually minor and subsidiary to the main objectives of the entity".*

Staff are of the view that this notion is consistent with the modification of AASB 136 to introduce DRC as a measure of value in use of assets that are not held primarily for their ability to generate cash inflows and where the entity would, if deprived of the asset, replace their remaining economic benefits. Staff do not see any further modifications warranted on that basis.

25 In relation to paragraph 23(c), staff think the application of AASB 136 to revalued assets of NFP entities may result in additional costs for preparers. However, in relation to benefits to users (paragraph 23(b)):

(a) when a revalued asset's value in use as a measure of recoverable amount exceeds its fair value, exempting the asset from the application of AASB 136 would not affect how well user needs are met because the asset is not impaired; and

(b) when a revalued asset's value in use as a measure of recoverable amount falls below its fair value, such an exemption would deprive users of useful information about impairment.

Accordingly, overall, staff see potential benefits for users from the application of AASB 136 to revalued assets of NFP entities.

26 Staff note exempting revalued assets of NFP entities from the scope of AASB 136 would increase internal inconsistency within Australian Accounting Standards [paragraph 22(c) of the *Process*].

Questions for Board members:

4. Do you agree with the staff view in paragraph 22 that there is no NFP-specific reason for exempting revalued assets of NFP entities from the scope of AASB 136 impairment model?
5. If you do not agree with the staff view and decide to propose a NFP-specific amendment to the scope of AASB 136, should the amendment be proposed as part of the current project or a separate project?

Appendix

Comments received in targeted outreach after the September 2014 AASB meeting

Commentator	Comments
Valuer	The discussion on the difference between the determination of Fair Value using the ‘cost approach’ and the determination of recoverable amount using Depreciated Replacement Cost to determine the Value in Use is interesting. Under AASB136, for Not For Profit entities, the recoverable amount is determined by the higher of the ‘Value in Use’ and ‘Fair Value less costs to sell’. For these entities, where the assets value is not determined by the cash flows to be generated from it and the entity would replace the asset the ‘Value in Use’ is to be determined at the ‘Depreciated Replacement Cost’. We agree that in the case of a NFP entity [where] the valuation 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. As such the Fair Value (Current Replacement Cost) under AASB13 should be the same as the Depreciated replacement Cost (Value in Use) under AASB136. While noting the comments on why there may be a situation where there could be a difference I have been unable to come with an example of where this would be the case. I have also sought feedback from a range of other experts and none of them have been able to identify an example of where such a difference would occur. I would be very interested in any theoretical examples that demonstrate situations where the Fair Value (for a NFP) is different from the DRC (Value in Use). I would argue that it is possible for the Fair Value to change from CRC to market or income and in this case the CRC might now be different to the Value in Use. However this is an example where the Fair Value has changed and therefore such an analysis is meaningless.
Local Government	We do not prepare separate valuations for the two different standards [AASB 136 and AASB 13], and don’t see much benefit or value from obtaining separate valuations.
Board member	I have always regarded these two concepts as being the same in the NFP public sector. That is, ‘replacement cost’ under AASB 13 is essentially the same at DRC (or DORC) in AASB 136. In any event, ‘replacement cost’ in AASB 13 provides a critical element of DRC/DORC with a valuer/preparer only then needing to assess remaining useful life and optimised value/life. In my view, inclusion of ‘replacement cost’ in AASB 13 reinforced this view.
Board member	We do not prepare separate DRC and CRC valuations. Due to our policy of holding assets at fair value, I would not expect there to be a significant difference as significant obsolescence changes would be captured in the fair value and would therefore feed into our depreciation charges. AASB13 para B9 cites the main cause of difference between obsolescence and depreciation being the narrow scope of depreciation as

Commentator	Comments
	an allocation of historical cost; our depreciation rates are applied prospectively to the fair value, meaning the impact of obsolescence should not be a significant issue. I should note though that the main area we see changing with revaluations is land which is not depreciated.
Board member	While I can appreciate some nuancing around the use of the relevant terms in the 2 standards [AASB 136 and AASB 13], from a public sector preparer perspective given that the highest and best use is generally reflecting the current use the terms are used interchangeably. So this, in my experience is not an issue.
Board member	This is an issue we don't come across very often, if at all. We don't often have a great deal of physical asset impairment. Where we do, typically, we find that while the two measures are different conceptually, in practice for us they are the same (or at least materially so). This is because in nearly all cases, the highest and best use for the types of assets we hold is their current use. (Given that highest and best use does not require consideration of every possible use, but reasonably possible uses).