AASB Exposure Draft **ED 269**

August 2015

Recoverable Amount of Non-cash-generating Specialised Assets of Not-for-Profit Entities

Comments to the AASB by 16 November 2015

Australian Government

Australian Accounting Standards Board

How to Comment on this AASB Exposure Draft

The AASB is seeking comments by 16 November 2015.

Formal Submissions

Submissions should be lodged online via the "Work in Progress – Open for Comment" page of the AASB website (www.aasb.gov.au/comment) as a PDF document and, if possible, a Word document (for internal use only).

Other Feedback

Other feedback is welcomed and may be provided via the following methods:

E-mail: standard@aasb.gov.au
Phone: (03) 9617 7600

All submissions on possible, proposed or existing financial reporting requirements, or on the standard-setting process, will be placed on the public record unless the Chair of the AASB agrees to submissions being treated as confidential. The latter will occur only if the public interest warrants such treatment.

ISSN 1030-5882

CONTENTS

[Draft] Australian Accounting Standard AASB 2015-X *Recoverable Amount of Non-cash-generating Specialised Assets of Not-for-Profit Entities* is set out in paragraphs 1 – 8. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. AASB 2015-X is to be read in the context of other Australian Accounting Standards, including AASB 1048 *Interpretation of Standards*, which identifies the Australian Accounting Interpretations. In the absence of explicit guidance, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies.

PREFACE

Introduction

Australian Accounting Standards

The Australian Accounting Standards Board (AASB) develops, issues and maintains Australian Accounting Standards.

The AASB is an Australian Government agency under the *Australian Securities and Investments Commission Act 2001*. AASB 1053 *Application of Tiers of Australian Accounting Standards* explains the two tiers of Australian Accounting Standards.

The approach the AASB takes in setting Standards, including requirements specific to not-for-profit and public sector entities, is outlined in *AASB Policies and Processes*.

Exposure Drafts

The publication of an Exposure Draft is part of the due process that the AASB follows before making a new Australian Accounting Standard or amending an existing one. Exposure Drafts are designed to seek public comment on the AASB's proposals for new Australian Accounting Standards or amendments to existing Standards.

What We are Proposing

This Exposure Draft proposes to amend AASB 136 *Impairment of Assets* to remove references to using depreciated replacement cost (DRC) as a measure of value in use for not-for-profit entities. This Exposure Draft also proposes to clarify that:

(a) many assets of not-for-profit entities that are not held primarily for the their ability to generate net cash inflows are typically specialised assets held for continuing use of their service capacity; and

(b) given that these assets are rarely sold, their cost of disposal is typically negligible, and their recoverable amount is expected to be materially the same as fair value, determined under AASB 13 *Fair Value Measurement*.

Why We are Making these Proposals

Clarifications have been sought by some constituents about the interaction between:

(a) DRC as a measure of value in use of assets held by not-for-profit entities under AASB 136; and

(b) current replacement cost (CRC) as a measure of fair value of assets under AASB 13.

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*, its role as a measure of value in use of primarily non-cash-generating assets of not-for-profit entities under AASB 136 might be a source of confusion.

AASB 136 requires not-for-profit entities to use DRC as a measure of value in use of an asset where 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. 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". The cost approach is one of the valuation techniques for measuring fair value under AASB 13. AASB 13 states that the cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as CRC).

Targeted outreach indicated that not-for-profit entities 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. A number of constituents have expressed the view that applying either measure to specialised assets would result in values that are materially the same. Further outreach led the AASB to reconsider the need for the existing Aus paragraphs in AASB 136.

Who Would be Affected

The proposals in this Exposure Draft would affect constituents who prepare, audit or use the financial statements of not-for-profit entities that have primarily non-cash-generating assets which are typically specialised assets held for the continuing use of their service capacity.

Not-for-profit entities that hold such assets would no longer be required to measure their value in use as DRC. Not-for-profit 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.

Not-for-profit 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.

What Happens Next

The AASB will consider constituents' feedback at a future meeting with a view to determining whether it will proceed with the proposed amendments to AASB 136 and, if so, the precise nature of those amendments.

Application Date

It is proposed that this [draft] Standard applies to annual periods beginning on or after 1 July 2016, with earlier adoption permitted.

We Need Your Feedback

Comments are invited on any of the proposals in this Exposure Draft by 16 November 2015. Submissions play an important role in the decisions that the AASB will make in regard to a Standard. The AASB would prefer that respondents express a clear overall opinion on whether the proposals, as a whole, are supported and that this opinion be supplemented by detailed comments, whether supportive or otherwise, on the major issues. The AASB regards supportive and non-supportive comments as essential to a balanced review of the issues and will consider all submissions, whether they address some or all specific matters, additional issues or only one issue.

Specific Matters for Comment

The AASB would particularly value comments on the following:

1 whether to delete references to depreciated replacement cost (DRC) as a measure of value in use from AASB 136 (paragraphs 5 – 6 of this Exposure Draft);

2 whether:

(a) the proposed paragraph Aus5.1 clarifies the role of AASB 13 in determining the recoverable amount of primarily non-cash-generating specialised assets of not-for-profit entities generally held for continuing use of their service capacity (paragraph 7 of this Exposure Draft);

(b) there are any regulatory or other issues arising in the Australian environment that may affect the implementation of the proposals by not-for-profit entities, including any issues relating to public sector entities (such as GAAP/GFS implications);

(c) overall, the proposals would result in financial statements that would be useful to users; and

(d) the proposals are in the best interests of the Australian economy; and

3 unless already provided in response to specific matters for comment 1 – 2 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative. In relation to quantitative financial costs, the AASB is particularly seeking to know the nature(s) and estimated amount(s) of any expected incremental costs, or cost savings, of the proposals relative to the existing requirements.

[DRAFT] ACCOUNTING STANDARD
AASB 2015-X

RECOVERABLE AMOUNT OF NON-CASH-GENERATING SPECIALISED ASSETS OF NOT-FOR-PROFIT ENTITIES

Objective

1 The objective of this [draft] Standard is to amend AASB 136 *Impairment of Assets* to:

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

(b) clarify that the recoverable amount of primarily non-cash generating assets of not-for-profit entities, 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 *Fair Value Measurement*.

Application

2 This [draft] Standard applies to:

(a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the *Corporations Act 2001* and that is a reporting entity;

(b) general purpose financial statements of each other reporting entity; and

(c) financial statements that are, or are held out to be, general purpose financial statements.

3 This [draft] Standard applies to annual periods beginning on or after 1 July 2016.

4 This [draft] Standard may be applied to annual periods beginning before 1 July 2016. When an entity applies this [draft] Standard to such a period, it shall disclose that fact.

Proposed Amendments to AASB 136

5 Delete paragraph Aus6.1 and the definition of depreciated replacement cost from paragraph Aus6.2.

6 Delete paragraphs Aus32.1 and Aus32.2.

7 Insert the following paragraph after paragraph 5:

Aus5.1 Many assets of not-for-profit entities that are not held primarily for their ability to generate net cash inflows are typically specialised assets held for continuing use of their service capacity. Given that these assets are rarely sold, their cost of disposal is 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*.

Commencement of the Legislative Instrument

8 For legal purposes, this [draft] legislative instrument commences on 30 June 2016.

[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 Exposure Draft. Individual Board members gave greater weight to some factors than to others.

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

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 argue 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 support 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 note 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 argue 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 note 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. 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

BC10 Comments from some preparers in the public sector indicate 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 are 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 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.

BC11 Some valuers 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

BC12 The AASB noted 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. 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.

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.

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.

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 concluded that in such circumstances, the recoverable amount of the asset would be materially the same as fair value determined under AASB 13.

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.

BC17 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

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 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.

BC19 The AASB decided to publish an Exposure Draft 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.