AASB Exposure Draft **ED 28X**
[Month] 2019

Commented [AP1]:

Amendments to Australian Accounting Standards – Fair Value Measurement of Non-cash-generating Assets of Not-for-Profit Public Sector Entities

Comments to the AASB by [date]

Staff have drafted the proposed amendments to AASB 13 *Fair Value Measurement*, implementation guidance, illustrative examples and basis for conclusions based on the staff recommendations in addressing the following issues:

- Issue 1: Appropriate valuation approach – for non-financial assets held by not-for-public sector entities for their service capacity and not primarily for their ability to generate net cash inflows;
- Issue 2: Treatment of restrictions at different levels of a consolidated entity;
- Issue 3: Obsolescence –Trigger for economic obsolescence;
- Issue 4: Nature of component costs to include in an asset's current replacement cost;
- Issue 5: Whether the current replacement cost of a self-constructed asset should include borrowing costs; and
- Issue 6: Whether the fair value of the land component of a non-cash-generating real property should always be measured in the land's present location.

Australian Government
Australian Accounting Standards Board

[Draft] Accounting Standard AASB 2019-X

The Australian Accounting Standards Board makes Accounting Standard AASB 2019-X *Amendments to Australian Accounting Standards – Fair Value Measurement of Non-cash-generating Assets of Not-for-Profit Public Sector Entities* under section 334 of the Corporations Act 2001.

Kris Peach

Chair – AASB

Dated … [date]

[Draft] Accounting Standard AASB 2019-X
Amendments to Australian Accounting Standards – Fair Value Measurement of Non-cash-generating Assets of Not-for-Profit Public Sector Entities

Objective

1 This Standard amends AASB 13 *Fair Value Measurement* (August 2015) to add authoritative implementation guidance for application by not-for-profit public sector entities.

Application

2 The amendments set out in this Standard apply to entities and financial statements in accordance with the application of AASB 13 as set out in AASB 1057 *Application of Australian Accounting Standards* (as amended).

3 This Standard applies to annual periods beginning on or after [1 July 2020]. This Standard may be applied to annual periods beginning before [1 July 2020]. When an entity applies this Standard to such an annual period, it shall disclose that fact.

4 This Standard uses underlining, striking out and other typographical material to identify some of the amendments to a Standard, in order to make the amendments more understandable. However, the amendments made by this Standard do not include that underlining, striking out or other typographical material. Amended paragraphs are shown with deleted text struck through and new text underlined. Ellipses (…) are used to help provide the context within which amendments are made and also to indicate text that is not amended.

Staff recommend that the amending standard should be effective for annual periods beginning on or after 1 July 2020, with early adoption to be permitted.

Question 1 to Board members

Do Board members agree with Staff's recommended effective date?

Amendments to AASB 13

5 Paragraphs Aus28.1 and Aus66.1 are added.

…

Application to non-financial assets

Highest and best use for non-financial assets

…

28 The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

(a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).

(b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).

(c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

Aus28.1 Notwithstanding paragraph 28(c), in respect of assets of not-for-profit public sector entities that are not held primarily for their ability to generate net cash inflows, a use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates sufficient services to justify a not-for-profit public sector market participant buyer incurring the current replacement cost of that asset.

…

Valuation techniques

…

Aus66.1 Notwithstanding paragraphs 61–66, in respect of not-for-profit public sector entities, the cost approach shall be used to estimate the fair value of assets that are not held primarily for their ability to generate net cash inflows.

6 Appendix F *Australian implementation guidance for not-for-profit public sector entities* is added as set out on pages X-X.

7 *Australian illustrative examples for not-for-profit public sector entities* is attached to accompany AASB 13 as set out on pages X-X.

Commencement of the legislative instrument

8 For legal purposes, this legislative instrument commences on … [date].

A2Paragraph 28(c) of AASB 13 refers to an asset's highest and best use generating an investment return that market participants would require from an investment in that asset. Staff recommend amending AASB 13, by including paragraph Aus28.1, to explain a financially feasible use as one that generates sufficient services to justify a not-for-profit public sector market participant buyer incurring the asset's current replacement cost. Staff's rationale for including paragraph Aus28.1 is included in BC25.

Question 2 to Board members

Do Board members agree with the drafting of paragraph Aus28.1?

At the April Board meeting, the Board decided to specify in AASB 13 that, for assets not held primarily for their ability to generate net cash inflows, the approach to determine their fair value should be current replacement cost. Therefore, Staff have drafted paragraph Aus66.1 to state this requirement.

The basis of conclusions related to the Board's decision made in April Board meeting are outlined in BC4–BC24.

Question 3 to Board members

Do Board members agree with the drafting of paragraph Aus66.1?

Appendix F [FOR AASB 13]
Australian implementation guidance for not-for-profit public sector entities

This appendix is an integral part of AASB 13 and has the same authority as other parts of the Standard. The appendix applies only to not-for-profit public sector entities.

Introduction

F1 AASB 13 *Fair Value Measurement* incorporates International Financial Reporting Standard IFRS 13 *Fair Value Measurement*, issued by the International Accounting Standards Board. Consequently, the text of AASB 13 is generally expressed from the perspective of for-profit entities in the private sector. The AASB has prepared this appendix to explain and illustrate the application of the principles of paragraphs 61 – 66 and Aus66.1 of the Standard by not-for-profit public sector entities, in relation to fair value measurement of non-financial assets. The appendix does not apply to for-profit entities or not-for-profit private sector entities, or affect their application of AASB 13.

F2 This appendix should be read in conjunction with the requirements of this Standard.

Fair value of non-financial assets

F3 Under paragraphs 61 – 66 and Aus66.1 of the [draft] Standard, for non-financial assets held by not-for-profit public sector entities:

(a) if an asset is held primarily for its ability to generate net cash inflows (ie it is a 'cash-generating asset'), its fair value is measured using whichever of the market approach, cost approach or income approach (or a combination of them) is the most appropriate in the circumstances. This is an unmodified requirement of AASB 13; and

(b) if an asset is not held primarily for its ability to generate net cash inflows (ie it is a 'non-cash-generating asset'), only the cost approach is used to estimate its fair value (ie the asset's fair value is measured at current replacement cost, applying the guidance in paragraphs B8 – B9 of AASB 13).

F4 Applying this proposed requirement in paragraph F3(b) to non-cash-generating assets would mean that, in the case of such an asset with a legally restricted use (eg land legally restricted for use as a cemetery, park or land under roads) or that is subject to legal restrictions on the prices that may be charged for using the asset, the asset's fair value should be measured as follows:

(a) if an equivalent restricted asset is obtainable in the marketplace, the asset's current replacement cost is equal to its market price based on observable market evidence (ie the fair value measurement of the asset under the cost approach would equal the amount that would be determined under the market approach described in paragraphs B5 – B7 of AASB 13); and

(b) if an equivalent restricted asset is not obtainable in the marketplace, the restricted asset's fair value is not measured at a discount to the current price of an equivalent but unrestricted asset.

F5 Under paragraph F4(b), the asset is measured at the price another not-for-profit public sector entity would be willing to pay to replace the asset in its current condition, 'stepping into the shoes' of the not-for-profit public sector entity holding (ie hypothetically selling) the asset. This price might exceed the amount a for-profit entity market participant buyer would be willing to pay for the asset, which would not exceed the price it would be prepared to invest to generate a commercial return from the asset.

F6 As referred to in paragraph F3(a), using the cost approach to measure the fair value of a non-financial asset is not limited to non-cash-generating assets of not-for-profit public sector entities. For example, the unmodified text of AASB 13 indicates that the fair value of specialised assets held primarily for their ability to generate net cash inflows in combination with other assets is often measured under the cost approach (AASB 13, paragraph B9).

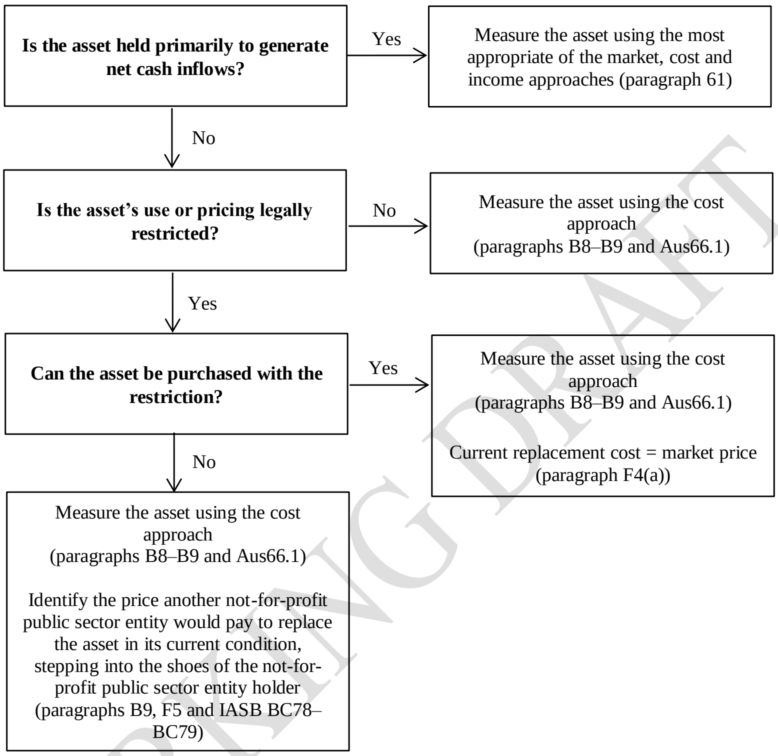
Staff have drafted paragraphs F3–F6 to provide authoritative guidance regarding assets with restrictions. The basis of conclusions related to the Board's decision made in April Board meeting are outlined in BC4–BC24.

Question 4 to Board members

Do Board members agree with the drafting of paragraphs F3–F6?

Valuation techniques

F7 The flowchart below summarises the principles in AASB 13 applied by not-for-profit public sector entities in determining the appropriate valuation technique to use when measuring the fair value of their non-financial assets.



Question 5 to Board members

Do Board members agree with the flowchart in paragraph F7?

Australian illustrative examples for not-for-profit public sector entities

These illustrative examples accompany, but are not part of, AASB 13. They illustrate aspects of the Australian guidance for not-for-profit public sector entities in AASB 13, but are not intended to provide interpretative guidance.

These examples illustrating aspects of the Australian guidance for not-for-profit public sector entities in AASB 13 complement, and have the same status as, the Illustrative Examples accompanying IFRS 13 Fair Value Measurement*, which are available on the AASB website to website users in Australia.*

IE1 The following examples portray hypothetical situations. They are intended to illustrate how a not-for-profit public sector entity might apply some of the requirements of AASB 13 *Fair Value Measurement* to particular types of assets, on the basis of the limited facts presented. Although some aspects of the examples might be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying AASB 13. The evaluations in each example are not intended to represent the only manner in which AASB 13 could be applied.

Valuation techniques – Assets held primarily for their service capacity rather than their ability to generate net cash inflows (paragraph Aus66.1)

IE2 Paragraph Aus66.1 states that, for not-for-profit public sector entities, the cost approach shall be used to estimate the fair value of assets that are not held primarily for their ability to generate net cash inflows (also termed 'non-cash-generating assets'). Example 1 illustrates the application of paragraph Aus66.1 and the elaboration of how to apply that principle set out in Appendix F (Australian implementation guidance).

Example 1 seeks to illustrate how the principles in paragraphs F3–F6 are applied. The basis of conclusions related to the Board's decision made in April Board meeting are outlined in BC4–BC24.

Question 6 to Board members

Do Board members agree with Example 1?

Example 1 – Assets held primarily for their service capacity
A local council (Council B) recently purchased a parcel of residential land for $30 million, which was rezoned as parkland. The local government does not have the power to rezone the land (that power resides with the State Government's Planning Minister). Land restricted for use as a park in a suitable location and with similar characteristics is not obtainable in the marketplace. At Council B's reporting date, there have been no changes in the market price of land in the area since the parkland was acquired, and the market value of a similarly sized parcel of adjacent residential land is $30 million. A restaurant was built on the parkland with the primary purpose of generating net cash inflows from lessees of the restaurant. In addition, barbecues, picnic facilities and a shelter were built on the parkland to provide services to park visitors (ie primarily not for their ability to generate net cash inflows). <u>Valuation techniques</u> Council B would measure the fair value of the parkland and the improvements on that land (excluding the restaurant) using the cost approach in AASB 13, in accordance with paragraph Aus66.1, because those assets are held primarily not for their ability to generate net cash inflows. Because land restricted for use as a park in a suitable location and with similar characteristics is not obtainable in the marketplace, the restricted parkland's fair value should not be measured at a discount to the current price of suitable unrestricted land that would be purchased in a replacement transaction. Based on the current market price of adjacent residential properties, the fair value of the parkland at the reporting date is estimated as $30 million. The fair value of the improvements on the parkland, other than the restaurant, is measured at the current replacement cost of the improvements. The restaurant's fair value is measured separately from that of the parkland, because it is held with the primary purpose of generating net cash inflows—that is, paragraph Aus 66.1 does not apply to it. Council B would use judgement in selecting an appropriate valuation technique under paragraphs 61 – 66 of AASB 13. Because the restaurant is capable of generating net cash inflows separately from the parkland, Council B concludes that either the income approach or the market approach would be appropriate to measure the fair value of the restaurant. Council B takes into account estimates under each of those approaches, maximising the use of relevant observable inputs to the fair value estimate (in accordance with paragraph 61 of AASB 13).

Highest and best use for non-financial assets

Legally permissible uses of an asset (paragraph 28(b))

IE3 Example 2 illustrates whether legal restrictions might be treated differently at a parent entity level (e.g. State Government level), compared with an individual entity (e.g. government department) level, when those restrictions were imposed by the parent entity.

Example 2 – Legal restrictions on the use of an asset treated differently at different levels within a group

At 30 June 20X0 (the reporting date), the Department of Infrastructure held a parcel of vacant land adjacent to an inner suburban railway station that its State Government has legally restricted for use as a parking lot pending a long-term decision on its best use. If the Department sold the parcel of land at the reporting date, the restriction over the land's restricted use would transfer to the market participant buyer. The State Government's Planning Minister can rescind the restriction through an administrative order (ie without parliamentary approval).

Treatment of the legal restriction at the level of the Department of Infrastructure

The Department of Infrastructure cannot rescind the legal restriction because the power of rescission vests in the Planning Minister. Therefore, the legal restriction would transfer to a market participant buyer of the parcel of land from the Department. Accordingly, the Department measures the fair value of the parcel of land as at 30 June 20X0 by taking the legal restriction into account in identifying the land's highest and best use, in accordance with paragraph 28(b) of AASB 13.

Valuation technique

The Department concludes that the restricted land is held primarily to generate net cash inflows because the State Government has privatised the delivery of commuter parking services. The Department also concludes that the income approach described in paragraphs B10 – B30 of AASB 13 is the most appropriate for measuring the fair value of the land, taking into account the best estimate of the present value of the parking fees the land will generate and the cost to a market participant buyer to convert the vacant land to a car park. Using this approach, the land's fair value is estimated at $2.8 million. This estimate is corroborated by observable market data for a nearby parking station operated by a private company. Therefore, the Department measures the land's fair value at $2.8 million.

Treatment of the legal restriction at the level of the State Government

The State Government can rescind the restriction without parliamentary approval because the power of rescission vests in the Planning Minister, who can rescind the restriction through an administrative order. Thus, the State Government has the unilateral capacity to remove the restriction and, consequently, the restriction is, in effect, self-imposed at the State Government level. Therefore, in preparing its whole-of-government consolidated financial statements for the year ending on 30 June 20X0, the State Government measures the parcel of land's fair value by not assuming that the restriction for use as a parking lot would definitely transfer to the market participant buyer in a hypothetical sale at the measurement date. The measurement of the asset's fair value reflects the present existence of the restriction but also the State Government's option to rescind the restriction. Therefore, the fair value measurement of the parcel of land by the State Government takes into account the effects of:

(a) the risk that the State Government is unable to rescind the restriction; and

(b) the current cost (if any) of rescinding the restriction, if it could be rescinded.

The State Government assesses that the risk of being unable to rescind the restriction is negligible in light of not being responsible for transport services, the present existence of alternative parking and the fact that the land is not yet providing a service to which community members have become accustomed. In addition, the current cost of rescinding the restriction is almost zero, because it would be effected through an administrative order.

Valuation technique

The State Government measures the fair value of the parcel of land on the basis of its highest and best use being for a shopping development, without any deduction for risk or cost of rescission. Using the market approach described in paragraphs B5 – B8 of AASB 13, the State Government measures the land's fair value at $4.0 million.

At the April Board meeting, the Board decided to include an illustrative example in AASB 13 to clarify that, if a government (parent entity) can rescind a law or regulation restricting the use (or pricing of the use of) an asset without parliamentary approval, the restriction should be treated as non-legally binding at the parent entity level. However, at the parent entity level, the asset's fair value should reflect the present existence of the restriction but also the parent's option to rescind the restriction.

The basis of conclusions related to the Board's decision made in April Board meeting are outlined in BC26–BC35. Staff have drafted Example 2 to reflect the Board's decision.

Question 7 to Board members

Do Board members agree with Example 2?

In the preparation of the whole-of-government financial statements as at 30 June 20X0, a consolidation adjustment of $1.2 million is made to remeasure the fair value of the parcel of land from $2.8 million to $4.0 million.

Cost approach (paragraphs B8–B9)

Nature of costs included in current replacement cost

IE4 Example 3 illustrates the costs included in the replacement cost of a non-financial asset when measuring its fair value using the cost approach.

Example 3 – Costs included in the current replacement cost of a road

Local Government A measures its roads at fair value using the cost approach set out in paragraphs B8 – B9 of AASB 13.

Year ending 30 June 20X0

As at 30 June 20X0, Local Government A controlled a new road in a new hilly housing estate to which the following costs[1] (measured using current prices[2]) relate. Local Government A assesses whether each of these costs should be included in the road's current replacement cost (before deducting obsolescence).

	Cost	Amount included under Views 1 and 3	Amount included under View 2
	$'000	*$'000*	*$'000*
Land	12,000	12,000	–
Design work	2,200	2,200	–
Earthworks	10,000	10,000	–
Formation	5,000	5,000	–
Pavement	3,000	3,000	3,000
Surfacing	2,000	2,000	2,000
Disruption of traffic (traffic control and detour costs)	1,000	1,000	1,000
Total	35,200	35,200	6,000

Accounting treatment

Local Government A concludes that each of these costs should be included in the road's current replacement cost, and measures the road's current replacement cost (before deducting obsolescence) as at 30 June 20X0 as $35,200,000. This is because the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility (as referred to in paragraph B9 of AASB 13 regarding application of the cost approach) would include each of those costs, including incidental disruption costs.

As noted in paragraph 12 of Agenda Paper 6.1, there are currently three views being debated with practitioners. Detailed explanation of these views have been included in BC36–BC43.

Example 3 seeks to illustrate the costs to be included in the CRC of a self-constructed asset if View 3 (Staff's view) was adopted. The majority of Panel members supported View 3.

If View 1 was adopted, the CRC would be $35,200,000 because all of the costs reflect conditions existing when the asset was initially constructed. The same measurement of CRC would occur as at 30 June 20X0 under View 3: note that this would not be the case as at 30 June 20X1 (see below).

If View 2 was adopted, the CRC would be $6 million because only the cost of the pavement, surfacing and disruption of traffic would be incurred in the future under actual conditions.

[1] In this example, it is assumed that the road's construction period is short, and therefore that the issue of whether borrowing costs should be included does not arise. Paragraphs BC57 – BC66 of the Basis for Conclusions discuss views regarding whether material borrowing costs should be included in the current replacement cost of an asset measured at fair value using the cost approach.

[2] These costs are not termed 'current replacement costs' here, because doing so would imply pre-empting the analysis of the issue addressed in this example, and would therefore be circular.

Example 3 – Costs included in the current replacement cost of a road
<u>Year ending 30 June 20X1</u> During the year ending 30 June 20X1, drainage works were installed under the road[3]. Consequently, as at 30 June 20X1, if the road were replaced, it would be necessary to incur additional current costs of $2,500,000 to repair damage to drainage works necessarily resulting from replacement of the road's components. For simplicity, it is assumed that none of the replacement costs as at 30 June 20X0 (listed above) changed during the year ending 30 June 20X1. *Accounting treatment* Local Government A concludes that the current cost of repairing damage to drainage works necessarily resulting from replacement of the road's components ($2,500,000) should be included in the road's current replacement cost (before deducting obsolescence) as at 30 June 20X1. This is because the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility would include that incidental disruption cost. Consequently, Local Government A measures the road's current replacement cost (before deducting obsolescence) as at 30 June 20X1 as $37,700,000. As at 30 June 20X0, Local Government A did not anticipate the additional current cost of $2,500,000 to repair damage to drainage works necessarily resulting from replacement of the road's components. This is because the operating environment of the road as at 30 June 20X0 did not require incurring that incidental disruption cost if the road were replaced as at that date.

For year ending 30 June 20X1, if View 1 were adopted, the cost of repairing incidental damage to drainage works would be excluded from the road's CRC because the drainage works did not exist when the road was initially constructed. Therefore, CRC would remain measured at $35,200,000. In contrast, under View 3, that fresh cost would be included in the road's CRC, for the reason explained in the example. Therefore, under View 3 the road's CRC would be remeasured to $37,700,000.

If View 2 were adopted, the cost of repairing incidental damage to drainage works would be included in the road's CRC because it is a cost that would be incurred in the future from actual replacements of components of the road. Therefore, the CRC would be remeasured to $8,500,000.

Question 8 for Board members

Do Board members agree with the Staff's recommendation to adopt View 3 – the CRC of a self-constructed asset should include estimates of current replacement cost on the assumption that the asset does not presently exist, and should reflect the conditions existing at the measurement date, including the costs of repairing damage to other facilities if those facilities exist at the measurement date?

Question 9 for Board members

Do Board members agree with Example 3, which reflect the Staff's recommendation to adopt View 3?

3 [*Note to Board members: a more realistic situation will be included in the next draft of this Exposure Draft*]

Economic obsolescence

IE5 Examples 4 and 5 illustrate when economic obsolescence of an asset held primarily to provide services should be identified, and how it should be measured, if the asset is measured at current replacement cost under the cost approach in paragraphs B8–B9 of AASB 13.

Example 4 – Assets with temporary overcapacity

A rural town's public school has a capacity for 500 students but, because of the local demographic changes, a school for 400 students would meet current requirements. The government expects that the demand for the school's services will increase to 500 students within the next three years as a result of a planned infrastructure project.

<u>Valuation of the school</u>

In accordance with paragraph Aus66.1 of AASB 13, because the school's non-financial assets (composed of its land, buildings and other facilities) are not held primarily for their ability to generate net cash inflows, the appropriate valuation technique to measure the fair value of the school's non-financial assets is the cost approach set out in paragraphs B8 – B9 of AASB 13.

<u>Economic obsolescence</u>

Under the cost approach, in measuring the current replacement cost of the school's non-financial assets, the school assesses whether economic obsolescence of those assets has arisen due to a decline in the market demand for the services those assets provide. The apparent but temporary excess capacity of the school would not be identified as giving rise to economic obsolescence because it is only temporary. The apparent excess capacity is in fact standby capacity forming part of the service capacity of the school's non-financial assets.

Example 5 – Assets with overcapacity that is highly unlikely to reverse

In this example, the facts of Example 4 apply, except that, due to demographic changes, a school for 100 students would meet current and reasonably foreseeable requirements (including a buffer for any underestimated student demand). There is only an insignificant chance that this reduction in needed capacity will reverse within the foreseeable future.

At the school's reporting date (30 June 20X0), the gross replacement cost of the school if its capacity for 500 students were replaced would be $16 million, composed of $10 million for the buildings and other facilities and $6 million for the land (for which the replacement cost equals its estimated market value). If a school for 100 students were to be built at the reporting date, the gross replacement cost of the building and other facilities would be $4.0 million and the replacement cost of the land would be $2.7 million[4].

The State Government has not made a formal decision to reduce the school's physical capacity.

<u>Valuation of the school</u>

For the same reasons as in Example 4, the appropriate valuation technique to measure the fair value of the school's non-financial assets is the cost approach.

<u>Economic obsolescence</u>

Under the cost approach, in measuring the current replacement cost of the school's non-financial assets, the school assesses whether economic obsolescence of those assets has arisen due to a decline in the market demand for the services those assets provide. The decline in the market demand for this school's services is an indicator of economic obsolescence because there is only an insignificant chance that the reduction in needed capacity (from 500 students to 100 students) will reverse within the foreseeable future. Therefore, the current replacement cost of the school should assume replacement of a school catering for 100 students

At the April Board meeting, the Board decided to include an illustrative example in AASB 13 to clarify that when measuring an asset's fair value at its current replacement cost, economic obsolescence should: (i) not be identified if the asset has apparent 'excess capacity' that is temporary or occurs cyclically; and (ii) not be limited to circumstances in which a formal decision has been made to reduce the asset's physical capacity.

The basis of conclusions related to the Board's decision made in April Board meeting are outlined in BC44–BC47. Staff have drafted Examples 4 and 5 to reflect the Board's decision.

Question 10 to Board members

Do Board members agree with Example 4?

Question 11 to Board members

Do Board members agree with Example 5?

4 The gross replacement cost of a school catering for 100 students exceeds one-fifth of the gross replacement cost of a school catering for 500 students. That is, a linear relationship between expected student enrolments and economic obsolescence does not exist because, to some extent, facilities will be needed regardless of the school's number of enrolments—for example, the administration office, cafeteria, and one or more toilet blocks, gymnasiums and car parks.

to reflect economic obsolescence, subject to the impact of any alternative uses that affect the school's capacity that would presently be replaced (see below).

Consideration of alternative uses

In measuring the school's economic obsolescence, consideration is given to whether some or all of the school's land, buildings and equipment that are surplus from a schooling perspective might have alternative community uses, reducing the amount of economic obsolescence that would otherwise be identified. Specifically, consideration is given to whether surplus capacity from a schooling perspective could be used for State Government-provided sporting and social services, namely, martial arts classes and computing classes.

The school concludes that alternative community uses of the school's surplus capacity for schooling would not affect the amount of the school's capacity that would be replaced in a hypothetical replacement transaction (ie if the school were deprived of its facilities, which is the assumption underpinning an assessment of the amount that a market participant buyer would be prepared to pay for the school). A decision to use the school's existing surplus capacity for other services or activities, now that the school already exists, does not necessarily indicate that those alternative uses warrant constructing schooling capacity to cater for those activities upon replacement of the school. In the circumstances of this particular school, it is concluded that it would be more economical to hire other premises to conduct those alternative State Government-provided activities than to construct surplus capacity from a schooling perspective. Therefore, the amount of the school's capacity that would be replaced upon deprival is limited to the amount needed for school student tuition.

Based on these conclusions, the school's current replacement cost as at 30 June 20X0 is estimated as $6.7 million.

Current replacement cost of land

IE6 Examples 6A and 6B illustrate how to measure the current replacement cost of land when measuring its fair value using the cost approach. Specifically, they illustrate whether the current replacement cost of land should be measured by assuming that the land is replaced in its current location.

Example 6A – Location of land: highest bidder can extract value unavailable to the reporting entity

Barton Hospital is a centrally located public hospital in a major city. The hospital is not held primarily for its ability to generate net cash inflows.

The hospital's land is not subject to any special zoning requirements or other legal restrictions. The hospital's services could be provided equally effectively in a nearby location where the land is 20% cheaper.

The highest and best use of the property is a hospital, because the highest bidder for the hospital (if the hospital's management sold the hospital) would be a for-profit entity that operates private hospitals. That for-profit entity bidder can extract value from the hospital site that is unavailable to Barton Hospital because, unlike Barton Hospital, it can use the location to generate higher returns than it could generate from a cheaper site.

The management of Barton Hospital considers how to measure the fair value of the hospital's land—in particular, whether the land's market value estimate should reflect the price of suitable land in a cheaper feasible site.

Valuation technique

Because the hospital is not held primarily for its ability to generate net cash inflows, in accordance with paragraph Aus66.1 of AASB 13, its fair value is measured at its current replacement cost.

The current replacement cost of the hospital's land is measured by reference to observable market prices of comparable land. Because the hospital's land is not subject to any special zoning requirements or other legal restrictions, in applying paragraph F4 of the Australian Implementation Guidance for Not-for-Profit Public Sector Entities there is no potential discount to apply to the observable market prices of adjoining or other comparable land.

The market value estimate of the hospital's land is an estimate of the price of the land in its current location, rather than the price of suitable land in a cheaper feasible site.

Example 6B – Location of land: highest bidder is another not-for-profit entity

The fact pattern is the same as in Example 6A, except that the highest bidder for the hospital would not be a for-profit entity (because a for-profit entity bidder could not extract value from the hospital site that is unavailable to Barton Hospital). Consequently, the highest bidder for the hospital (if the hospital's management sold the hospital) would be a market participant buyer that would continue to operate the hospital but would be unwilling to pay more for the hospital land than the market price of land in a suitable alternative site (ie at a 20% discount to the price of the land in the hospital's existing site).

The management of Barton Hospital considers how to measure the fair value of the hospital's land—in particular, whether the land's market value estimate should reflect the price of suitable land in a cheaper feasible site.

Valuation technique

Because the hospital is not held primarily for its ability to generate net cash inflows, in accordance with paragraph Aus66.1 of AASB 13, its fair value is measured at its current replacement cost.

Because the market participant buyer would be unwilling to pay more for the hospital land than the market price of land in a suitable alternative site, the market value estimate of the hospital's land is measured by reference to the price in that alternative location (ie at a 20% discount to the price of the land in the hospital's existing site).

Staff have drafted Examples 6A and 6B to address Issue 6: Whether the fair value of the land component of a non-cash-generating real property should always be measured in the land's present location, which is referred to in paragraph 14 of Agenda Paper 6.1 and discussed in paragraphs BC47–BC56.

Three views were identified:

View 1 – the fair value of real property should reflect the price of suitable property in a cheaper feasible location if it exists.

View 2 – (supported by the majority of Panel members) the fair value of real property should always reflect the property's current location.

View 3 (Staff's view) – it will depend on facts and circumstances whether the fair value of real property should reflect the property's current location. The answer will depend on the assumptions made by the market participant buyer regarding the location that would generate the highest returns, when there is a feasible alternative location for a property providing the same services.

Question 12 for Board members

Do Board members agree with Staff's recommendation to adopt View 3?

Question 13 for Board members

Do Board members agree with Examples 6A and 6B, which reflect the Staff's recommendation to adopt View 3?

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, AASB 2019-X Amendments to Australian Accounting Standards – Fair Value Measurement of Non-cash-generating Assets of Not-for-Profit Public Sector Entities.

Introduction

BC1 This Basis for Conclusions summarises the Australian Accounting Standards Board's considerations in reaching the conclusions in this Exposure Draft (ED). It sets out the reasons why the Board developed the ED, the approach taken to developing the ED and the key decisions made. In making decisions, individual Board members gave greater weight to some factors than to others.

Reasons for developing the Exposure Draft

Project History will be included in the next version of this draft Exposure Draft.

BC2 The Board has heard from some public sector stakeholders that there is diversity in practice in how the principles in AASB 13 *Fair Value Measurement* are applied in measuring the fair value of non-financial assets held by not-for-profit public sector entities. Many non-financial assets held by not-for-profit public sector entities are 'non-cash-generating', that is, they are held primarily for continuing use of their service capacity rather than for their ability to generate net cash inflows. Because AASB 13 is generally expressed from the perspective of for-profit entities in the private sector, there is a need for public-sector-specific guidance to assist not-for-profit public sector entities in identifying the appropriate valuation approach to determine the fair value of their non-financial assets, particularly non-cash-generating assets.

BC3 After considering input from its Fair Value Measurement Project Advisory Panel (the Panel), the Board decided to propose guidance to assist the application of the following principles:

(a) highest and best use (paragraphs 27–30), including consideration of the physical characteristics of an asset and legal restrictions imposed on the use of an asset;

(b) when to use the cost approach (paragraphs 61–Aus66.1), including clarifying that the fair value of non-cash-generating assets must be measured using the cost approach only; and

(c) the cost approach (paragraphs B8–B9), including the nature of component costs to include in an asset's current replacement cost, consideration of borrowing costs and other finance costs, trigger for economic obsolescence, and whether the current replacement cost of the land component of a non-cash-generating real property should always be measured in the land's present location.

Valuation techniques – Non-cash-generating assets (paragraph Aus66.1)

Paragraphs BC4–BC24 capture the Board's rationale in deciding to specify in AASB 13 that, for assets not held primarily for their ability to generate net cash inflows, the approach to determine their fair value should be current replacement cost (Issue 1).

BC4 Many assets held by not-for-profit public sector entities are non-cash-generating, and some of those assets have legal restrictions imposed on their use or the prices that can be charged for using them. Constituents have asked the Board to clarify how to apply the principle in paragraph 28(b) of AASB 13 that the highest and best use of a non-financial asset takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property). Paragraph IE29 of the Illustrative Examples accompanying IFRS 13 indicates that legal restrictions on the use of an asset that would not transfer to market participant buyers of the asset would not be taken into account in the asset's fair value measurement; however, the reverse is not always true. Legal restrictions on the use of an asset affect the identification of the highest and best use of the asset—and therefore its fair value—*if, and only if, market participants would take those legal restrictions into account when pricing the asset.* The Board has been informed that uncertainty and diverse interpretation have arisen regarding how to identify whether particular legal restrictions transferable to market participant buyers would affect pricing decisions made by those buyers.

BC5 Legal restrictions imposed on the use of an asset held by a not-for-profit public sector entity, or on the prices that can be charged for using that asset, might significantly reduce the price that a for-profit entity would currently be prepared to pay for the asset (compared with otherwise-identical unrestricted assets). A for-profit entity market participant buyer would be unwilling to pay more for an asset than the amount on which it can generate a commercial rate of return. For example, if land is acquired by a local government from private sector owners and immediately thereafter becomes legally restricted for use as a cemetery, park or land under roads, that restriction would typically prevent a market participant from generating a commercial return on the price paid immediately beforehand to the private sector vendors (for the unrestricted parcel of land). Many public sector commentators argue that, if the market approach or income approach were applied to measure the fair value of the newly restricted land, the resulting fair value measurement would be an amount significantly less than the amount paid to acquire the asset.

BC6 If restricted land in a suitable location and with similar characteristics was obtainable in the marketplace (impounding the discount resulting from the restriction):

(a) no market participant buyer would be willing to pay more than the price of that restricted land. As paragraph B9 of AASB 13 states: " … 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.";

(b) the market approach and income approach would be valid candidates for estimating the fair value of the not-for-profit public sector entity's existing restricted land under paragraphs 61 – 66 and B5 – B33 of AASB 13; and

(c) if a not-for-profit public sector entity (eg the local government referred to in paragraph BC5) paid a higher price to acquire unrestricted land immediately before the measurement date, that price would exceed the fair value of the restricted land (ie that entity would have made an uneconomic decision to acquire unrestricted land when suitable restricted land is available for a lower price).

BC7 However, restricted land in a suitable location and with similar characteristics to the asset being measured by a not-for-profit public sector entity often is unobtainable in the marketplace, because such land (and the buildings and other improvements on that land) are generally held by the not-for-profit public sector entity for continuing use of their service capacity rather than for sale. In such cases, a market participant buyer that is a not-for-profit public sector entity could not acquire the land for an amount impounding the discount resulting from the restriction. Such an entity might have no choice but to acquire unrestricted land that subsequently becomes subject to a legal restriction. Consequently, the legal restrictions would have no effect on the price that another not-for-profit public sector entity would currently be prepared to pay for the land.

BC8 Some of the Board's public sector constituents questioned whether the characteristics of the market participant buyer should be assumed to be similar to that of the entity holding the asset being measured at fair value under AASB 13. Accordingly, in the circumstances described in paragraph BC7, they argued it is unclear whether the market approach or income approach referred to in paragraph 62 of AASB 13 would be valid candidates for estimating the fair value of the not-for-profit public sector entity's existing restricted land.

BC9 Some commentators in the public sector have argued that, in the circumstances described in paragraph BC7, the market approach or income approach should be applied and the restricted land's fair value should be measured at a significant discount to the current price of comparable unrestricted land. Their reasons include that:

(a) the prices for unrestricted land reflect uses of the land, and rights to charge rentals for using the land, that are not permitted under the restriction. If the restricted land's fair value were measured without a discount to the current price of comparable unrestricted land, the measurement would lack comparability because it would depict different assets as having the same value;

(b) market participant buyers would be unwilling to pay more for the land than the amount on which they can generate a commercial rate of return (this argument reflects a view that only the pricing decisions of for-profit entity market participants should be taken into account);

(c) measuring the fair value of assets[5] at amounts exceeding the net cash inflows from their permitted use discounted at a commercial rate of return would not faithfully represent the assets' contribution to the entity's solvency; and

(d) this treatment has been widely adopted in a number of jurisdictions.

BC10 However, the Board is concerned that such a measurement of the restricted land's fair value would:

(a) in effect, measure the land at its scrap value. This would not represent faithfully the current market price of the land's service capacity. In addition, it would contradict the Board's conclusion, in making AASB 2016-4 *Amendments to Australian Accounting Standards – Recoverable Amount of Non-Cash-Generating Specialised Assets of Not-for-Profit Entities*, that the fair value of an asset not held primarily for its ability to generate net cash inflows (which typically is a specialised asset held for continuing use of its service capacity) is not its scrap value. The Board stated that this conclusion in AASB 2016-4 is "because an exit price reflects the sale of an asset to a market participant that has, or can obtain, the complementary assets … 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" (Basis for Conclusions on AASB 2016-4, paragraph BC15). In the context of this Exposure Draft, a market

5 Either on a stand-alone basis or as part of a group of interdependent assets, under the valuation premises outlined in paragraph 31 of AASB 13.

participant buyer stepping into the shoes of a not-for-profit public sector entity holding a non-cash-generating asset is another not-for-profit public sector entity that needs that asset to provide services to beneficiaries[6]; and

(b) if the restricted land had necessarily been acquired by purchasing unrestricted land, cause the imposition of the restriction to result in a heavy write-down of the asset's fair value. Such a write-down would represent unfaithfully that the land's service capacity has reduced significantly.

BC11 The Board considers that its concerns described in paragraph BC10 apply equally to restricted assets other than land. For example, if the fair value of restricted land were to be measured at a significant discount to the current price of comparable land, the fair value of buildings restricted for use as public schools or public hospitals should for consistency be measured at scrap values. This would result in statements of financial position of not-for-profit public sector entities representing unfaithfully that those entities essentially only possess financial assets.

BC12 For the reasons in paragraphs BC10 – BC11, the Board proposes requiring that, in respect of not-for-profit public sector entities, the cost approach shall be used to estimate the fair value of their non-cash-generating assets[7] (ie those assets' fair values would be measured at current replacement cost, applying the guidance in paragraphs B8 – B9 of AASB 13): see paragraph Aus66.1 of the [draft] Standard. Applying this proposed requirement would mean that, in the case of the restricted land described in paragraph BC5:

(a) if restricted land in a suitable location and with similar characteristics was obtainable in the marketplace (impounding the discount resulting from the restriction), the land's current replacement cost would equal its market price based on observable market evidence (ie the fair value measurement of the land under the cost approach would equal the amount that would be determined under the market approach described in paragraphs B5 – B7 of AASB 13); and

(b) if restricted land in a suitable location and with similar characteristics was not obtainable in the marketplace, the restricted land's fair value should not be measured at a discount to the current price of suitable unrestricted land.

BC13 Under the Board's proposal, the same principle would apply to all restricted non-cash-generating assets[8] held by not-for-profit public sector entities (eg their non-cash-generating buildings, plant and equipment). Measuring the fair value of a restricted non-cash-generating asset held by a not-for-profit public sector entity at the price another not-for-profit public sector entity would need to pay to acquire its service capacity is not constrained by a general lack of observable sale transactions of that nature. Paragraph BC30 of the IASB's Basis for Conclusions on IFRS 13 *Fair Value Measurement* states that the definition of fair value in AASB 13 (IFRS 13) assumes a hypothetical exchange transaction. Furthermore, under the contrary approach described in paragraph BC9, measuring the fair value of a restricted asset at a significant discount to the current price of comparable unrestricted assets often involves the use of unobservable inputs to determine the amount of the discount—that is, a hypothetical transaction is also assumed.

BC14 Other points made by the Board in response to the arguments for the contrary view in paragraph BC9 are that:

(a) the Board considers that (with reference to paragraph BC9(a)) its proposal would result in measurements of restricted assets that lack comparability only if the concept of fair value in AASB 13 was an asset's current cash equivalent (which is the amount of cash that can be obtained immediately from sale of an asset on a stand-alone basis). The Board observes that the concept of fair value in AASB 13 is not limited to an asset's current cash equivalent and considers that the concept of fair value in AASB 13 is consistent with measuring the current value of an asset in its highest and best use to any market participant—including the holder of the asset—and that restrictions might, but do not necessarily, affect that value for a not-for-profit public sector entity. Therefore, the Board considers

6 Paragraphs BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13 state that: "… for specialised non-financial assets that have a significant value when used together with other non-financial assets, for example in a production process, but have little value if sold for scrap to another market participant that does not have the complementary assets, … the scrap value for an individual asset would be irrelevant because the valuation premise assumes that the asset would be used in combination with other assets … . Therefore, an exit price reflects the sale of the asset to a market participant that has, or can obtain, the complementary assets … 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 the specialised asset. … When a market price does not capture the characteristics of the asset … 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." Although the IASB refers to the market participant buyer stepping into the shoes of an entity holding a *specialised* asset, the IASB's conclusion can logically be extended in a not-for-profit entity context to any assets (whether specialised or not) that contribute more to an entity when used together with other non-financial assets than their selling price to another market participant without the complementary assets. The market participant buyer stepping into the shoes of the not-for-profit public sector entity holding the non-cash-generating asset obtains value from that asset in the first instance by providing needed services to beneficiaries, but also obtains value through financial support [in the form of rates, taxes, grants and appropriations] and through any user charges.

7 Paragraphs BC19 – BC24 discuss in more detail the Board's consideration of how to delineate the assets to which this proposed requirement should apply.

8 By definition, this proposal applies to non-financial assets. Non-financial assets are not explicitly referred to in the subject matter of this proposal, because they are implicit in references to 'non-cash-generating assets'.

that adopting its proposal in paragraph BC12 would not cause a loss of comparability between fair value measurements of restricted and unrestricted assets;

(b) the Board disagrees with the implicit view in paragraph BC9(b) that only the pricing decisions of for-profit entity market participants should be taken into account when measuring a non-cash-generating asset of a not-for-profit public sector entity. It considers that the market participant buyer stepping into the shoes of that entity (see paragraph BC10(a)) would be another not-for-profit public sector entity if that entity would need to pay more for the non-cash-generating asset than the amount on which a market participant buyer could generate a commercial rate of return;

(c) with reference to the argument in paragraph BC9(c) that measuring the fair value of assets at amounts exceeding the net cash inflows from their permitted use discounted at a commercial rate of return would not faithfully represent the assets' contribution to the entity's solvency, the Board observes that:

(i) the concept of fair value in AASB 13 is not limited to an asset's current cash equivalent (see paragraph BC14(a));

(ii) if the non-cash-generating assets of not-for-profit public sector entities were to be measured at their current cash equivalents (with the aim of better depicting the assets' contribution to the entity's solvency), those assets would be measured at their scrap values and the entities' statements of financial position would represent unfaithfully that, in effect, those entities only hold financial assets; and

(iii) the solvency of any entity depends, in the first instance, on the entity's ability to generate net cash inflows from the goods and services it provides to customers or beneficiaries (either through exchange transactions or non-exchange transfers). In this regard, the solvency of a not-for-profit public sector entity depends in large part of the willingness and capacity of its financial contributors to continue supporting its operations (which depends on a range of factors, including, importantly, the entity's service performance); and

(d) with reference to the implication of paragraph BC9(d) that ceasing to measure the fair value of restricted land at a significant discount to the current price of comparable unrestricted land would result in a widespread change to current practice, the Board observes that measuring the fair value of other restricted assets at a significant discount to the current price of comparable assets (eg measuring the fair value of buildings restricted for use as public schools or public hospitals at scrap values) would also be a significant change to current practice.

BC15 The Board's proposal to modify AASB 13 to specify using the cost approach to measure the fair value of non-cash-generating assets for not-for-profit public sector entities is broadly consistent with the requirement in AASB 1059 *Service Concession Arrangements: Grantors* to use the cost approach to measure the fair value of a grantor's service concession assets (AASB 1059, paras. 7, 8, and 9(b)). This requirement reflected the AASB's view that, if the grantor in a service concession arrangement compensated the service concession operator for the service concession asset and service provision by granting the operator a right to earn third-party user tolls, the service capacity embodied in the grantor's service concession asset is unaffected by granting the operator a right to toll, because the asset provides the same utility to the public regardless of that grant. Unlike other approaches to measuring fair value, the cost approach (current replacement cost) results in the same measure of the fair value of a particular service concession asset regardless of whether the operator was granted a right to earn third party user tolls (AASB's Basis for Conclusions on AASB 1059, paragraphs BC50 – BC53 and BC62 – BC66).

BC16 As indicated in AASB 2016-4, non-cash-generating assets are not held primarily for their ability to generate net cash inflows, and typically are specialised assets held for continuing use of their service capacity. Because non-cash-generating assets are not necessarily specialised, and because it sometimes is debatable whether particular assets (such as restricted land) are specialised, the Board's proposed requirement for not-for-profit public sector entities to use the cost approach to measure the fair value of particular assets does not explicitly refer to specialised assets (see also the footnote to paragraph BC10(a)). The Board's proposal is delineated as applying to non-cash-generating assets, because the fact that these assets are not held primarily for their ability to generate net cash inflows is the key reason why their fair value should not be measured using the market approach or income approach where the resulting measures of fair value differ from the assets' current replacement cost.

BC17 The Board's proposal to require that, in respect of not-for-profit public sector entities, the cost approach shall be used to estimate the fair value of non-cash-generating assets would not preclude using observable market prices when they are materially the same as current replacement cost. For example, this could occur when:

(a) such assets are compulsorily acquired and the compensation arrangements are based on market value principles; or

(b) a restricted asset highly similar to that held by the entity was obtainable in the marketplace (impounding the discount resulting from the restriction).

BC18 The Board considers that it presently is not sufficiently clear under AASB 13 whether particular legal restrictions transferable to market participant buyers would affect pricing decisions made by buyers of non-cash-generating assets held by not-for-profit public sector entities, and particularly whether the characteristics of the market participant buyer should be assumed to be similar to that of the entity holding the asset. Therefore, the Board's proposal to require using the cost approach to measure the fair value of non-cash-generating assets of not-for-profit public sector entities, designed to reduce uncertainty and diversity in practice in how the principles in AASB 13 are applied:

(a) would not necessarily change practice for some of those entities; and

(b) does not indicate that entities applying a different approach to account for restrictions are departing from the existing requirements of AASB 13.

Boundary of the proposed requirement

BC19 Paragraphs BC20 – BC24 discuss the Board's considerations in identifying the boundary of its proposed requirement that the fair value of particular non-financial assets of not-for-profit public sector entities is to be estimated using the cost approach.

BC20 As mentioned in paragraph BC16, the Board's measurement proposal is delineated as applying to non-cash-generating assets, because the fact that these assets are not held primarily for their ability to generate net cash inflows is the key reason why their fair value should not be measured using the market approach or income approach where the resulting measures of fair value differ from the assets' current replacement cost. That is, the proposed measurement requirement is designed to avoid not-for-profit public sector entities measuring at scrap value their assets that are not held primarily for their ability to generate net cash inflows. In AASB 2016-4, assets not held primarily for their ability to generate net cash inflows were termed 'primarily non-cash-generating assets'. For brevity, 'non-cash-generating assets' is the phrase used in this Basis for Conclusions to refer to assets that are not held primarily for their ability to generate net cash inflows, although the longer phrase is used in the [draft] Amending Standard (the Board concluded it is unnecessary to use 'primarily' twice).

BC21 The Board tested that boundary firstly by considering whether the cost approach to measuring fair value should be mandated in respect of any cash-generating assets held for not-for-profit public sector entities, particularly if those assets are specialised and/or their uses (or the prices that may be charged for using them) are legally restricted. The Board:

(a) noted that AASB 13 already indicates, in effect, that the fair value of specialised assets held primarily for their ability to generate net cash inflows in combination with other assets is often measured under the cost approach (AASB 13, paragraph B9 and the IASB's Basis for Conclusions on IFRS 13, paragraphs BC78 – BC79), but does not mandate using the cost approach for all specialised assets; and

(b) considered that, if a specialised asset is held primarily for its ability to generate net cash inflows on a stand-alone basis, and is subject to a legal restriction, the asset's fair value would not exceed the price a market participant buyer would be prepared to invest to generate a commercial return from the asset. (Restrictions over assets that would transfer with the assets to market participant buyers generally result in those assets being specialised.) Therefore, if sales evidence of similarly restricted assets were unavailable but market prices were observable for similar but unrestricted assets, it would be appropriate to apply a discount to the market price of the comparable asset when measuring the fair value of the restricted asset. For example, assume that:

    (i) a not-for-profit public sector entity held a surplus building subject to heritage preservation requirements, to generate rental income and for capital appreciation;

    (ii) that entity originally acquired the building for service-delivery and administrative purposes because of its location and physical capacity: it is not required to retain the building for heritage purposes (the heritage preservation requirements simply transfer to any market participant buyer); and

    (iii) the heritage preservation requirements increased the building's maintenance costs and impeded changing the layout of its accommodation in response to tenants' needs, and therefore that under either the market approach or income approach, the building's fair value is estimated to be 10 per cent less than the observable market price of an adjacent unrestricted building that is otherwise identical.

    In that example, a for-profit entity market participant buyer would be unwilling to pay more for the heritage building than the price of the adjacent building minus a 10 per cent discount. Similarly, the not-for-profit public sector entity would be unwilling to pay more than that discounted price for the heritage building if it hypothetically were bidding for it, and (because of the nature of the asset) another not-for-profit public sector entity stepping into its shoes would be unwilling to pay more than that discounted price for the heritage building. It is unrealistic to expect that another market participant buyer would have a need for that specific heritage building and be willing to pay more than a for-profit entity market participant buyer if the reporting entity (ie the not-for-profit public sector entity holding the building) is not; and

(c) noted that the issues raised regarding how to measure the fair value of specialised and/or restricted assets generally relate to non-cash-generating assets.

BC22 For the reasons in paragraph BC21, the Board concluded that the cost approach to measuring fair value should not be mandated for cash-generating assets held for not-for-profit public sector entities, regardless of whether they are specialised and/or subject to legal restrictions.

BC23 The Board considered whether the boundary for its proposed requirement (namely, that the fair value of particular non-financial assets of not-for-profit public sector entities is to estimated using the cost approach) should be based on one or more of the factors to consider when selecting a measurement basis for assets, as identified by the International Public Sector Accounting Standards Board (IPSASB) in its Consultation Paper entitled *Measurement* (April 2019). Those factors identified by the IPSASB in that Consultation Paper (paragraph 1.5(b)) that are related to the nature and circumstances of the asset, and the Board's responses to them, are set out below:

(a) The asset was acquired in a non-exchange transaction – the Board concluded that this should not affect how to measure an asset's fair value as at a particular date, because market conditions affecting an asset at that date are independent of how the asset was acquired;

(b) The assets are held to provide services (non-cash-generating assets), to generate a commercial return (cash-generating assets) and/or for trading or sale – the Board noted that this distinction draws upon the distinction between 'cash-generating assets' and 'non-cash-generating assets' in IPSAS 26 *Impairment of Cash-Generating Assets* and IPSAS 21 *Impairment of Non-Cash-Generating Assets*.[9] IPSAS 21 defines 'cash-generating assets' as "assets held with the primary objective of generating a commercial return" and 'non-cash-generating assets' as "assets other than cash-generating assets". Under IPSAS 21, the value in use of a non-cash-generating asset is measured by reference to the asset's replacement cost or restoration cost (described as the present value of the asset's remaining service potential) instead of the present value of future cash flows expected from the asset. The substance of the definition of a 'non-cash-generating asset' in IPSAS 21 is similar to the substance of the term 'non-cash-generating assets' used in this Exposure Draft. The only noteworthy difference is that under this Exposure Draft's proposals, 'cash-generating-assets' are assets held primarily for their ability to generate net cash inflows; whereas, under IPSAS 21, those assets are held with the primary objective of generating a *commercial* return. Those notions are substantially the same. The Board decided to use the term 'non-cash-generating asset' with the meaning given to it in AASB 2016-4, particularly because both that Standard and this Exposure Draft are concerned with avoiding non-cash-generating assets being written down (inappropriately) to their scrap values. The Board will review the relationship between the meaning of 'cash-generating-assets' in IPSASs and Australian Accounting Standards as part of a broader future review of the similarities and differences between those suites of Standards;

(c) The assets are specialised, where they have been created or adapted for a particular purpose – the Board considers that the scope of its proposal for mandating use of the cost approach caters for specialised assets. The Board concluded that an asset's being specialised should not always be a determining factor for when the cost approach must be applied (see paragraphs BC21 – BC22); and

(d) There are restrictions on what the entity is able to do with the asset – the Board considers that the scope of its proposal for mandating use of the cost approach caters for restricted assets. The Board concluded that an asset's being restricted should not always be a determining factor for when the cost approach must be applied (see paragraphs BC21 – BC22).

BC24 The Board also considered the United Kingdom *Government Financial Reporting Manual 2019-20* in determining the boundary for its proposed requirement. The only category of property, plant and equipment that the Manual identifies as being measured at fair value using IFRS 13 *Fair Value Measurement* is a surplus asset (ie an asset not being used to deliver services, where there is no plan to bring the asset back into use) without any restrictions on sale and that falls within the scope of neither IAS 40 *Investment Property* nor IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations* (paragraph 7.1.8). The Manual specifies that when assets are held for their service potential (ie they are operational assets used to deliver either front line services or back office functions) and are specialised, their current value should be measured at the present value of the asset's remaining service potential, which can be assumed to be at least equal to the cost of replacing that service potential (paragraph 7.1.4). The Board observes that the boundary of its

9 In view of the potential overlap between 'cash-generating assets' and assets held for trading or sale, the Board did not consider referring explicitly to 'assets held for trading or sale' when describing the category/categories of assets for which fair value should not be required to be measured using the cost approach in AASB 13.

measurement proposal (ie non-cash-generating assets) is consistent with the reference in the United Kingdom *Government Financial Reporting Manual 2019-20* to assets held for their service potential.

Financially feasible use of an asset (paragraph Aus28.1)

BC25 The Board proposes the addition of guidance clarifying the meaning of a 'financially feasible' use of an asset (as described in paragraph 28(c) of AASB 13) in relation to non-cash-generating assets of not-for-profit public sector entities. Paragraph 28(c) of AASB 13 refers to an asset's highest and best use generating an investment return that market participants would require from an investment in that asset put to that use. Without a clarifying modification, paragraph 28(c) might nullify the Board's conclusion that the fair value of a non-cash-generating asset held by a not-for-profit public sector entity can exceed the amount on which a market participant buyer could generate a commercial rate of return (see paragraph BC14). Therefore, the Board proposes including paragraph Aus28.1 to explain a financially feasible use as one that generates sufficient services to justify a not-for-profit public sector market participant buyer incurring the asset's current replacement cost. The reference to an asset's current replacement cost is consistent with the proposed requirement in paragraph Aus66.1 that the fair value of non-cash-generating assets of not-for-profit public sector entities is measured using the cost approach.

Highest and best use for non-financial assets

Physically possible uses of an asset (paragraph 28(a))

BC26 Paragraph 28(a) of AASB 13 states that the highest and best use of a non-financial asset takes into account the use of the asset that is physically possible (ie the physical characteristics of the asset, such as its location and size, that market participants would take into account when pricing the asset). The Board was asked by constituents to clarify that some restrictions affecting the fair value of assets are physical rather than legal in nature. For example, those constituents noted that if an entity holds a parcel of land that has been used as a garbage tip, the risk of methane emissions might limit the land's potential uses (eg to only being suitable for conversion to parkland). They argued that using that land as a tip creates a physical restriction on that land affecting the highest and best use that market participants would take into account when pricing that land, regardless of any legal restrictions on the use of the land (ie zoning restrictions) or on the prices that can be charged for using that land. Legal restrictions are the subject of paragraph 28(b) of AASB 13.

BC27 The Board noted that using that land as a tip affects the physical characteristics of the land that market participants would take into account when pricing the land (ie would limit the use of the land that is physically possible, as referred to in paragraph 28(a) of AASB 13). Therefore, the Board concluded it is unnecessary to modify paragraph 28(a) of AASB 13 to also refer to 'physical restrictions'.

Legal restrictions on the use of an asset (paragraph 28(b))

BC28 The Board was asked by constituents to provide guidance clarifying whether, in applying paragraph 28(b) of AASB 13, legal restrictions might in some circumstances be treated differently at a parent entity level (e.g. State Government level), compared with an individual entity (e.g. government department) level, when those restrictions were imposed by the parent entity.

BC29 If a law or regulation imposes a restriction on the use of an asset held by a government department, and this restriction would transfer to any market participant buyer of the asset, paragraph 28(b) of AASB 13 states that the asset's highest and best use would take into account the restriction if market participant buyers would take it into account when pricing the asset. The Board considered whether the restriction should be treated as non-legally binding at the whole-of-government level if the government can rescind the law or regulation. This issue is unique to the public sector, because private sector entities cannot rescind laws.

BC30 The Board considered that, if a restriction had been imposed by a law that can only be rescinded by parliament (and has yet to be rescinded), the existing legal requirement should be treated as legally binding at the whole-of-government level in addition to being treated as legally binding for the controlled entity (reflecting that the government does not control parliament). In this regard, if a rescission of a restriction has been approved by one House of Parliament but requires approval by another House of Parliament, or requires Royal Assent, the restriction is treated as still requiring rescission by parliament (ie presently legally binding).

BC31 However, if the existing legal restriction can be rescinded without parliamentary approval, the Board concluded that the restriction should be treated as non-legally binding at the parent entity (e.g. whole-of-government) level, because:

(a) the parent entity has the unilateral capacity to remove the restriction; and, consequently,

(b) the restriction is in effect a self-imposed restriction (even if it was formalised in legislation or a regulation).

Paragraphs BC28–BC35 capture the Board's rationale in deciding to clarify that, if a government (parent entity) can rescind a law or regulation restricting the use (or pricing of the use of) an asset without parliamentary approval, the restriction should be treated as non-legally binding at the parent entity level (Issue 2).

BC32 That is, the measurement of the asset's fair value at the parent entity level should not assume that the restriction would definitely transfer to the market participant buyer in a hypothetical sale at the measurement date if it could be rescinded without parliamentary approval. The measurement of the asset's fair value should reflect the present existence of the restriction but also the parent's option to rescind the restriction. Therefore, the fair value measurement of the parent entity's asset should in principle include the estimated enhancement in value from rescinding the restriction, reduced by the effects of:

(a) the risk that the parent is unable to rescind the restriction. For example, if land is zoned as a park by government regulation and the government has the power to change that zoning (e.g. to allow the land to be used for a freeway extension) without parliamentary approval, it might face strong community opposition to that change in zoning; and

(b) the current cost (if any) of rescinding the restriction, if it could be rescinded. The Board considers that it is appropriate to deduct those costs in measuring the asset's fair value because those costs are analogous to costs of transporting an asset to its marketplace (which are deducted when determining an asset's fair value, in accordance with paragraph 26 of AASB 13).

BC33 The Board noted arguments that financial reporting should reflect laws currently effective or substantively enacted, regardless of the probability that particular laws will change in the future. Some commentators have argued that treating an existing legal restriction as non-legally binding at the parent entity level would be inconsistent with the treatment of sovereign powers in the IPSASB's *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities.* The IPSASB Conceptual Framework specifies that a government's sovereign power (ie its general ability to establish a power through a statute) only gives rise to an asset when the power is exercised and creates rights to receive resources (paragraph 5.13)[10]. The Board observed that:

(a) as advised to it by professional valuers in outreach activities, current valuation practice in estimating the fair value of land takes into account any material potential that the land will be rezoned for a higher and better use, with any estimated net enhancement reduced for the risk that such rezoning will not occur and the time value of the period until such rezoning is expected to occur (weighted for the different possible periods until rezoning occurs). This practice is consistent with the comments in paragraphs IE7 – IE8 of the IASB's Illustrative Examples accompanying IFRS 13 and paragraphs BC68 – BC69 of the IASB's Basis for Conclusions on IFRS 13 that potential changes in zoning restrictions that market participants would take into account when pricing a property should be considered in the property's fair value measurement unless the alternative use is legally prohibited; and

(b) anticipating rescission of a law or regulation when measuring an asset's fair value does not imply disagreement with the IPSASB's view about anticipating the exercise of a government's sovereign powers. The IPSASB's view about sovereign powers is concerned with the identification and recognition of assets and liabilities—not measurement.

BC34 In practice, the reliability with which the parent's option could be measured would largely depend on the ability to estimate the probability that the restriction could be rescinded. In some instances in which an existing legal restriction can be rescinded without parliamentary approval, the risk of being unable to rescind the restriction would be very low and could be ignored in the measurement of fair value, on materiality grounds. However, if there is a significant risk of being unable to rescind a restriction and the risk cannot be estimated reliably, the restriction should be wholly taken into account in the fair value measurement because rescission of a restriction should not be assumed if there is significant doubt that it will occur.

BC35 The Board noted that, if a restriction is considered to be legally binding only at a controlled entity level, different fair value measurements of the asset would be made at the controlled entity and group level, requiring a consolidation adjustment when preparing the consolidated financial statements for the group. The Board observed that precedent exists in Australian Accounting Standards for the need for consolidation adjustments in relation to the same asset. For example, paragraph 15 of AASB 140 *Investment Property* stipulates that, in some circumstances, a property that is investment property of a controlled entity is classified as owner-occupied property from the perspective of the group. Similarly, paragraph 6.3.5 of AASB 9 *Financial Instruments* states that hedge accounting applied at a controlled entity level for transactions between entities in the same group might not be appropriate in the consolidated financial statements of the group.

[10] The IPSASB Conceptual Framework also states that a government's sovereign power to make, amend or repeal legal provisions, which potentially allows governments to repudiate obligations to other entities, should not be taken into account in determining whether those obligations should be identified as liabilities of the government. That is, the IPSASB concluded that the existence of a liability should be identified by reference to the legal position existing at the reporting date (paragraphs 5.22 and BC5.35).

Paragraphs BC36–BC43 relate to Issue 4 – Nature of costs included in CRC. They have been drafted based on the assumption that the Board agrees with Staff's view and would be amended if the Board has a different view. As noted in paragraph 12 of Agenda Paper 6.1, there are currently three views being debated regarding which costs should be included in the CRC of a self-constructed asset.

Cost approach (paragraphs B8–B9)

Nature of costs included in current replacement cost

BC36 The Board was asked to clarify which costs should be included in the replacement cost of a self-constructed asset when measuring its fair value using the cost approach. (This issue excludes consideration of borrowing costs and other finance costs, which are discussed in paragraphs BC57 – BC66.)

BC37 Some commentators have argued that:

(a) an asset's current replacement cost should be estimated by assuming that the asset does not presently exist and needs to be replaced from scratch; and

(b) therefore, it is appropriate to base the estimates of current replacement cost on the conditions that existed when the asset was initially constructed. Therefore, they argue, it would be inappropriate to include in an asset's current replacement cost the costs of repairing damage to other facilities if those facilities did not exist when the asset was initially constructed.

View 1 – the CRC of a self-constructed asset should be estimated by assuming that the asset does not presently exist and needs to be replaced from scratch; and therefore should include estimates of current replacement cost on the conditions that existed when the asset was initially constructed. Costs of repairing damage to other facilities should not be included in the CRC if those facilities did not exist when the asset was initially constructed.

BC38 Other commentators argue that the replacement cost of a self-constructed asset should exclude any components of the asset that will not require replacement in the future because their service potential does not expire over time. For example, in relation to a self-constructed road, they argue an estimate of its current replacement cost should exclude the cost of land, design work, earthworks and formation costs because those components do not wear out or become otherwise obsolete, and therefore do not require replacement in the future.

View 2 – the CRC of a self-constructed should exclude any components of the asset that will not require replacement in the future because their service potential does not expire over time.

BC39 In relation to these arguments, the Board observed that:

(a) paragraphs B8 and B9 of AASB 13 state that the cost approach to measuring an asset's fair value reflects the amount that would be required currently to replace the asset's service capacity. From the perspective of the 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; and

(b) paragraph BC30 of the IASB's Basis for Conclusions on IFRS 13 *Fair Value Measurement* states that the definition of fair value in AASB 13 (IFRS 13) assumes a hypothetical exchange transaction. Therefore, the components of replacement cost included in an asset's fair value are not limited to *actual* replacement transactions expected to occur in the future.

View 3 [reflected in the draft "Board's view", ie Staff recommendation] – the CRC of a self-constructed asset should include estimates of current replacement cost on the assumption that the asset does not presently exist, and should reflect the conditions existing at the measurement date. It includes the costs of repairing damage to other facilities if those facilities exist at the measurement date.

Summary of Project Advisory Panel views

Majority of Panel members supported View 3. Some Panel members said AASB 13 does not require like-for-like replacement, instead it requires replacing the service potential; therefore, the CRC of an asset should focus on replacing an asset's service potential rather than its physical features.

For the reasons set out in BC39–BC43, Staff recommend the Board adopts View 3.

BC40 Therefore, the Board concluded that, in estimating the replacement cost of a self-constructed asset, it should be assumed that:

(a) the market participant buyer does not presently possess the asset and needs to acquire it from scratch. Because the definition of fair value in AASB 13 assumes a hypothetical exchange transaction, the components of replacement cost included in an asset's fair value are not limited to *actual* replacement transactions expected to occur in the future; and

(b) the hypothetical replacement of the asset occurs at the measurement date, reflecting the economic environment of the asset existing at that date. Therefore, it would be appropriate to include in an asset's current replacement cost the costs of repairing damage to other facilities if those facilities exist at the measurement date. In this regard, it is irrelevant whether those other facilities existed when the asset was initially constructed.

BC41 Some commentators contended it would be inappropriate to include the costs of repairing damage to other facilities in the current replacement cost of an asset because those repairs do not enhance the service capacity of the asset. The Board disagreed with that contention, because repairs to other assets necessarily incurred as a result of acquiring or constructing an asset would be included in the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility (as referred to in paragraph B9 of AASB 13). The Board considers that the costs of repairing damage to other facilities are similar to costs to install pollution abatement equipment in a production process in accordance with new legislation. Although the pollution abatement equipment is not expected to generate increased net cash inflows or services from using the asset, a market participant buyer would include the cost of that equipment in the price it would bid for the asset, because that cost is necessarily incurred to obtain access to the net cash inflows, or services, that the asset is expected to generate. It is implicit in using the cost approach to measure an asset's fair value that the market participant buyer would be prepared to pay each of the costs included in an asset's current replacement cost. In other words, if an asset's current replacement cost provides the best estimate of the asset's fair value (selling price), that conclusion indicates that a market participant buyer would be prepared to pay all of the costs included in an asset's current replacement cost.

BC42 Some commentators expressed concern that, if the costs of repairing damage to other facilities were included in the current replacement cost of an asset without having been incurred during the asset's initial construction, the asset's current replacement cost would increase simply because of a change in the asset's operating environment (ie without the entity having improved the asset). They argued that recognition of such an increase in the asset's fair value through comprehensive income would not faithfully represent the entity's performance. The Board observed that:

(a) this concern is similar to the contention discussed in paragraph BC41, but extended in relation to effects on comprehensive income. The Board disagrees with this concern for the same reason it disagreed with the contention in paragraph BC41: a market participant buyer would be willing to pay more for an asset due to the change in the asset's operating environment, despite the asset not having been improved, because that additional cost is necessarily incurred to obtain access to the net cash inflows, or services, that the asset is expected to generate; and

(b) measurement of an asset's fair value under AASB 13 is unaffected by the impacts of resulting remeasurement changes on an entity's comprehensive income.

BC43 The Board noted that the IPSASB Consultation Paper *Measurement* (April 2019) includes draft application guidance on replacement cost measurement stating that, regarding site preparation, "Work that may have been undertaken to prepare the actual site for occupation might not need to be carried out on an assumed equivalent site. An entity might therefore assume that the site being valued is level and serviced and ready for development" (paragraph D37). Arguably, this view is consistent with that outlined in paragraph BC38 and rejected by the Board in paragraph BC40(a). However, to the extent that replacement of an asset's service capacity would occur in a more efficient manner (e.g. by relocating a cutting through a hill to where the earth is more stable)—thus avoiding some costs incurred in the existing location of the asset—the statement that "Work that may have been undertaken to prepare the actual site for occupation might not need to be carried out on an assumed equivalent site" might be compatible with the Board's view in paragraph BC40(a). The Board considers that excluding some costs of acquiring or constructing the asset being measured at fair value would clearly be inconsistent with the principles of fair value in AASB 13, and noted that, in the IPSASB Consultation Paper, replacement cost is not proposed to be used as a measure of fair value.

Economic obsolescence

BC44 Paragraph B9 of AASB 13 states that obsolescence incorporated in an asset's current replacement cost includes 'external (economic) obsolescence'. Paragraph IE12(b) of IFRS 13 gives an example of economic obsolescence of a machine held for use as "conditions external to the condition of the machine such as a decline in the market demand for similar machines". An equivalent notion of economic obsolescence of an asset or facility held by a not-for-profit public sector entity is a decline in demand for the services provided by the asset or facility, such as a school. The Board was asked to provide guidance on when to identify economic obsolescence of assets measured at fair value using the cost approach, in light of uncertainty and diverse interpretations. In particular, the Board was asked to clarify whether an entity should identify economic obsolescence of a facility that has suffered a reduction in demand for its services before a formal decision has been made to reduce the facility's physical capacity, including a plan for when that decision will be implemented.

Paragraphs BC44–BC46 capture the Board's rationale in deciding to clarify that when measuring an asset's fair value at its current replacement cost, economic obsolescence should: (i) not be identified if the asset has apparent 'excess capacity' that is temporary or occurs cyclically; and (ii) not be limited to circumstances in which a formal decision has been made to reduce the asset's physical capacity (Issue 3).

BC45 Some commentators have argued that an entity should not identify economic obsolescence of a facility before a formal decision has been made to reduce the facility's physical capacity because, until then, it is highly unlikely to be clear whether—and to what extent—economic obsolescence exists. The Board noted that the primary consideration in assessing when to identify economic obsolescence is whether market participant buyers would deduct such an amount from the asset's replacement cost when pricing the asset. This consideration depends on the entity's circumstances, and is not dependent on whether a formal decision has been made to reduce the asset's physical capacity. In some instances, it might be clear that market participant buyers would deduct an amount for economic obsolescence when pricing an asset, even if a formal decision has not been made. Deferring inclusion of economic obsolescence in the measurement of the asset's current replacement cost until a formal decision is made would not result in a faithful representation of the adjustment for obsolescence required by paragraph B9 of AASB 13. In addition, such deferral would not result in the best estimate of the price that market participant buyers would pay for the asset, and therefore would be inconsistent with the requirement in paragraph 22 of AASB 13 to measure an asset's fair value using the assumptions that market participants would use when pricing the asset. The Board observed that its conclusion on this issue is consistent with the guidance on the measurement of replacement cost in the IPSASB's Conceptual Framework (paragraph 7.41 of which states that an asset's replacement cost reflects reductions in required service capacity, without mentioning a need to formally decide to reduce the asset's capacity).

BC46 The Board noted that part of the debate about when to identify economic obsolescence stemmed from perceptions that AASB 13 does not have regard to the temporary or cyclical nature of shortfalls in demand for services rendered by an asset when determining whether economic obsolescence exists. Therefore, the Board decided to clarify that economic obsolescence should not be identified for a facility with a current apparent overcapacity if there is more than an insignificant chance that future increases in the demand for its services will largely eliminate that overcapacity within the foreseeable future. Such an illusory overcapacity might be created to cater for expected increases in future demand for the facility's services. Increases in demand that eliminate an apparent, but illusory, overcapacity need not be long-term in nature. For example, a school in a mining town might presently appear to have overcapacity but require a higher service capacity than indicated by present enrolments, because its enrolments are cyclical due to booms and busts in mining activity. Such apparent overcapacity is similar to standby assets held by entities in either the for-profit or not-for-profit sector to cope with peaks in demand (eg electricity suppliers): such standby assets are not affected by economic obsolescence simply because they are presently inactive. The Board observed that this is consistent with the guidance in:

(a) the IPSASB Conceptual Framework, paragraph 7.41 of which states that the appropriate service potential included in measuring an asset's replacement cost "is that which the entity is capable of using or expects to use, having regard to the need to hold sufficient service capacity to deal with contingencies"; and

(b) the New Zealand Accounting Standard for Public Benefit Entities entitled PBE IPSAS 17 *Property, Plant and Equipment.* Paragraph AG21 of the Application Guidance included in PBE IPSAS 17[11] states that: "No obsolescence adjustment is made in respect of surplus capacity that, while rarely or never used, is necessary for stand-by or safety purposes."

Measuring the current replacement cost of real property forming part of a group of non-cash-generating assets

BC47 The issue relates to non-cash-generating real property held by a not-for-profit public sector entity and measured at current replacement cost by reference to observable market prices of comparable property. Examples of such real property are:

(a) land that is part of a facility such as a public school or public hospital; and

(b) a lessee's right of use asset to occupy an office premises.

BC48 The Board was asked to clarify whether the location of the real property being valued should necessarily be the property's current location. For example, if a facility or right to use an office premises could deliver its services equally well in a nearby location with cheaper property, should it be assumed that "the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility" (as referred to in paragraph B9 of AASB 13) reflects the price of the property in the cheaper location?

BC49 Some commentators have argued that the property's market value estimate should reflect the price of suitable property in a cheaper feasible location because paragraph B8 of AASB 13 describes the current replacement cost of an asset as "the amount that would be required currently to replace the service capacity of an asset". They argue that, if the facility or right to use office premises could deliver its services equally well in a nearby location with cheaper property, the service capacity of the entity's land or right to use office premises could be acquired by a market participant buyer at the price of property in the cheaper nearby location. In other words, they argue, applying the generally accepted principle that an asset's current replacement cost is measured on an optimised basis by reference to the price of a modern equivalent asset adjusted for differences in service capacity, the modern equivalent asset to refer to is nearby property in a cheaper location. The market value premium of property in its current location over a suitable alternative location is a commercial element superfluous to the entity's not-for-profit (service delivery) objectives. They note that their view is consistent with the following text of The Royal Institution of Chartered Surveyors' Guidance Note *Depreciated replacement cost method of valuation for financial reporting* (November 2018)[12]:

> "Although the ultimate objective of the DRC method is to produce a valuation of the actual property in its actual location, the initial stage of estimating the gross replacement cost should reflect the cost of a site suitable for a modern equivalent facility. While this may be a site of a similar size and in a similar location to the actual site, if the actual site is clearly one that a prudent buyer would no longer consider appropriate because it would be commercially wasteful or would be an inappropriate use of resources, the modern equivalent site is assumed to have the appropriate characteristics to deliver the required service potential. The fundamental principle is that the hypothetical buyer for a modern equivalent asset would purchase the least expensive site that would realistically be suitable and appropriate for its proposed operations and the envisaged modern equivalent facility. …" (paragraph 7.1)
>
> "… An example could be a hospital that was originally constructed in the centre of a city that might now be better situated in the suburbs because of changes in the transport infrastructure or in the migration of the population it served." (paragraph 7.2)

[11] That Application Guidance was created by the New Zealand Accounting Standards Board and is additional to the text of IPSAS 17.

[12] This Guidance Note is not explicitly identified as applying to fair value measurements, or non-fair value measurements, using depreciated replacement cost. However, paragraphs 2.1 and 2.2 of the Guidance Note refer to depreciated replacement cost being used in relation to the 'cost approach' to valuation, and to the market and income approaches as the other principal approaches to valuation, implying the Guidance Note would be relevant to fair value measurements (even if not exclusively).

BC47–BC56 relate to Issue 6 – Whether the fair value of the land component of a real property not held primarily to generate cash inflows should always be measured in the land's present location. They have been drafted based on the assumption that the Board agrees with Staff's view and would be amended if the Board has a different view.

As noted in paragraph 14 of Agenda Paper 6.1, two views were discussed by the Project Advisory Panel. The third view was added subsequently.

View 1 – Apply the principle that an asset's CRC is measured on an optimised basis by reference to the price of a modern equivalent asset adjusted for differences in service capacity. The property's market value estimate should reflect the price of suitable property in a cheaper feasible location if it exists.

BC50 The IPSASB proposed a similar view to that of The Royal Institution of Chartered Surveyors in its Consultation Paper *Measurement* (April 2019), stating that:

> "If there is no locational requirement for the asset, the asset's replacement cost may assume that the notional replacement will be situated on an alternative site which can provide the same service potential in a more cost effective way. However, the location of an asset may impact its replacement cost in situations where a social policy decision has been made requiring the asset to be located in a specific location." (paragraph D4)
>
> "For example, hospitals and schools will ideally be located within the communities they serve; and local authority offices will be easily accessible to all citizens. The land on which these schools, hospitals or offices are built might be in expensive inner-city sites or in town and city centers. Where a social policy decision has been made requiring the asset be located in a specific location, the replacement cost of the land is based on the current value of the existing site, rather than on cheaper land located further away from the communities they serve." (paragraph D5)

BC51 In contrast, some argue that the fair value of real property should always reflect the property's current location (rather than the price of land in a cheaper feasible site). This is because the land's characteristics include its location, and the price premium for the existing site (compared with a cheaper feasible site) could be realised through sale and reinvested in other assets used to provide services. For example, the Application Guidance included in the New Zealand Accounting Standard for Public Benefit Entities entitled PBE IPSAS 17 *Property, Plant and Equipment* states that:

> "If depreciated replacement cost is used to measure the fair value of property, plant and equipment: (a) The value of the land shall reflect the fair value of the land held, in terms of both its size and location; …" (paragraph AG2)
>
> "In instances where land is underutilised, the fair value of the land shall be determined by reference to the highest and best use of such land. For example, in a case where specialised facilities are located in a prime central business district site but the operation would be able to run from a smaller sized and/or less valuable alternative site offering the same service potential, the fair value of the land would be the market value of the entire central business district-located site." (paragraph AG9)

View 2 – the fair value of real property should always reflect the property's current location, for the reasons in para. BC51.

Summary of Project Advisory Panel views

Majority of Panel members supported View 2 and agreed that the land's market value (used to measure its fair value) should not reflect the price of land in a cheaper feasible site for the reasons in para. BC51. However, some Panel members noted that adopting View 2 could change practice in some jurisdictions.

BC52 The Board concluded that it will depend on the facts and circumstances whether the fair value of real property should reflect the property's current location when a cheaper alternative site exists. The Board considers that in making this assessment, the key principle to apply is that if land has improvements (eg facilities) on it, its fair value reflects the higher of the following:

(a) the price a market participant buyer would be prepared to pay to remove the improvements and then sell the property as a vacant site for an alternative use – reflecting the land's existing location; and

(b) the price a market participant buyer would be prepared to pay to replace the service capacity of the land and improvements in the most economical manner for the purpose of continuing to provide the same services as those currently provided using the property. The amount this market participant buyer would be prepared to pay for the land would be determined as follows:

   (i) if the property needs to remain in its present location due to legal restrictions or operational requirements, the land's current replacement cost should reflect the market price of land in that existing location[13]; and

   (ii) if the property does not need to remain in its present location, the land's current replacement cost should reflect the market price of land in a suitable cheaper alternative site (because the market participant buyer's alternative course of action to buying the property being measured would be to build a modern equivalent facility in that alternative cheaper site).

View 3 (Staff's view) – it will depend on facts and circumstances whether the fair value of real property should reflect the property's current location. The answer will depend on the assumptions made by the market participant buyer regarding the location that would generate the highest returns, when there is a feasible alternative location for a property providing the same services.

BC53 This key principle in paragraph BC52 reflects the following supporting principles:

(a) an asset's fair value can never be less than the price for which that asset could be sold at the measurement date (excluding transaction costs)—however, the unit of account for applying this principle might be a group of assets: see (b) below; and

(b) if real property is part of an interdependent group of assets for which the highest and best use is to be used (and therefore sold) as a group of assets, it is essential to use consistent assumptions about the highest and best use of each asset in that group of assets (consistent with paragraph 31(a) of AASB 13). For example, it would be inconsistent with paragraph 31(a)(iii) of AASB 13 to measure the fair value of land based on its sale for a use other than continued operation of its existing facilities, and measure the fair value of the buildings and other specialised improvements on that land at their current replacement cost (reflecting an assumption of their continued operation).

13 The Board's conclusion on this issue is consistent with the IPSASB's proposal in paragraph D4 of its Consultation Paper *Measurement* (quoted in paragraph BC50).

BC54 If a parcel of land has no improvements on it, its fair value should always be measured on the basis of its existing site, because there are no improvements that would be sacrificed in realising its market price.

BC55 In relation to the principle in paragraph BC53(a), although the asset is held by a not-for-profit public sector entity not primarily to generate net cash inflows, if a for-profit entity has a higher and better use for an asset than any not-for-profit public sector entity, the fair value of the asset will reflect the higher and better use for that for-profit entity.

BC56 For example, if a public hospital controlled by a Health Department is located in a prime inner city location and:

(a) there are no legal restrictions on the use of the land that would transfer to a market participant buyer;

(b) the hospital would not currently be built in that prime location by the hospital's management if it did not already exist; but

(c) a for-profit operator of private hospitals is willing to pay the premium for land reflected in the hospital's current location (because it can generate increased revenues in that location),

the fair value of the land should be estimated based on the existing site of the hospital. The for-profit entity has a higher and better use for the hospital in its current location because it can generate increased revenues in the private health system. Measuring the fair value of the land based on its existing location in this circumstance reflects that the service capacity of an asset (as referred to in paragraph B8 of AASB 13) can include the asset's capacity to be sold for a price exceeding the price of land in a needed location and reinvested in other facilities rendering services.

This issue has been discussed with the Board's Project Advisory Panel, but was not deliberated by the Board in April. The Board's "observations" and "conclusions" in the draft discussion of this issue reflect the staff's recommendations, for the Board's comment at the June meeting.

Borrowing costs and other finance costs

BC57 The Board was asked to provide guidance to not-for-profit public sector entities on whether they should include borrowing costs in the fair value of a self-constructed asset measured at current replacement cost under the cost approach (eg whether the current replacement cost of a self-constructed freeway should include borrowing costs incurred during construction). This issue relates to all self-constructed assets of such entities measured at current replacement cost, regardless of whether that the cost approach to measuring fair value is adopted in accordance with paragraph Aus66.1 of AASB 13 or in applying paragraphs B8 – B9 of AASB 13 to specialised cash-generating assets. The issue raised is distinct from the question of whether not-for-profit public sector entities should capitalise borrowing costs into the cost of qualifying self-constructed assets, which is addressed in AASB 123 *Borrowing Costs*.

This wording reflects the staff's recommendation regarding whether the Board should mandate a particular treatment of borrowing costs when measuring current replacement cost.

Question 14 to Board members

Do Board members agree with the staff's recommendation? If so, do Board members agree that an Illustrative Example should not be provided in the Exposure Draft?

BC58 The Board observed that the treatment of borrowing costs and other finance costs when measuring the current replacement cost of a self-constructed asset is not specific to not-for-profit entities in the public or private sector. It concluded that, in light of AASB 13 not specifying the treatment of those costs for fair value measurements by for-profit entities, it would be inappropriate to mandate a particular treatment for not-for-profit public sector entities applying AASB 13.[14]

BC59 Nevertheless, the Board decided to note some views and key arguments regarding this issue expressed by commentators in relation to not-for-profit public sector entities, to assist entities in reaching their own conclusions on this issue after consulting, where appropriate, with their professional valuers.

Question 15 to Board members

Do Board members agree with noting these views and arguments if the Board does not state a conclusion on the issue?

View 1

BC60 Some commentators argue that a not-for-profit public sector entity should be required to exclude borrowing costs from the current replacement cost of a self-constructed asset if that entity elects, under paragraph Aus8.1 of AASB 123 *Borrowing Costs*, not to capitalise borrowing costs into the cost of qualifying assets. This is because:

(a) under Government Finance Statistics, borrowing costs are not capitalised into the cost of qualifying assets—it would be inconsistent and confusing to their financial statement users for public sector entities to adopt different policies for borrowing costs on initial recognition and in subsequent revaluations;

(b) current replacement cost is, in principle, a current measure of the costs included in the measurement of an asset on initial acquisition. Therefore, the treatment of borrowing costs should be the same when measuring the asset's historical cost (on initial recognition) and current replacement cost (on revaluation);

(c) some not-for-profit public sector entities self-construct assets using their own funds, in which cases it would be inappropriate to attribute borrowing costs to the current replacement cost of those assets; and

(d) due to the complexity of funding arrangements in the public sector, identifying borrowing costs attributable to particular self-constructed assets is complex, time-consuming and potentially unreliable. These practical problems were acknowledged by the Board when it provided not-for-profit public sector entities the option not to capitalise borrowing costs into the cost of qualifying assets, under paragraph Aus8.1 of AASB 123.

BC61 The IPSASB's Consultation Paper *Measurement* (April 2019) proposes that all borrowing costs should be expensed rather than capitalised, with no exception for borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset (paragraph 3.28). Similarly[15] to View 1, the IPSASB's Consultation Paper also proposes that in determining an asset's replacement cost, it is assumed that all construction occurs 'instantly' and, consequently, no financing costs are to be included in the valuation (paragraph D38). The Royal Institution of Chartered Surveyors' Guidance Note *Depreciated replacement cost method of valuation for financial reporting* (November 2018) states that:

> "In assessing the cost of the replacement asset, due account should be taken of all the costs that would be incurred by a potential buyer on the valuation date unless there is application direction to the contrary, such as the instant build (or 'overnight') concept as prescribed for much of the UK

[14] The AASB has provided guidance on the treatment of borrowing costs when measuring an asset's current replacement cost, in paragraphs IE8 and IE17-IE21 of the Illustrative Examples in AASB 1059 *Service Concession Arrangements: Grantors*. However, this guidance applies to a much narrower range of entities than AASB 13 and does not give rise to a risk of inadvertent or inappropriate use of additional guidance by publicly accountable for-profit entities that may result in non-IFRS compliance (in the context of the AASB's Not-for-Profit Entity Standard-Setting Framework, May 2018, paragraph 32(c)).

[15] It should be borne in mind that the IPSASB Consultation Paper proposes measuring replacement cost as an entity-specific current value (paragraph D25), in contrast with the concept of fair value in AASB 13 (which measures current value from the perspective of market participants).

public sector. Examples of costs that may be expected to be incurred in replacing the asset include … finance costs, taking into account the likely pattern of payment." (paragraph 6.3)

View 2

BC62 Others argue that borrowing costs should always be included in the current replacement cost of a self-constructed asset held by a not-for-profit public sector entity. This is because:

(a) market participant sellers of an asset constructed over a period of time would demand a return on the capital tied up in that asset during the construction period (in other words, borrowing costs are simply another cost of the asset on which a return would be sought). Market participant buyers would be prepared to compensate the seller for those borrowing costs, because they would need to incur those costs if they (instead of the entity) self-constructed the asset. Evidence of this market participant behaviour is found with the renegotiation of construction contract prices due to delays in completion that give rise to additional financing costs. Therefore, it is necessary to include borrowing costs in the measurement of current replacement cost if that measure is to faithfully represent the price that would be received to sell the asset at the measurement date;

(b) the accounting policy choice for borrowing costs made by an entity under AASB 123 is irrelevant to how those costs should be treated when measuring a self-constructed asset's fair value. The price that market participant buyers would pay for an asset is unaffected by accounting policies adopted in respect of that asset. The recognition of costs and the measurement of current value are fundamentally different processes. Therefore, there should be no presumption that the treatment of borrowing costs should be consistent for both;

(c) current replacement cost is not merely the asset's recognised acquisition cost updated for changes in the prices of the inputs to that cost, because current replacement cost is used to estimate the price that would be received to sell the asset at the measurement date. Therefore, an asset's current replacement cost should include all current costs that the vendor would seek to recover, regardless of whether each type of cost was included in the measurement of the asset's historical cost; and

(d) regarding the complexity of funding arrangements in the public sector, some argue that (unlike with applying AASB 123 to capitalise borrowing costs into the cost of a qualifying asset) it is unnecessary to identify borrowings directly attributable to the construction of the qualifying asset. This is because:

(i) costs included in the current replacement cost of an asset (as a measure of fair value) are those that would currently be incurred by a typical market participant. Therefore, it is unnecessary to 'look through' centralised borrowing arrangements in the public sector jurisdiction to attribute borrowings to a particular not-for-profit public sector entity during the period while it self-constructs an asset. Instead, the entity needs to identify the period of financing of construction activity, and the pattern of drawdowns of finance, for a typical market participant—which might not necessarily be a not-for-profit public sector entity; and

(ii) market participant sellers of an asset constructed over a period of time would demand a return on all the capital tied up in that asset during the construction period. Therefore, to the extent that construction is not financed by borrowings, a return on equity capital tied up in the asset's construction would be sought by the market participant seller; a market participant buyer should be willing to pay for that opportunity cost of finance as well[16]. A practical step for not-for-profit public sector entities would be to assume that the construction project is entirely funded by borrowings and apply the entity's own borrowing rate[17] for the period of financing during construction (notwithstanding that, in principle, the entity's own borrowing rate should not be used in preference to the rate demanded by, and paid to, a typical market participant).

BC63 The AASB has indicated that borrowing costs should be included in the current replacement cost of a non-financial asset held by a public sector grantor in a service concession arrangement:

> Paragraphs IE8 and IE17-IE21 of the Illustrative Examples in AASB 1059 *Service Concession Arrangements: Grantors* indicate that the current replacement cost of a public sector grantor's self-constructed asset includes borrowing costs incurred during the construction period, notwithstanding that the entity's accounting policy is to expense borrowing costs. Specifically, paragraph IE8 states that the current replacement cost of a self-constructed road includes "implied funding costs due to the extended construction period". Table 6.2 under paragraph IE21 states that the asset is revalued to include the funding cost in measuring the service concession asset at current replacement cost in year 2, since the grantor's accounting policy is to expense borrowing costs.

Summary of Project Advisory Panel views

Members of the Board's Fair Value Measurement Project Advisory Panel discussed Views 1 and 2 on this issue without expressing a strong consensus either way. Their arguments are reflected in the discussion of those views. The consensus of the Panel was that guidance should be provided by the Board on this issue.

16 This view is supported by the reference to finance costs and entrepreneurial profit in paragraph 70.11 of International Valuation Standard IVS 500 *Valuation Approaches and Methods*, quoted in paragraph BC65.

17 Or, where that rate is unknown, the government's borrowing rate.

BC64 Some commentators argue that the position in AASB 1059 would also be appropriate for not-for-profit public sector entities in measuring the current replacement cost of any self-constructed assets.

BC65 The International Valuation Standards Committee (IVSC) has indicated that consideration should be given to including borrowing costs and equity costs in the fair value of property, plant and equipment. International Valuation Standard IVS 500 *Valuation Approaches and Methods* includes:

> "The cost elements *may* differ depending on the type of the asset and should include the direct and indirect costs that would be required to replace/recreate the asset as of the valuation date. Some common items to consider include: (a) direct costs … (b) indirect costs: … 7. finance costs (eg, interest on debt financing), and 8. profit margin/entrepreneurial profit to the creator of the asset (eg, return to investors)." (paragraph 70.11)

BC66 In outreach activities, professional valuers have advised that practice is mixed regarding whether borrowing costs are included in valuations of the current replacement cost of self-constructed assets held by not-for-profit public sector entities.