Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Fair Value Measurement for Public Sector Entities**	**Meeting:**	AASB April 2019 (M170)
Topic:	**Progress Update and Items for Discussion**	**Date:**	16 April 2019
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		Project Priority:	Medium
		Decision-Making:	Medium
		Project Status:	Form tentative views on issues discussed

Objectives of this paper

1. The objectives of this paper are:

- for the Board to **decide**, in relation to three practice issues experienced by public sector entities in applying AASB 13 *Fair Value Measurement* (see Appendix B):
  - o whether public-sector-specific guidance should be added to AASB 13; and, if so,
  - o the principles to be set out in that guidance;
- for the Board to **decide** on the next steps; and
- in regard to both of these decisions, to provide Board members an overview of progress made to date on the Fair Value Measurement for Public Sector Entities project.

Reasons for bringing this paper to the Board at this meeting

2. Public sector constituents have requested that the Board provides guidance on how the requirements in AASB 13 would be applied to the fair value measurement of public sector entities' assets. Through consultation with the Fair Value Measurement Project Advisory Panel (the Panel), eight specific topic areas have been identified to date on which clarifying guidance is sought by the Board's constituents (see paragraph 8 below and Appendix A for details of the eight topics).

3. At its December 2017 Board meeting, the Board instructed Staff to commence work on the Fair Value Measurement for Public Sector Entities project (the Project) to address

these eight areas of practice issues. However, shortly after the Panel's meeting held on 16 May 2018, the Project was paused because the Board directed Staff to prioritise other projects.

4. Staff have recently resumed the Project and have commenced discussions with the Panel. In this meeting, Staff ask the Board to:

- consider the views expressed by the Panel on three issues related to four topic areas previously identified by the Panel (see Appendix B);
- consider and make decisions about Staff recommendations regarding these issues (see Appendix B); and
- decide on the next steps required to progress the issues identified in the project plan.

5. Staff also request Board members to consider and provide views on the proposed project timeline outlined in paragraph 14 below.

Structure

6. This paper is structured as follows:

   (a) Background;

   (b) Summary of Staff recommendations;

   (c) Proposed project timeline;

   (d) Appendix A: Overview of progress made to date;

   (e) Appendix B: Proposed issues to be addressed in public-sector-specific guidance; and

   (f) Appendix C: Summary of IPSASB's proposed principles of 'Replacement Cost' (for the Board's reference).

Background

7. At Panel meetings in November 2017 and May 2018, a majority of Panel members agreed that no modifications of the requirements of IFRS 13 (as incorporated in AASB 13) are needed to address the public sector issues arising on application of AASB 13. However, they also agreed to request the Board to develop public-sector-specific guidance in the form of illustrative examples in an appendix forming part of AASB 13 (along the lines of the not-for-profit entity-specific guidance in an appendix forming part of AASB 10 *Consolidated Financial Statements*).

8. The eight specific topic areas that were identified by the Panel as needing public-sector-specific guidance, and agreed by the Board to be included in this Project, are:

- Topic 1 – Restrictions on assets;
- Topic 2 – "Highest and best use" concept;
- Topic 3 – When to use the different valuation approaches;
- Topic 4 – Implementation guidance for current replacement cost (CRC);
- Topic 5 – Obsolescence;
- Topic 6 – Disclosure relief;
- Topic 7 – Interaction of AASB 13 with other Standards; and
- Topic 8 – Repurchased internally generated intangible assets.

Appendix A contains an overview of the progress made to date in addressing these topics.

9. After the above-mentioned project hiatus in 2018, in recent weeks Staff have resumed work in addressing the following proposed issues to be addressed in the possible public-sector-specific guidance:

- Issue 1: Appropriate valuation approach – specialised assets and assets with restrictions (relates to Topic 1, Topic 2 and Topic 3);
- Issue 2: Treatment of restrictions at different levels of a consolidated entity (relates to Topic 1); and
- Issue 3: Obsolescence –Trigger for economic obsolescence (relates to Topic 5).

Staff have held discussions with the Panel about these issues (the most recent Panel meeting was held on 10 April 2019) and mixed views were expressed by Panel members. Appendix B presents all of the significant alternative views expressed by Panel members on the issues, for the Board's consideration. Staff ask the Board to consider Staff's recommendations and decide the next steps required to progress these issues.

Scope of additional guidance

10. Since this project incepted, its scope has encompassed public sector entities, because many of the more difficult issues regarding the application of AASB 13 are encountered in the public sector. However, in Issue 1 (regarding restrictions on the use of assets), Staff's analysis has focused on assets of not-for-profit entities that are not held primarily for their ability to generate net cash inflows. This focus is consistent with the Board's analysis of measurement issues in its recent projects on 'Recoverable Amount of Non-Cash-Generating Specialised Assets of Not-for-Profit Entities' and 'Service Concession Arrangements: Grantors' (see paragraphs 19 – 20 and 26 of Appendix B). Staff think the rationale for their recommendations applies equally to private sector not-for-profit entities and to public sector not-for-profit entities. Staff think further that private sector not-for-profit entities should not be excluded from applying application guidance emanating from this project, and therefore recommend including them in the scope of this project. However, the project's primary focus can remain on

public sector entities, because many of the implementation issues addressed in this project arise wholly, or mainly, in the public sector.

11. Staff also think the Board does not need to decide at this stage whether public sector for-profit entities should be within the scope of the project—such a decision can be made later, after the nature of the Board's proposed guidance takes shape.

Acknowledgements

12. AASB Staff and the Panel have been assisted considerably by extensive background research performed by Panel member David Edgerton and staff of the Queensland Audit Office. Some of that work is reflected in the agenda papers for this Board meeting; the remainder will form input to the development of future Panel meeting papers and Board agenda papers.

Summary of Staff recommendations

13. Staff recommend the following:

    (a) Including private sector not-for-profit entities in the scope of this project (see paragraph 10 above);

    (b) Providing public sector guidance on Issues 1 – 3 in Appendix B, in the form of illustrative examples supporting (and included within) AASB 13;

    (c) re Issue 1—Specialised assets and assets with restrictions:

        (i) in respect of Example 1 in Appendix B, concluding that the cemetery land's fair value should be measured using the cost approach (ie at its current replacement cost). The land's current replacement cost should be determined as the price of the comparable land that would need to be purchased to replace the cemetery land (which, in Example 1, is the market price of the adjoining residential land); and

        (ii) the AASB develops a proposal to modify AASB 13 to specify that, where assets of not-for-profit public sector entities are not held primarily for their ability to generate net cash inflows, their fair value should be determined as their current replacement cost;

    (d) re Issue 2—Treatment of restrictions at different levels of a consolidated entity:

        (i) If a law or regulation imposes a restriction on the use of an asset held by a controlled entity (eg government department), and this restriction would transfer to any market participant buyer of the asset, *but* the restriction can be rescinded at the parent entity level without parliamentary approval, concluding that, in the financial statements for the whole-of-government:

(A) the measurement of the asset's fair value should not assume that the restriction would definitely transfer to the market participant buyer in a hypothetical sale at the measurement date;

(B) specifically, the asset's highest and best use should reflect the present existence of the restriction but also the government's option to rescind the restriction (adjusted for the risk of being unable to rescind the restriction); and

(C) this treatment should be adopted at the consolidated entity level even though, in the financial statements of the controlled entity, the measurement of the asset's fair value should assume that the restriction would definitely transfer to the market participant buyer in a hypothetical sale at the measurement date. That is, at the controlled entity level, 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, requiring a consolidation adjustment at the whole-of-government level; and

(e) re Issue 3—Trigger for economic obsolescence:

(i) In respect of Example 2 in Appendix B, provide guidance that:

(A) if a current apparent 'overcapacity' of a school exists but future increases in student enrolments are expected to largely eliminate that 'overcapacity' within the foreseeable future (ie the 'overcapacity' is temporary or occurs cyclically–eg enrolments are cyclical due to booms and busts in mining activity), economic obsolescence should not be identified for that school; and

(B) economic obsolescence of the school should be identified as soon as there is evidence of a decline in the market demand for the school's services for the reasonably foreseeable future, if there is only an insignificant chance that the decline in demand will reverse. Accordingly, the guidance should reject the view that economic obsolescence of a school or similar community facility should not be identified until a formal decision has been made to reduce the physical capacity of the school/facility, including a plan for when that decision will be implemented.

The questions for Board members regarding the recommendations in (b) – (e) above are set out in Appendix B. These will be discussed in the Board meeting before discussing Questions 1 and 2 beneath the proposed project timeline.

Proposed project timeline

14. The following table contains a proposed project timeline for the Board's consideration and comment. The milestones and timeline will periodically be reviewed and updated to ensure the project path remains appropriate and the project can be adequately resourced.

Meeting / Deliverable	Project Milestones
30 April 2019: Board meeting	Seek the Board's direction on the following three issues of the eight specific topic areas agreed by the Board: • Issue 1: Appropriate valuation approach – specialised assets and assets with restrictions – Cemetery Land Example (relates to Topic 1, Topic 2 and Topic 3); • Issue 2: Treatment of legal restrictions at different levels of a consolidated entity (relates to Topic 1); and • Issue 3: Obsolescence – Trigger for economic obsolescence – School Example (relates to Topic 5).
1–30 May 2019	Analyse issues on fair value measurement of lessees' right-of-use (ROU) assets. Depending on the Board's decisions in its April 2019 meeting, Staff to commence drafting ED with proposed illustrative examples and (if applicable) amendments to AASB 13 in addressing the first three issues.
14 June 2019: Board meeting	Present analysis of fair value measurement issue regarding ROU assets for the Board to determine whether the guidance should be provided in the form of illustrative examples or whether FAQs would suffice. Provide a draft timeline for the due process required to amend AASB 13 by including illustrative examples for ROU assets (if the Board proceeds with this option). Depending on the Board's decisions in its April 2019 meeting, Staff are to present a working draft ED for Board consideration in addressing the first three issues. Seek the Board's direction on the following additional three issues: • Issue 4 – Nature of component costs to include in an asset's current replacement cost (relates to Topic 4); • Issue 5 – Whether the current replacement cost of a self-constructed asset should include borrowing costs (relates to Topic 4); and

Meeting / Deliverable	**Project Milestones**
	• Issue 6 – Whether the fair value of the land component of a property held for its service potential should always be measured in the land's present location (relates to Topic 3).
1 June – 31 July 2019	Complete draft ED addressing the six issues discussed in the April and June 2019 Board meetings. Commence drafting guidance on ROU assets.
14 August 2019	Panel meeting – present draft ED and draft guidance on ROU assets to Panel for feedback.
15 August – 3 September 2019	Incorporate feedback from Panel on the two items of draft guidance and prepare Board papers for September 2019 Board meeting.
17–18 September 2019: Board meeting	Present draft ED and draft guidance on ROU assets for Board consideration. Provide Board with feedback from the Panel on these documents.
19 September – 10 October 2019	Update draft ED and draft guidance on ROU assets based on decisions made in September meeting. Issue FAQs on ROU assets (if the Board proceeds with this option).
10 October – 24 October 2019	Circulate ballot draft of ED for Board to vote out of session on 10 October 2019. Propose 2 weeks to vote until 24 October 2019.
31 October – 14 February 2020	Issue ED on 31 October 2019 for public comment for a period of 105 days (slightly longer comment period due to public holidays in December and January). Comment period ends 14 February 2020.
October – December 2019	Conduct outreach to stakeholders regarding the ED.
January 2020	Staff to analyse other issues raised by individual Panel members, which are in addition to the eight topic areas approved by the Board, and consider whether there is a need to develop guidance on these additional issues.
January 2020	Panel meeting – present analysis on the additional issues to Panel for feedback, present a collation of feedback from outreach on ED.

Meeting / Deliverable	**Project Milestones**
February 2020: Board meeting	Provide Board with feedback from outreach and Panel meeting on ED and any other issues raised by the Panel for consideration to decide whether further guidance would be required. Present a draft project plan for Board consideration in addressing the additional potential issues raised by Panel members.
February – March 2020	Staff to collate comments from submissions on ED, draft Board papers and draft Amending Standard reflecting Staff recommendations on how to address constituent comments, which could include changes to examples/guidance in ED and/or drafting more examples/guidance in AASB 13.
March 2020	Panel meeting - present draft Amending Standard (or draft Fatal-Flaw Review version) to Panel for feedback.
April 2020: Board meeting	Board to consider feedback on ED, Staff recommendations on how to address constituents' feedback and draft Standard with changes to guidance.
April – May 2020	Staff to update draft Standard based on decisions made in April 2020 meeting.
June 2020: Board meeting	Board to consider Fatal Flaw draft Standard (if Board decides to issue a Fatal Flaw draft Standard for comment).
July 2020	Circulate updated Fatal Flaw draft Standard to Board members out of session for voting based on decisions made in June 2020 meeting (if Board proceeds with this option).
July – August 2020	Issue Fatal Flaw draft Standard for public comment with a comment period of 30 days (if Board proceeds with this option).
September 2020	Panel meeting – discuss the Fatal Flaw draft Standard with the Panel.
September 2020	Collate comments on Fatal Flaw draft Standard, prepare Staff paper, and update draft Amending Standard with Staff recommendations on how to address constituent comments.
September – October 2020	Board to consider Staff paper and comments on Fatal Flaw draft Standard out of session and vote on ballot draft Standard updated for those comments.
October 2020	Issue final Amending Standard

Questions for Board members

Q1 Do Board members agree with the proposed project milestones and timeline?

Q2 Do Board members agree with the proposal to include private sector not-for-profit entities in the scope of this project (see paragraph 10 above)?

Next steps

1. Staff to prepare draft minutes of the Panel meeting held on 10 April 2019 and circulate them for comment from Panel members;

2. Staff to prepare a summary of feedback from valuers from major accounting firms in recent meetings with project Staff (to be included in agenda papers for the Board's meeting in June 2019);

3. Staff to complete the development of an Appendix setting out the views of Panel members on Issues 4 – 6 identified in the Proposed project timeline and analysis of the fair value measurement issue regarding lessees' right-of-use assets in concessionary leases, for consideration at the Board's June 2019 meeting; and

4. Depending on the Board's decisions at its April 2019 meeting, Staff to prepare a working draft Exposure Draft covering the project background and the three issues in this agenda paper, for consideration at the Board's meeting in June 2019.

Appendix A: Overview of progress made to date

The table below outlines the progress made to date in addressing the eight key Fair Value Measurement topics previously identified by the Panel and agreed by the Board.

Key measurement topics raised and work done to date		
Ranking	**AASB 13 Area/Issue**	**Staff Comments**
1	Restrictions on assets – Restrictions on assets are more prevalent in the public sector and there is diversity in practice on how restrictions are considered in fair valuing public sector assets that have restrictions, for example heritage assets, land zoned for a particular use and leased assets in the public sector, which have restrictions on what they can be used for.	Refer Issue 1 and Issue 2 in Appendix B paragraphs 1 – 57.
2	"Highest and best use" concept – the cost of applying this concept in the public sector often exceeds the benefits as most assets in the public sector are held for their service potential, which may not be their highest and best use. There is also the question of how to apply this concept to the valuation of restricted assets.	Refer Issue 1 in Appendix B paragraphs 1 – 37. Staff also note that the IASB published a project report and feedback statement on its Post-implementation Review of IFRS 13 in December 2018. In relation to applying the "highest and best use" concept, the IASB noted that, although many respondents found the concept challenging to apply[1], there was insufficient evidence of its inconsistent application and it is doubtful that supporting material would be helpful. Therefore, the IASB decided not to develop supporting materials. Staff observe that the IASB's remit excludes public sector entities, and accordingly it is reasonable to expect that challenges with applying the "highest and best use" concept

[1] Respondents to the IASB's Request for Information said that most challenges with applying the "highest and best use" concept arise when assessing whether an alternative use is legally permissible.

		would be more pervasive and difficult in the public sector. Current Project work is focused on how to apply the concept for the public sector.
3	Appropriate valuation techniques to measure fair value – implementation guidance is needed to help entities determine the appropriate fair value measurement approaches/techniques for assets with different characteristics.	Refer Issue 1 in Appendix B paragraphs 1 – 37, including the decision tree beneath paragraph 21 (which reflects one of the two Views set out in respect of Issue 1). Issue 6 planned for discussion at the Board's June 2019 meeting (see Proposed project timeline above) relates to this topic. Staff have discussed aspects of Issue 6 with the Panel.
4	Current replacement cost model (CRC) – additional guidance is needed on the application of CRC to different public sector assets as most public sector assets are valued using this approach (eg due to their specialised nature or because they are held primarily for their service potential rather than to generate cash flows/returns). There is also a need to clarify the difference between CRC, which is the cost approach in AASB 13, and depreciated replacement cost as most use these terms interchangeably.	Staff have discussed aspects of this topic with the Panel, and expect to bring this issue to the Board in the June 2019 Board meeting. Issues 4 and 5 planned for discussion at that Board meeting (see Proposed project timeline above) relate to this topic.
5	Obsolescence – constituents expressed a need for illustrative examples on the consideration of obsolescence when determining fair value.	Refer Issue 3 in Appendix B paragraphs 58 – 75.
6	Disclosures – Consideration of greater disclosure relief for public sector assets valued using significant Level 3 inputs.	Panel members did not specify what further disclosure relief they propose. One Panel member proposed an increase in disclosures. Staff note that disclosure exemptions have been provided in 2015 for the public sector to address concerns about costs of

		compliance and potential disclosure overload for users of not-for-profit public sector general purpose financial statements, which exceeded their benefits. Staff suggest that the ED has a Specific Matter for Comment on whether any further disclosures are needed, and why.
7	Interaction of AASB 13 with other Standards – may potentially be addressed by preparing a 'Frequently Asked Questions (FAQs)' document illustrating the interaction of AASB 13 with AASB 1058 *Income of Not-for-Profit Entities*, AASB 16 *Leases* and AASB 136 *Impairment of Assets*.	Depending on the Board's decisions in its meetings in April and June 2019, Staff expect to commence drafting guidance on fair value measurement of right-of-use assets in concessionary leases, either for inclusion in the ED as an illustrative example or as a Staff FAQ, if the Board considers that an FAQ would suffice.
8	Repurchased internally generated intangible assets – request for guidance on the measurement of internally generated intangible assets (eg licences) which have been repurchased by the issuing entity and held with no intention to be re-sold into the market. This could also be addressed by doing an FAQ.	Staff will conduct more research to consider whether any guidance in the form of FAQs is needed.

Appendix B: Proposed Issues to be Addressed in Public-Sector-Specific Guidance – Analysis and Staff Recommendations

AASB 13 *Fair Value Measurement* – Proposed issues to be addressed in public-sector-specific guidance (including illustrative examples)

Issue 1	Appropriate valuation approach – Specialised assets and assets with restrictions – Cemetery Land Example
Issue 2	Treatment of legal restrictions at different levels of a consolidated entity
Issue 3	Obsolescence – Trigger for economic obsolescence – School Example

The scenarios (particularly in Issue 1) are comprehensive to facilitate discussion by Board Members. It is important to note that the format and structure of these scenarios are not intended to be an illustration of the final product.

Issue 1 Appropriate valuation approach – Specialised assets and assets with restrictions – Cemetery Land Example

Issue

1 For a public sector entity, what effects do restrictions on the use of an asset or on what can be charged for use of the asset have on the valuation approach to be used, when those restrictions would transfer to market participant buyers of the asset?

Example 1—Cemetery Land

A local government acquires a parcel of residential land from several owners for use as a cemetery, for a price of $10 million. The land is rezoned for use solely as cemetery land to provide the community in the vicinity the ability to buy burial plots at nominal prices. This is a public service benefit that the local government provides to its constituents. The zoning (including the requirement to charge nominal prices for burial plots) was approved by the State Government Minister for Planning, and cannot be amended without the approval of the State Government.[1] The zoning has no prospect of being amended for several decades and the land's zoning for use as cemetery land would also apply to any market participant buyer of the land.

The local government charges a fee for the sale of each right to use a plot of land in the cemetery for an indefinite period. However, as mentioned above, fees charged are relatively nominal in amount, and as such do not generate a commercial return on the local

[1] Therefore, this example differs fundamentally from that in Issue 2, regarding how to treat a restriction that an entity has the potential to revoke without parliamentary or regulatory approval.

government's $10 million investment in the land's service potential[2]. If the land were to be sold to a market participant buyer, the buyer would be legally obligated to limit plot fees to their current level, indexed for inflation, and to maintain the cemetery. If the income approach were to be used to estimate the land's fair value, the amount estimated would be $400,000.

Some valuers have estimated that the local government's inability to rezone the land for residential use for a period of at least several decades means that market participant buyers of the cemetery land would price that land at a discount of 95% to the market value of adjacent residential land (ie $500,000).

Issues specific to the example

2 The first step in measuring the fair value of a non-financial asset is to ascertain whether a principal market for sale of the asset exists. If the answer is yes, in accordance with AASB 13.18[3], the asset's fair value measurement is represented by the price in that market. Normally, cemetery land is sold so infrequently that it would not qualify as having a principal market. Therefore, IFRS 13.18 normally would not apply to the fair value measurement of cemetery land and, in accordance with AASB 13.16[4], the land's fair value measurement assumes the transaction to sell the land takes place in the most advantageous market for the land to which the local government has access[5].

3 Controversy arises when a market price is not observable for sales of assets that are restricted in their use (or legally prevented from charging a commercial return for using the asset) and the restriction (in use or pricing) transfers with the asset to the market participant buyer of the asset. The primary issue affecting public sector entities for land, like the post-rezoning cemetery land in Example 1, that is subject to restrictions over how to use or sell it (coupled with restrictions on what rates can be charged to third parties for using it) is:

> Does the land's fair value incorporate a deep discount to the market value of comparable land (eg surrounding land, which, in Example 1, is surrounding residential land)?

4 The answer to this question depends, in turn, on determining which valuation approach(es) are most appropriate for estimating the cemetery land's fair value under

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[2] This is substantially different from the mere regulation by government of prices charged for essential services by private sector businesses (in which case the prices nonetheless are commercially determined).

[3] "If there is a principal market for the asset …, the fair value measurement shall represent the price in that market … ." (AASB 13.18)

[4] In the absence of a principal market, "A fair value measurement assumes that the transaction to sell the asset … takes place … (b) … in the most advantageous market for the asset … ." (AASB 13.16)

[5] AASB 13.19 specifies that: "The entity must have access to the principal (or most advantageous) market at the measurement date. …"

AASB 13. In particular, the following questions need to be answered under the fact pattern in Example 1:

(a) does the effect of the land's rezoning from residential land to cemetery land cause the land's fair value to change from $10 million to either $400,000 or $500,000 (and, if so, which amount)?

(b) is the market approach appropriate for measuring the fair value of some arguably specialised assets[6] and, if so, do the circumstances in which the market approach is appropriate (such as where there is observable market evidence of the amount of the above-mentioned discount) determine when the discount should affect the measurement of the land's fair value?

5 In the absence of an observable market price for a restricted non-financial asset, the following two important steps are necessary to identify how to measure the asset's fair value under AASB 13:

(a) identifying the characteristics of the market participant buyers for the asset; and

(b) identifying the asset's highest and best use.

6 In the absence of an observable market price for a restricted non-financial asset, ie where it is necessary to choose between the market, income and cost approaches for measuring the asset's fair value, the appropriateness of fair value estimates under each approach will depend, in part, on assumptions made about the characteristics of the market participant buyers for the asset. These assumptions affect the estimated amount the market participant buyer is willing to pay for the asset.

7 Regarding highest and best use, AASB 13.31 states that:

> "The highest and best use of a non-financial asset establishes the valuation premise used to measure the fair value of the asset, as follows:
>
> (a) The highest and best use of a non-financial asset might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) … (i) [in which instance] … the fair value of the asset is the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets … and that those … (complementary) assets … would be available to market participants. …
>
> (b) The highest and best use of a non-financial asset might provide maximum value to market participants on a stand-alone basis. [In that instance] the fair value of the asset is the price that would be received in a current

[6] See paragraph 17 for arguments why certain assets are specialised.

transaction to sell the asset to market participants that would use the asset on a stand-alone basis."

8 Crucially, AASB 13.28 states that: "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: … (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). …". Thus, 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. Because the price of an asset reflects the price the highest bidder is willing to pay, if a legal restriction affects the price that some market participants—but not others—would be willing to pay, it would not necessarily affect the asset's fair value. Views are divided on whether some restrictions—particularly some that codify the reason why assets were acquired by a not-for-profit entity—affect the price that market participants are willing to pay for an asset. This divergence of views is discussed in paragraphs 12 – 21 below.

9 There are two aspects to the fact pattern that need to be considered, as there are two elements to the restriction on use: a) how to use the asset and b) what price can be charged to third parties for use of the asset. Either of these elements of a restriction that is imposed immediately after the asset (eg land) is acquired can potentially cause a fair value estimate made under the market approach or the cost approach to be less than the price paid in the market place to acquire the asset.

10 For example, in Example 1, fees charged for each right to use a plot of land in the cemetery for an indefinite period are restricted to relatively nominal amounts. However, in other cemeteries, where crematoria are operated by for-profit entities charging commercial rates (ie with no restriction on prices they charge, but a restriction on how to use the asset), any fair value estimate based on either the market approach or income approach typically would be a much lesser amount than the price paid by the local government to acquire the land if that land had been acquired from adjoining residential property owners in an urban environment. In either case, the plot fees would not generate a commercial return on the local government's $10 million investment in the land's service potential. It is also worth noting that if the for-profit crematorium operator were to buy the land on its own, it would not have bought the land at a price of $10 million, but probably would have opted for another location that would have been cheaper and more in line with the return on investment that the for-profit crematorium operator would want.

11 Two main views (see below) have been argued regarding how to address the issues in paragraphs 3 – 4. The issues, and possible models for addressing them, affect a range of assets in the public sector that are restricted in use or sale. Cemetery land has been used as the paradigm example to illustrate these issues because:

(a) the percentage of discount frequently used for cemetery land is so high and has such a dramatic effect on fair value measurements and contains both elements of restrictions on how to use and what to charge for use;

(b) a variety of other types of restricted land/assets can be measured under the market approach or income approach (eg land subject to railway easements in inner city areas, which is capable of commercial redevelopment while remaining subject to those easements); and

(c) some assets are restricted in use to the current holder/occupier only and (consistent with IFRS 13, paragraph IE29 of Illustrative Examples[7]) these restrictions are therefore not part of the fair value assessment.

Views

View 1—Measuring the land using the market or income approach

12 Various commentators, including a majority of members of the Fair Value Measurement Project Advisory Panel, argue that the fair value of the cemetery land in Example 1 should be measured using either the market approach or income approach in AASB 13. This is 'View 1'.

13 The views of those Project Advisory Panel members differed on whether the income approach would always be appropriate in cases similar to Example 1. Some argued that, under the fact pattern in Example 1, the income approach to measuring fair value would be inappropriate because fees charged for each right to use a plot of land in the cemetery for an indefinite period are restricted to relatively nominal amounts. Therefore, they argue that applying the income approach does not produce a faithful representation of the land's fair value, and the land should only be measured under the market approach as described in paragraph 14 below. These Project Advisory Panel members would use the income approach where crematoria are operated by for-profit entities charging commercial rates (ie with no restriction on prices they charge), even when user charges do not generate a commercial return on the local government's $10 million investment in the land's service potential. However, other Panel members supporting View 1 would use an income approach, at least as a cross-check against the amount estimated under the market approach, whenever there is a cash flow from the asset.

14 A majority of members of the Panel argue that the fair value of the cemetery land in Example 1 should, after rezoning, be measured using the market approach in

[7] Paragraph IE29 of the IASB's Illustrative Examples for IFRS 13 (Example 9) indicates that a legal restriction on the use of an asset by its holder would be taken into account in the asset's fair value measurement if, and only if, that restriction were to transfer to market participants upon sale of the asset by its holder. If a legal restriction is taken into account in measuring an asset's fair value, it does so by constraining the asset's highest and best use.

AASB 13.B5 – .B6[8]. Consequently, they argue that the land's fair value should be measured as the price of comparable (eg adjoining) land, discounted for the effect of the zoning restriction.

15 Holders of View 1 note that holders of View 2 (see paragraphs 17 – 21 below) support applying the cost approach by measuring the cemetery land's current replacement cost as the price of the residential land that would need to be purchased to replace the cemetery land ($10 million)—that is, the price of adjoining land without any discount for the effect of the zoning restriction. They disagree with that approach to measuring the cemetery land's fair value primarily because:

(a) the cemetery land is no longer comparable to adjoining residential land unless the effect of the zoning restriction (a deep discount) is taken into account. This is because the prices for adjoining residential land reflect a use of the land, and a right to charge rentals for using the land, that are not permitted under the zoning restriction applying to the cemetery land. Crucially, the price-capped cash flows from using the cemetery land in its permitted use, discounted at a market rate of return, would not justify a for-profit market participant buyer bidding the price of the adjoining land to acquire the cemetery land at the measurement date; and

(b) the use of the adjoining land for residential purposes is a much higher and better use than the restricted use of the cemetery land;

16 Holders of View 1 also consider that:

(a) the cost approach should only be used when there is no other observable evidence of fair value, because of the requirement in AASB 13.61 to maximise the use of relevant observable inputs and minimise the use of unobservable inputs[9]. Those who support View 1 consider that comparable (eg adjoining) land prices adjusted for the effect of restrictions are observable evidence of fair value, albeit the discount is generally not observable (AASB 13.75 appears to permit this treatment, provided the measurement is identified at Level 3 of the fair value hierarchy[10]);

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[8] "The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets … .

For example, valuation techniques consistent with the market approach often involve market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range involves judgement, considering qualitative and quantitative factors specific to the measurement." (AASB 13.B5 – .B6)

[9] "An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs." (AASB 13.61)

[10] "If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within

(b) the cost approach should only be used for specialised assets because:

  (i) AASB 13. B9 states that: "In many cases, the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets and liabilities"; and

  (ii) assets that achieve their highest and best use only in combination with other assets are described as 'specialised assets' in paragraphs BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13[11].

  Those who support View 1 consider that land can never be a specialised asset, and therefore that the cost approach should never be applied to land;

(c) using an asset's replacement cost to measure its fair value (exit price) is problematic for land. For example, if a building is purchased together with a parcel of land, and then demolished to enable highest and best use of that parcel of land, the destroyed building is not included in the valuation of the empty parcel of land. Valuing the cemetery land as formerly residential property is akin to including a destroyed building in the valuation of an empty parcel of land;

(d) the amount paid for the cemetery land is a good surrogate for the social policy benefits embodied in that land, but this measure of social policy benefits is incompatible with the exit price principle underpinning the concept of fair value in AASB 13.24[12]; implicitly this view treats the restrictions on how to use the asset and what can be charged to use the asset as being inseparable;

Level 3 of the fair value hierarchy. For example, if a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a *Level 2 input* and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorised within Level 3 of the fair value hierarchy." (AASB 13.75)

[11] "… 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." (IASB's Basis for Conclusions on IFRS 13, paras BC78 and BC79).

[12] "Fair value is the price that would be received to sell an asset … in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique." (AASB 13.24).

(e) measuring the fair value of a group of interdependent assets at an amount exceeding the net cash inflows from their permitted use, discounted at a market rate of return, would not provide useful information to users of the entity's financial statements because it would not represent faithfully the assets' contribution to the entity's solvency (which should be expected of a fair value measurement). The reasons for using the cost approach explained in the IASB's Basis for Conclusions on IFRS 13, paras BC78 and BC79, relate to using observable evidence of the contribution of each asset within that interdependent group to the collective value of the group of assets (ie where individual assets create higher cash inflows used within the group than when sold on a stand-alone basis)—these reasons do not justify measuring the fair value of the group of assets at an amount exceeding the net cash inflows from their permitted use, discounted at a market rate of return (which is what View 2 would result in); and

(f) the approach in View 1 of applying a discount to the observed prices of comparable properties is current practice in various jurisdictions (eg New South Wales and Victoria, but not Queensland or Tasmania); in contrast, adopting View 2 would dramatically change current practice in those jurisdictions.

View 2—Measuring the land under the cost approach at the price of comparable land

17 Others (holders of View 2) argue that, after rezoning, the cemetery land's highest and best use (AASB 13.27 – 29[13]) is for use as a cemetery. The cemetery land would provide maximum value to market participants through its use in combination with other cemetery assets (eg buildings, fences and maintenance equipment) as a group. Therefore, in accordance with AASB 13.31(a)[14], the fair value of the cemetery land is the price that would be received to sell the land assuming that the land would be used with other cemetery assets. Paragraphs BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13[15] refer to assets that provide maximum value to market participants through their use in combination with other assets as a group as 'specialised assets'. For the rest of this section, holders of View 2 are described as arguing that the cemetery land should be valued as a specialised asset used in

[13] "A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use."

"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: … (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). …"

"Highest and best use is determined from the perspective of market participants, even if the entity intends a different use. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset." (AASB 13.27 - .29)

[14] See paragraph 7.

[15] See footnote 11.

combination with other assets (regardless of whether the cemetery land satisfies the everyday meaning of a 'specialised' asset).

18 Therefore, holders of View 2 argue that the cemetery land's fair value should be measured using the cost approach (i.e. at its current replacement cost), consistent with AASB 13.B9[16] and paragraphs BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13. They argue that the cemetery land's current replacement cost should be determined as the price of the comparable land that would need to be purchased to replace the cemetery land (which, in this example, is the market price of the adjoining residential land, ie $10 million). Their other reasons for this view are:

(a) the IASB's Basis for Conclusions on IFRS 13 states that, to measure the fair value of a specialised asset, the market participant buyer is assumed to need that asset in its own operations and, in effect, "steps into the shoes of the entity that holds the specialised asset" (para. BC78). Similarly, the IASB's Basis for Conclusions on IFRS 13 states that: "… an entity's cost to replace an asset would equal the amount that a market participant buyer of that asset (*that would use it similarly*) would pay to acquire it …" (para. BC141, emphasis added);

(b) given the specialised service potential of the cemetery land, the only market participant for that land used in its highest and best use is a local government, i.e. an entity with a non-commercial service-delivery objective for the group of assets including that land. In effect, the market participant buyer would have the same characteristics as the holder of the cemetery land, ***stepping into the shoes*** of that holder. (This contrasts with View 1, which implicitly assumes the market participant buyer would be a for-profit entity pricing the asset according to the cash inflows it can generate: see paragraph 15(a) above.) Such a market participant buyer stepping into the holder's shoes could only acquire that parcel of land by purchasing residential land (which currently has a market price of $10 million) because that buyer needs to compete for that land with other buyers who can generate much higher net cash inflows from the land. Therefore, using the cost approach, the amount at which the market participant buyer would price the cemetery land is $10 million. For any not-for-profit entity buyer of an asset in circumstances similar to these, the cash inflows ultimately underlying the holder's sales price are the rates, taxes, appropriations and/or donations that support the operations of the not-for-profit entity buyer;

(c) in relation to the argument for View 1 that the cost approach should only be used for specialised assets because AASB 13 para. B9 states that "In many cases, the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets and liabilities", supporters of View 2 argue that AASB 13 does not specifically limit the use of the cost approach to 'specialised' assets. In addition, they argue that the land should not need to be specialised to warrant its measurement using the cost approach,

[16] "… In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets … ." (AASB 13.B9)

because the cost approach reflects the land's contribution to the exit price of the group of assets in which it is used for its highest and best use. AASB 13.B8[17] and the definition of cost approach in AASB 13, Appendix A[18], specifically refer to the replacement of service potential, supporting the notion that it is meant to be used for assets where the specific cash flows are less important than service potential (such as, but not limited to, tangible assets used in combination with other assets). Implicitly this view separates the restriction on what can be charged to third parties as being a key element of why the asset is 'specialised';

(d) under the fact pattern for this example, the asserted discount to the market value of adjacent residential land resulting from the local government's long-term inability to rezone the land for residential use would typically be a significant unobservable input[19]. As noted in paragraph 16(a), consistent with AASB 13.75, any resulting fair value estimate would be at Level 3 of the fair value hierarchy. Therefore, the fair value hierarchy does not preclude the entity from considering evidence of fair value other than the price of the adjoining land, discounted for the effect of the zoning restriction;

(e) AASB 13 does not restrict use of the cost approach to when there is no other observable evidence of fair value: instead, under AASB 13.61 – .62[20], it is used when it provides the most faithful representation of fair value. Fair value is not always an exit price on a stand-alone basis: under AASB 13.B8 – .B9[21], it can be an entry price used to represent service capacity and the asset's use. In Example 1, the service potential is to provide services as a cemetery in combination with other assets. If another public sector entity is buying this cemetery to provide the same service, it will need to buy the land at the original

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[17] "The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)." (AASB 13.B8)

[18] "Cost approach: A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)." (AASB 13, Appendix A)

[19] Some members of the Fair Value Measurement Project Advisory Panel noted that, in unusual cases, cemeteries are sold for redevelopment after a very long period after the last cemetery plot is used, providing information about terminal cash flows from cemeteries (which may be compared with assumptions previously made about cash flows included in present value estimates).

[20] "An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs." (AASB 13.61) "… Three widely used valuation techniques are the market approach, the cost approach and the income approach … summarised in paragraphs B5-B11. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value." (AASB 13.62)

[21] "The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)." (AASB 13.B8)

"… In many cases the current replacement cost method is used to measure the fair value of tangible assets that are used in combination with other assets … ." (AASB 13.B9) purchase price (i.e. as residential land, without a discount).[22] Accordingly, the fair value of the cemetery land is much greater in its highest and best use (as part of a sale of the entire cemetery to another public sector entity) than through sale on a stand-alone basis;

(f) in the public sector and not-for-profit private sector, if restrictions are imposed on the amount any holder of an asset may charge for the use of the asset (as occurs in Example 1, where only nominal prices may be charged for burial plots), then measures of fair value that reflect the cash inflows the asset can generate (either using the market approach or the income approach in AASB 13 para. B5 – B6[23] or para. B10 – B11[24]) would not reflect the fair value of the asset's service potential. As noted in paragraph 16(d) above, holders of View 1 regard service potential as social policy benefits that are not reflected in fair value. Applying that view to measuring the fair value of non-cash-generating assets of public sector entities and private sector not-for-profit entities would entail measuring those assets at nil or negligible amounts. Although holders of View 2 concede that the solution to this problem argued in paragraph 18(b) would dramatically change practice in various jurisdictions (eg New South Wales and Victoria), they argue this disruption is preferable to measuring non-cash-generating assets at nil or negligible amounts; and

(g) regarding the criticism of View 2 that it would not represent faithfully the assets' contribution to the entity's solvency (see paragraph 16(e)), holders of View 2 argue that where assets of not-for-profit entities are not held primarily for their ability to generate net cash inflows, measuring them at amounts that can be obtained from sale in order to meet debts as they fall due would:

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[22] The virtual absence of such transactions does not preclude taking them into account when estimating the land's fair value. As para. BC30 of the IASB's Basis for Conclusions on IFRS 13 *Fair Value Measurement* says, the definition of fair value in AASB 13 (IFRS 13) assumes a hypothetical exchange transaction. In such a hypothetical exchange transaction, the holder of the cemetery land would seek to be paid $10 million to restore its capacity to acquire equivalent needed land, and the buyer would be willing to pay $10 million because it could not acquire the land more cheaply (and, having a not-for-profit purpose in mind, would be willing to pay an amount far exceeding the amount a for-profit market participant buyer would be willing to pay).

[23] See footnote 8.

[24] "The income approach converts future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

Those valuation techniques include, for example, the following:

(a) present value techniques (see paragraphs B12 – B30);

(b) option pricing models, such as the Black-Scholes-Merton formula or a binomial model (ie a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and

(c) the multi-period excess earnings model, which is used to measure the fair value of some intangible assets." (AASB 13.B10 – .B11)

(i) entail ignoring the service potential for which they were acquired. This would not be useful to users of their financial statements, who recognise that not-for-profit entities are dependent on contributors (rather than customers) for their financial support and generally do not hold assets for sale on a stand-alone basis;

(ii) entail heavy write-downs of various assets immediately upon, or shortly after, acquisition—this would not provide useful information to users of financial statements because it would signal, unfaithfully, that the acquisition was a poor economic decision; and

(iii) reflect a narrow view of assessments of the solvency of a not-for-profit entity, which depends in large part on the willingness of financial contributors to continue supporting its operations. That willingness depends on a range of factors, including, importantly, the entity's service performance.

19 Another concern that holders of View 2 express about View 1 is that it seems to contradict the AASB's views regarding the fair value of assets of not-for-profit entities that are not held primarily for their ability to generate net cash inflows, which typically are specialised assets held for continuing use of their service capacity. AASB 2016-4 *Amendments to Australian Accounting Standards – Recoverable Amount of Non-Cash-Generating Specialised Assets of Not-for-Profit Entities* (June 2016) stipulated that AASB 136 *Impairment of Assets* does not apply to the above-mentioned category of assets when those assets are regularly revalued to fair value. The AASB decided there is no need to modify the corresponding IFRS wording in AASB 136 to specify the use of current replacement cost when measuring the recoverable amount of such assets. AASB 13.B9 includes guidance that the fair value of such assets is often measured at current replacement cost, because such assets typically are specialised. Major factors in that scope exclusion and related decision not to modify the corresponding IFRS wording in AASB 136 were the AASB's conclusions that:

(a) fair value will not materially exceed fair value less costs to sell—which is one limb of the definition of recoverable amount in AASB 136—because costs to sell of these assets will be immaterial (which in turn is because the market for these assets is typically inactive and their highest and best uses would usually be their current uses rather than their sale). Therefore, such an asset cannot be impaired under AASB 136 if it is regularly revalued to fair value (Basis for Conclusions on AASB 2016-4, para. BC13); and

(b) scoping out of AASB 136 assets of not-for-profit entities that are not held primarily for their ability to generate net cash inflows removes the risk that some will continue to interpret 'fair value less costs to sell' in that Standard as a scrap value, focusing on net cash inflows, which can give rise to significant impairment losses of those scoped-out assets. Such assets typically have a very low value in use compared with their current replacement cost (and even their depreciated historical cost). The AASB noted that the fair value (and therefore fair value less costs to sell) of such an asset is not its scrap value "because 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 that specialised asset" (Basis for Conclusions on AASB 2016-4, para. BC15).

20 Holders of View 2 express concern that, if the fair value of land with a restricted use that is held for continuing use of its service capacity is the price of the adjoining land, discounted significantly for the effect of the zoning restriction, that measure of fair value would be in effect its scrap value (a measure focused on cash inflows from sale on a stand-alone basis, which would not assume sale of the land to a market participant buyer using the land for its highest and best use). Thus, revaluations to fair value would give rise to significant write-downs of the land if it became restricted after acquisition in the market place. They are concerned that this outcome would:

(a) be inconsistent with the economics of investing valuable resources in service potential restricted to the provision of community services; and

(b) in effect, undo the AASB's decisions made in AASB 2016-4 and, in particular, contradict the AASB's conclusion noted in paragraph 19(b) above.

21 An outline of the decision process underpinning View 2 is set out in the decision tree following this paragraph. That decision tree is applicable to the measurement of the fair value of a non-financial asset[25] by any entity (eg whether for-profit or not-for-profit). It includes parenthetical references to the relevant paragraph(s) in AASB 13 and the IASB's Basis for Conclusions on IFRS 13. The answers applicable to Example 1: Cemetery Land under View 2 are signified by the heavier arrows. Some additional points to note in relation to this decision tree are that:

(a) if observable market inputs exist for estimating the asset's sales price, they would not be used to measure the asset's fair value if either:

(i) the use or sale of an asset is legally restricted and the asset cannot be purchased with the restriction. Conversely, if an asset is restricted and observable market evidence exists of its selling price with that restriction transferring to the market participant buyer, there is no need to assess the impact of the restriction on the asset's fair value because it is already impounded in the market selling price; or

(ii) the asset is specialised (because the observable selling price or other observable market inputs are not representative of the asset's fair value, for the reasons explained in paragraphs BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13—see (b) below);

[25] The decision tree does not ask whether there exists Level 1 evidence of fair value, because such evidence is very unlikely to exist for a non-financial asset.

(b) it does not mention the requirement in AASB 13.61 to maximise the use of observable inputs and minimise the use of unobservable inputs. This is because AASB 13.61 also requires the use of valuation techniques ('approaches') that are appropriate in the circumstances. Therefore, it might be necessary to disregard some observable inputs if they are used in valuation techniques that are inappropriate in the circumstances (see also (a) above). As para. BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13 state:

> "Some respondents … expressed concerns about using an exit price notion 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. They were concerned that an exit price would be based on that scrap value (particularly given the requirement to maximise the use of observable inputs, such as market prices) and would not reflect the value that an entity expects to generate by using the asset in its operations. However, IFRS 13 clarifies that this is not the case. …
>
> It is unlikely in such a situation that a market price, if available, would capture the value that the specialised asset contributes to the business because the market price would be for an unmodified 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 … depending on the circumstances and the information available.";

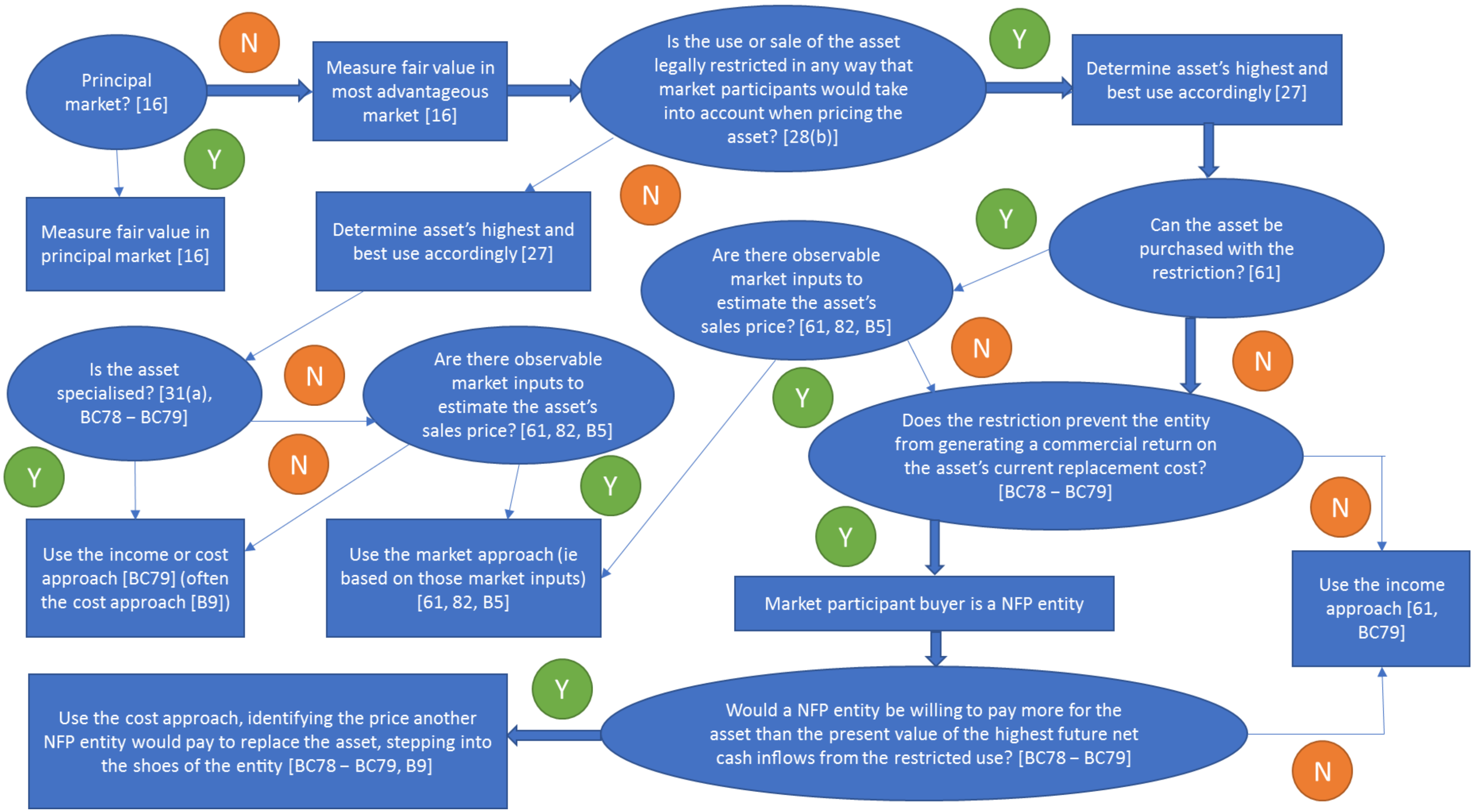
(c) the implicit indication in the decision tree that the income approach is not used when observable market inputs of an asset's selling price exist is meant to reflect that the income approach would not be used *instead* of the market approach in that situation: it might nevertheless be used to confirm the fair value estimate under the market approach;

(d) a restricted asset might be specialised in nature; however, it does not need to be determined whether it is specialised, because the questions about the effect of the restrictions on the relevance of the cash flows the asset can generate already address whether the market approach should be considered when estimating the asset's fair value;

(e) if the fair value of an unrestricted asset is measured using the cost approach because the asset is specialised, the market participant buyer could be either a for-profit or not-for-profit entity (ie applying the cost approach in this circumstance would not be subject to such specific criteria as those set out in the decision tree for when the fair value of a restricted asset is measured under the cost approach); and

(f) the question "Are there observable market inputs to estimate the asset's sales price?" is asked in two places, to avoid a 'no' answer in relation to an unrestricted asset leading to two different possible paths (one of which would be to consider whether the restriction prevents the entity from generating a commercial return on current replacement cost, which would be nonsensical since it has already been answered that the asset is unrestricted).

Decision tree for determining the fair value of a non-financial asset (View 2)



Policy issue

22 A policy issue that could arise is whether the AASB should consider modifying AASB 13 to avoid the consequences described in paragraphs 19 – 20. Such a modification would specify that, where assets of not-for-profit entities that are not held primarily for their ability to generate net cash inflows (typically assets held for continuing use of their service capacity and restricted in how they are used or sold or what can be charged for their use) are measured at fair value, the approach to determine their fair value should be current replacement cost. However, this would not preclude using observable market prices when they are materially the same as current replacement cost (e.g. this could occur when such assets are compulsorily acquired and the compensation arrangements are based on market value principles).

23 The assets that would be affected by the possible modification described in paragraph 22 are assets that:

(a) are held by public sector/not-for-profit entities for their service potential; and

(b) have a current replacement cost greater than the amount a for-profit entity would be willing to pay to acquire them in view of the cash inflows obtainable from their restricted use/restricted pricing.

24 If, unlike Example 1, a market exists for an asset with the reduced net cash inflows resulting from restrictions that would transfer to the market participant buyer, the amount any market participant (including the public sector/not-for-profit entity holder of the asset) would be willing to pay for the asset is limited to the asset's market price (which is reduced by the effect of the restriction). However, if the public sector/not-for-profit entity would need to pay more at the measurement date to acquire an asset than the price a for-profit entity would be willing to pay to acquire it in view of the cash inflows obtainable from its restricted use/restricted pricing, the asset's current replacement cost will exceed the amount determined under either the market approach or income approach. For example, if a local government, to achieve community service objectives:

(a) constructed a child care centre in a remote area that would obtain insufficient patronage to generate a commercial return on the centre's current cost of self-construction; and

(b) the centre could not currently be replaced more cheaply by purchasing it for a price reflecting the amount on which a commercial return could be generated (because there are no for-profit entity owners of child centres in that remote location),

the centre's current replacement cost would be measured at the current cost of self-construction (after deducting obsolescence in accordance with AASB 13.B9[27]) and the

[27] "From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility,

resulting fair value measurement would include an amount for the centre's service potential that exceeds the current market price of the centre's cash-generating potential.

25 The principle explained in the child care centre example immediately above would apply to any restricted asset for which the current replacement cost of its service potential may exceed the current market price of its cash-generating potential. Note the use of 'may' in this statement: some restrictions over the use, or charging for the use of, an asset might not cause the current replacement cost of its service potential to exceed the current market price of its cash-generating potential. Consider, for example, heritage assets (ie assets subject to heritage restrictions, including requirements to replace like-for-like):

(a) some heritage assets (such as office buildings with heritage features) held by any entity, whether for-profit or not-for-profit, might have little difference between fair value estimates under the market, income or cost approach, because a commercial return can be generated on their current replacement cost; whereas

(b) some other heritage assets (such as statues and local war memorials) might have negligible fair value estimates under the market approach or income approach but have significantly greater estimates of fair value under the cost approach. Note that these types of heritage assets are held almost exclusively by public sector/not-for-profit entities because the current replacement cost of their service potential exceeds the current market price of their cash-generating potential.

26 For assets of public sector entities and not-for-profit entities that are not held primarily for their ability to generate net cash inflows, modifying AASB 13 to specify that the approach to determine their fair value should be current replacement cost would be broadly consistent with the requirement in AASB 1059 *Service Concession Arrangements: Grantors* that current replacement cost is the basis for fair value measurements of 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 grantor's service concession asset would not be limited to its residual interest in the asset after the service concession period ends, and the unit of account to be measured at fair value is the entire service concession asset. That is, the service potential 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

adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence … ."
(AASB 13.B9)

particular service concession asset regardless of whether the operator was granted a right to earn third party user tolls. Therefore, it is appropriate to initially measure service concession assets at fair value using only the cost approach (current replacement cost) [AASB's Basis for Conclusions on AASB 1059, para. BC50 – BC53 and BC62 – BC66].

27 Public-sector-specific guidance in other jurisdictions does not address how to measure the fair value of assets of not-for-profit entities that are not held primarily for their ability to generate net cash inflows. For example:

(a) the IPSASB has a draft proposal for public sector entities to measure at replacement cost (an entity-specific entry value that does not attempt to estimate selling price) non-financial assets with specialised features, restrictions in use or sale, or an historic nature [see Appendix C]; and

(b) the United Kingdom Government's Financial Reporting Manual 2019-20 requires property, plant and equipment held for its service potential ('operational assets') and in use to be measured at its current value in its existing use, which:

(i) for non-specialised assets, is market value for the existing use (which disregards any higher and better use, and therefore does not attempt to reflect fair value); and

(ii) for specialised assets, is the present value of the asset's remaining service potential (which is assumed to be at least equal to the cost of replacing that service potential).

28 However, International Valuation Standard IVS 500 *Valuation Approaches and Methods* gives support to the notion that the fair value of assets that are not held primarily for their ability to generate net cash inflows should be measured at current replacement cost. It includes: "The cost approach *should* be applied and afforded *significant weight* under the following circumstances: … (b) the asset is not directly income-generating and the unique nature of the asset makes using an income approach or market approach unfeasible …" (para. 60.2).

29 Applying the AASB's Not-for-Profit Entity Standard-Setting Framework[28] to the above-mentioned possible modification of AASB 13, the following aspects are noted:

(a) arguably, such a modification would better meet user needs. Presently, not-for-profit public sector entities required to revalue their property, plant and equipment are being required in a number of Australian jurisdictions to write down their assets because of restrictions that would transfer to market participant buyers, even though those restrictions often merely codify the service-delivery purpose for which they acquired those assets. The usefulness of that treatment to users is doubtful;

[28] AASB's Not-for-Profit Entity Standard-Setting Framework

(b) this issue affects a wide range of not-for-profit public sector entities and often highly significant assets of those entities;

(c) the modification would broadly align with draft proposals of the IPSASB for the current value measurement of specialised/restricted assets, even though the IPSASB does not propose adopting fair value measurement for such assets;

(d) the modification is proposed in a 'justified circumstance' identified in paragraph 28(a)(iii) of that Framework, namely, it is necessary to adequately reflect that not-for-profit public sector entity assets are generally held for their service potential, not cash generation;

(e) the modification would be likely to increase internal consistency within Australian Accounting Standards, for the reasons discussed in paragraphs 19 – 20 and 26 above; and

(f) there is low risk that the modification could adversely affect perceptions of Australian Accounting Standards complying with IFRS Standards, because the modification would only apply to the restrictions and specialisation of assets of not-for-profit public sector entities.

Summary of arguments for each View

30 A high-level summary of the main arguments for View 1 and View 2 is set out in the table below. The reference to the relevant paragraph(s) above is provided in parentheses at the end of each argument.

Main arguments for View 1	Main arguments for View 2
The cost approach should only be used for specialised assets, and land can never be a specialised asset (16(b)). The market participant buyer would not be willing to pay more than a for-profit entity pricing the permitted cash flows from using the cemetery land, discounted at a market rate of return.	The cemetery land has specialised service potential for which fair value should not be measured assuming sale on a stand-alone basis. The only market participant for the land would be another local government stepping into the shoes of the holder of the cemetery land, and they would be willing to pay the market price of adjoining land under the assumed facts in Example 1 (18(a)-(c)).
There is no alternative to using adjoining land values and applying a discount to them (13, 14, 16(a)), unless the income approach is adopted (which would reflect only nominal cemetery fees from the land).	The asserted discount to the value of adjoining land under View 1 is typically a significant unobservable input. Therefore, a measure under View 1 is at the lowest level of the fair value hierarchy (Level 3) (18(d)).
Using adjoining land values without discounting them would misrepresent the	When assets of not-for-profit entities are restricted from generating commercial returns on their current replacement cost,

Main arguments for View 1	Main arguments for View 2
cemetery land as being as valuable as the unrestricted adjoining land (15).	limiting their fair values to amounts reflecting those non-commercial returns ignores the presence of other not-for-profit entities willing to pay above those commercial values—where necessary—to acquire those assets (18(b), 24 – 25). It also can give rise to significant understatement of the service potential of specialised assets not held primarily to generate net cash inflows (18(f), 19 – 20).
The fair value of a group of interdependent assets should not be measured at an amount exceeding the net cash inflows from their permitted use, discounted at a market rate of return. If it is, the assets' measures would not represent faithfully the assets' contribution to the entity's solvency (16(e)).	Adopting View 1 can give rise to significant write-downs of assets acquired without restrictions, upon becoming restricted, despite no change in their service potential having occurred (18(g)).
View 1 is current practice in various jurisdictions (eg New South Wales and Victoria, but not Queensland or Tasmania). Adopting View 2 would entail a significant change in practice in those jurisdictions (16(f)).	The argument in View 2 that where the fair value of a not-for-profit entity's assets does not depend on their ability to generate cash inflows, requiring the fair value of the assets to be measured at current replacement cost would be consistent with the AASB's reasoning for removing not-for-profit entity-specific modifications to IAS 36 in AASB 136 *Impairment of Assets* (June 2016) and for specifying in AASB 1059 *Service Concession Arrangements: Grantors* that the fair values of service concession assets are measured at current replacement cost (19, 22, 26).

Considerations affecting treatment of other restricted assets

31 Staff obtained input from members of the Project Advisory Panel, and valuers, on how they would measure the fair value of other restricted assets, and their reasons for those treatments. They were informed that other assets held by not-for-profit entities give rise to similar issues and challenges, and are also subject to diversity in practice. For example, properties controlled by surf lifesaving clubs are often surrounded by very valuable properties but are restricted from sale (except to another lifesaving club with similarly very limited financial means) and can only generate limited revenue through selling food, drinks and sunscreen. Some holders of View 1 think this is a

better example to consider than cemetery land, because, under View 1, the fair value of cemetery land depends on the number of remaining unsold plots. In addition, they noted that surf lifesaving clubs illustrate the importance of the requirement in AASB 13.28 that: "The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, … (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)." Whilst the AASB's Fair Value Measurement Project Advisory Panel did not discuss this example at length, it appears to give rise to similar issues and Views as cemetery land (eg should the fair value of the property be based on the net cash inflows from any shop operated by the club?).

32 Land under roads (other than toll roads) is another example of a restricted asset that is subject to a general lack of market reference transactions, does not generate net cash inflows and cannot be sold to a for-profit entity market participant buyer. As with cemetery land, practice varies between jurisdictions (for example, in New South Wales and Victoria it is measured by discounting the market price of comparable properties in the area, whereas in Queensland no discount is deducted). Similar differing Views have been expressed about how to measure the fair value of land under roads, as those expressed about cemetery land.

33 Public schools are an example of restricted assets that do not generate net cash inflows other than government support and cannot be sold to a for-profit entity market participant buyer while their restricted use as a school remains in force. The fair values of school buildings and facilities are generally measured at current replacement cost because those assets:

(a) do not generate net cash inflows separately from other assets (funding is received from government for the land and buildings as a group of assets working together). Therefore, the income approach summarised in AASB 13.B10 – .B11[29] cannot be applied to them;

(b) are not sold separately (being specialised as to nature and proportions). Therefore, applying the market approach would not provide observable evidence of their fair value; and

(c) typically have observable replacement costs.

34 Because school closures occur from time to time, there is much more market evidence of their fair values than exists in relation to cemetery land. However, the selling prices for school properties as redevelopment sites (after their restriction for use as a school is lifted) essentially reflect the value of the land (the buildings are typically a blight on the land)—therefore, those market transactions do not provide market evidence of the buildings' and facilities' fair values. Holders of View 1 argue it is consistent with that View to measure the fair values of school buildings and facilities at current

[29] See footnote 24.

replacement cost because (unlike cemetery land) they are specialised assets and sales evidence indicates that the group of assets to which they belong will command a collective selling price to a for-profit market participant buyer that equals or exceeds the sum of their fair values determined under the cost approach. Holders of View 2 query this logic. They contend that sale prices for schools as redevelopment properties generally reflect the value of the land alone. They argue that applying View 1 should logically lead to the fair values of school buildings and facilities being measured at negligible amounts—not their current replacement costs.

Summary of Project Advisory Panel views

35 As noted in paragraph 12, the majority of the members of the AASB's Fair Value Measurement Project Advisory Panel support View 1 for the reasons set out in paragraphs 13 – 16. A significant minority of Panel members support View 2, although some of them expressed reservations about the potential for overstating the fair value of specialised/restricted assets.

Staff recommendations

36 For the reasons for View 2 summarised in paragraph 30, staff recommend adopting View 2 in respect of this issue. Staff think the treatment in View 2 conforms to the requirements of AASB 13 when applied to measuring the fair value of the cemetery land in Example 1.

37 However, given the diversity in practice and for the reasons articulated in paragraph 29 above, Staff recommend that the AASB proposes to modify AASB 13 to specify that, where assets of public sector entities and not-for-profit entities that are not held primarily for their ability to generate net cash inflows are measured at fair value, the approach to determine their fair value should be current replacement cost. Staff observe that such a modification would be justified under the AASB's Not-for-Profit Entity Standard-Setting Framework.

Questions for Board members

Q3 Do Board members agree that View 2 conforms to the requirements of AASB 13 in determining the fair value of the cemetery land in Example 1? Do Board members think that this View would faithfully reflect the economics of the asset held? Are there any additional Views or arguments that should be addressed?

Q4 Do Board members agree with the staff recommendation that the AASB should propose modifying AASB 13 to specifically require using current replacement cost to measure the fair value of restricted assets of not-for-profit/public sector entities held primarily for continuing use of their service capacity?

Q5 Do Board members consider the decision tree beneath paragraph 21 useful to be provided as a general decision tree for fair value measurement purposes in the public sector?

Issue 2 Treatment of legal restrictions at different levels of a consolidated entity

Issue

38 Guidance has been sought on whether particular restrictions might be treated differently at a parent entity level (e.g. whole-of-government level), compared with an individual entity (e.g. government department) level, when those restrictions were imposed by the parent entity.[30]

Background

39 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, AASB 13.28(b) 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.

40 A question asked regarding the issue in paragraph 38 is whether the restriction described in paragraph 39 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.

41 The majority of the members of the AASB's Fair Value Measurement Project Advisory Panel consider 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 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). Staff agree with the majority view of the Panel.

42 The issue of contention is about how a legally imposed restriction should be treated if it can be rescinded without parliamentary approval. Three identified Views on this issue are discussed below.

43 Paragraphs IE7-IE8 of IFRS 13 and paragraphs BC68-BC69 of the IASB's Basis for Conclusions on IFRS 13 state that zoning restrictions would not prevent an entity from considering an alternative use to the use permitted by the zoning restrictions, when determining an asset's highest and best use:

(a) provided the alternative use is not legally prohibited; and

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[30] This issue was raised by a member of the Fair Value Measurement Project Advisory Panel and discussed by the Panel.

(b) if market participants would take the possibility of a different zoning into account when pricing the asset.

44 Whilst it is useful to note that AASB 13 does not preclude taking possible rezonings into account, it is not clear what implications to draw from this regarding rescissions of restrictions that arguably are within an entity's power. This is not surprising, because AASB 13 was developed by the IASB (as adopted in Australian Accounting Standards) with private sector business entities in mind; as noted in paragraph 40, this issue is unique to the public sector, because private sector entities cannot rescind laws.

Views

View 1—Disregard the restriction at the parent entity level if it can be rescinded without parliamentary approval

45 Some argue that the restriction should be treated as non-legally binding at the parent entity (e.g. whole-of-government) level if, and only if, the existing legal restriction can be rescinded without parliamentary approval. They argue that, at the parent entity level, if the restriction can be rescinded without parliamentary approval:

(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).

46 If a restriction is treated as non-legally binding by an entity when measuring an asset's fair value, the entity deducts the costs of removing the restriction from the estimated benefits resulting from removing the restriction. Holders of View 1 argue that it is appropriate to include those costs (as a deduction) in the fair value measurement because those costs are analogous to transport costs of getting an asset to its market place (which are deducted when determining an asset's fair value, in accordance with AASB 13.26).

View 2—Take the restriction into account at the parent entity level even if it can be rescinded without parliamentary approval

47 Others disagree with View 1 and argue that restrictions imposed at the parent entity (e.g. whole-of-government) level should always be taken into account if, at the measurement date, they would transfer to any market participant buyer of the asset. They adopt this view because:

(a) they consider that financial reporting should reflect laws currently effective or substantively enacted, regardless of the probability that particular laws will change in the future;

(b) they consider that the government acts as a regulator when it imposes restrictions on agencies it is theoretically capable of lifting from itself, and that focusing only on legally binding restrictions may overlook practical restrictions over the use of an asset; and

(c) they note that, if a restriction is considered to be legally binding only at a controlled entity level (e.g. legally binding at the level of a government department but not legally binding at a whole-of-government 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 at the whole-of-government level.

View 3—If the restriction can be rescinded at the parent entity level without parliamentary approval, reflect the present existence of the restriction but also the government's option to rescind the restriction (adjusted for the risk of being unable to rescind the restriction)

48 Yet others argue for a hybrid of Views 1 and 2 above. View 3 effectively supports View 1, tempered for the risk that the restriction might not be able to be rescinded even though there is no parliamentary hurdle to overcome.

49 Holders of View 3 argue that the measurement of the asset's fair value at the whole-of-government 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. However, they argue that the fair value measurement should in principle be reduced for the effects of both:

(a) the risk that the government 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.

50 In essence, holders of View 3 argue that the measurement should reflect the present existence of the restriction but also the government's option to rescind the restriction.

51 In practice, the reliability with which the option could be measured would largely depend on the ability to estimate the probability that the restriction could be rescinded.

52 Regarding the concern (noted in paragraph 47(c)) that treating a restriction as not being wholly legally binding at a group level when it is wholly legally binding at a controlled entity level would give rise to consolidation adjustments, supporters of View 1 and View 3 note that precedent exists in Australian Accounting Standards for the need for consolidation adjustments in relation to the same asset. For example, para. 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.

53 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.

54 If there is a significant risk of being unable to rescind a restriction and the risk cannot be estimated reliably, the choices appear to be to default to adopting either View 1 or View 2. Some argue that, in these circumstances, View 2 should be adopted (ie 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.

Summary of Project Advisory Panel views

55 The AASB's Fair Value Measurement Project Advisory Panel discussed Views 1 and 2 on this issue. Of those Panel members expressing a view on this issue, their views were evenly divided between View 1 and View 2. The reasons of Panel members for supporting those Views are reflected in the discussion of those Views. View 3 was added by the Staff to capture seemingly the best points of each of Views 1 and 2.

56 Some Panel members commented that different processes and constraints apply to the removal of restrictions at the Federal, State and Local Government levels, and suggested that, if the AASB issues guidance on this issue, it acknowledges this aspect. For example, some Panel members suggested providing an example illustrating how this issue might affect local governments.

Staff recommendations

57 Staff recommend:

(a) providing public sector guidance on this issue, in the form of an illustrative example to AASB 13; and

(b) identifying View 3 as the approach that most appropriately applies the requirements of AASB 13.28(b) regarding restrictions over the use or sale of assets at different levels within a group entity. This is because View 3 reflects that the parent entity has the legal capacity to remove the restriction, but also takes into account the risk that the restriction might not be able to be rescinded even though there is no parliamentary hurdle to overcome. It is reasonable to expect that this risk would affect the pricing of the restricted asset by market participants.

Questions for Board members

Q6 Do Board members agree with the staff recommendation that, if a law or regulation imposes a restriction on the use of an asset held by a government-controlled entity, and this restriction would transfer to any market participant buyer of the asset, View 3 should be applied to the restriction at the whole-of-government level if the government can rescind the law or regulation without needing parliamentary approval? Are there any additional Views or arguments that should be addressed?

Q7 Do Board members agree with the staff recommendation that the AASB should provide public sector guidance in the form of an illustrative example on this issue?

Issue 3 Obsolescence – Trigger for economic obsolescence – School Example

58 This issue relates to identifying when economic obsolescence of an asset held 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 AASB 13.B8 – .B9[31].

Example 2—School with arguably excess capacity

In this example, a government owns a public school with capacity for 500 students but, because of demographic changes, a school for 100 students would meet current and reasonably foreseeable requirements. There is only an insignificant chance that this reduction in needed capacity will reverse within the foreseeable future. If a school for 100 students were to be built at the measurement date, only 45 per cent of the existing school's land would be needed; the remainder of the land is separately saleable.

The fair value of the school's buildings and other facilities is measured using the cost approach because those assets do not generate separate cash inflows with which to apply the income approach summarised in AASB 13.B10 – .B11[32] and, because those assets are not sold separately (being specialised as to nature and proportions), applying the market approach would not provide observable evidence of fair value. AASB 13.B9 and paragraphs BC78 – BC79 of the IASB's Basis for Conclusions on IFRS 13[33] indicate that, in many cases, the current replacement cost method is used to measure the fair value of specialised assets.

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[31] See footnotes 21 and 26 for extracts from AASB 13.

[32] See footnote 24.

[33] See footnote 11.

Issue

59 In relation to the public school in Example 2, the issue to address is: What amount of economic obsolescence, if any, should be reflected in the current replacement cost of the school's buildings and other facilities? Specifically, for how many students should the school's capacity to be replaced be determined?

60 It seems to be widely accepted that the (gross) replacement cost of the school should be based on a capacity for 500 students, consistent with AASB 13.B8, which states that: "The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)." The school's service capacity is 500 students. This is because the service capacity is what the school currently **can** provide, which is not necessarily the same as what the school actually provides (or actually needs to provide).

61 Therefore, the aspect requiring judgement is whether economic obsolescence should be identified in respect of the school when measuring its current replacement cost (which, under AASB 13.B9, is net of obsolescence). Replacement cost (after deducting obsolescence) reflects the capacity the school would need to replace in a current replacement transaction.

62 AASB 13.B9 states that obsolescence incorporated in an asset's current replacement cost includes 'external (economic) obsolescence'. IFRS 13 para. IE12(b) 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 to that, in assessing economic obsolescence of the school, is a decline in the market demand for the school's services. The subject of debate on this issue is determining the point at which economic obsolescence should be identified when demand for a facility (such as a school) falls or is expected to fall.

63 There was general consensus among the members of the AASB's Fair Value Measurement Project Advisory Panel that:

(a) the existence of economic obsolescence arising from a reduction in the demand for services from an asset (such as a school) depends on the facts and circumstances in each case;

(b) if a current apparent 'overcapacity' of a school exists but future increases in student enrolments are expected to largely eliminate that 'overcapacity' within the foreseeable future, economic obsolescence should not be identified for that school. Such an illusory 'overcapacity' might be created to cater for increases in student enrolments in growing population centres; and

(c) increases in student enrolments 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 capacity than indicated by present enrolments, because 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.

64 However, perceptions exist that AASB 13 does not have regard to the temporary or cyclical nature of shortfalls in demand for services rendered with an asset when determining whether economic obsolescence exists. Therefore, Project Advisory Panel members requested that the AASB issues public sector guidance on this issue, in addition to publishing public sector guidance on identifying when surplus capacity is substantive (see below). Staff agree with the views of the Panel in paragraph 63, and with the Panel's request for AASB guidance reflecting those views.

65 In Example 2, the school has the capacity for 500 students but:

(a) a school for 100 students would meet current and reasonably foreseeable requirements; and

(b) there is only an insignificant chance that this reduction in needed capacity will reverse within the foreseeable future.

Thus, the circumstances in Example 2 differ from those discussed in paragraphs 63(b) and (c), on which there is consensus among Panel members. Panel members expressed different views regarding how to treat the fact pattern in Example 2: these are outlined below.

Views on Issue

View 1—Economic obsolescence should not be identified until a formal decision has been made to reduce physical capacity

66 Some argue that economic obsolescence of a school or similar community facility should not be identified until a formal decision has been made to reduce the physical capacity of the school/facility, including a plan for when that decision will be implemented. They argue that:

(a) until such a decision is made, there is insufficient evidence that economic obsolescence exists;

(b) identifying economic obsolescence before such a decision adopts an unduly short-term focus, creating an unacceptable risk of measurement error and subsequent reversal of economic obsolescence; and

(c) until a formal decision (including an implementation plan) is made to reduce the physical capacity of the school, it is highly unlikely to be clear whether—and to what extent—economic obsolescence exists. They argue that a school's excess capacity for the expected number of school students might not indicate a loss of service potential (measured in fair value terms). For example, they argue, potential alternative community uses of a school might have sufficient importance that a market participant buyer of the school would pay for the full capacity of the school, taking into account wear and tear.

67 In relation to paragraph 66(a) and (b), supporters of View 1 argue that premature recognition of economic obsolescence and subsequent reversals of such measurement errors create measurement volatility that is not representationally faithful. Supporters of View 1 give the example of demographic changes that are not initially known to be cyclical (e.g. decisions to reduce immigration that are subsequently reversed).

View 2—A formal decision to reduce physical capacity should not be a pre-requisite for identifying economic obsolescence

68 Others argue instead that:

(a) economic obsolescence of the school should be identified as soon as there is evidence of a decline in the market demand for the school's services for the reasonably foreseeable future, if there is only an insignificant chance that the decline in demand will reverse; and, therefore,

(b) under the fact pattern in the example, economic obsolescence should be identified to the extent that the capacity for 500 students exceeds the capacity needed for 100 students.

69 The view in paragraph 68(b) does not mean economic obsolescence measured as 80 per cent of the school's gross replacement cost (ie a linear relationship between expected student enrolments and economic obsolescence) because:

(a) 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; and

(b) some or all of a 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. If the alternative community uses of the asset are sufficiently important that market participant buyers would be willing to pay the replacement cost of such a 'surplus' asset (after deducting all forms of obsolescence other than economic obsolescence), economic obsolescence would not be identified for that asset. Judgement would be required under the circumstances of each case to identify whether, for each such 'surplus' asset, market participant buyers would be willing to pay that amount.

70 If there are no significant alternative community uses of assets that are surplus to the school's requirements, the surplus land (55% of the existing school's land) should be treated as a separate unit of account for fair value measurement (highest and best use) purposes. This is because the surplus land is separately saleable—thus, the highest and best use of that surplus land is not constrained by the highest and best use of the land still needed for the school.

71 Supporters of View 2 argue that:

(a) the primary consideration in assessing when to identify economic obsolescence in respect of an asset measured at fair value using the cost approach is whether market participant buyers would deduct such an amount from the asset's replacement cost when pricing the asset. The answer to that question 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 the best estimate of fair value, and therefore would implicitly be inconsistent with AASB 13's requirements;

(b) an inherent aspect of fair value is that remeasurements will arise when expectations of market participants change about future economic events that might affect an asset. A fair value estimate that, in the absence of observable market prices for the same or similar assets, is calculated on the basis of various assumptions would contain measurement uncertainty but would only contain measurement error (ie fail to faithfully represent fair value) if the assumptions differ from those that other market participants would use when pricing the asset;

(c) even decisions to close and/or dispose of public assets are sometimes reversed in light of new conditions or events. Therefore, if economic obsolescence of a school (or similar community facility) was identified only when a formal decision has been made to reduce the physical capacity of the school, the potential need to subsequently remeasure economic obsolescence would remain; and

(d) under View 2, the view in paragraph 68(a)—that economic obsolescence should not be identified in respect of the school if there is more than an insignificant chance that the decline in demand will reverse—could be regarded as proposing a probability criterion for including economic obsolescence in the school's fair value measurement. Such a proposal might seem inconsistent with AASB 13, which includes no probability or other criteria in fair value measurements. However, supporters of View 2 argue that there would be no inconsistency with AASB 13 because, if the chance that the decline in demand will reverse is more than insignificant, there would be serious doubt about any conclusion that the school has surplus capacity. In addition, identifying no economic obsolescence in such a circumstance would be consistent with valuation practice of assuming continuation of existing use at the existing scale of operations unless there is clear evidence to the contrary.

72 The IPSASB's *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (para. 7.40 – 7.41) includes an example highly similar to that in Example 2:

"… Replacement cost adopts an optimised approach … and is based on an alternative asset if that alternative would provide the same service potential more cheaply.

The appropriate service potential 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. Therefore, the replacement cost of asset reflects reductions in required service capacity. For example, if an entity owns a school that accommodates 500 pupils but, because of demographic changes since its construction, a school for 100 pupils would be adequate for current and reasonably foreseeable requirements, the replacement cost of the asset is that of a school for 100 pupils."

73 The IPSASB Conceptual Framework lends support to View 2 in that it does not indicate that a formal decision to reduce the school's capacity is a pre-requisite for adjusting the school's current replacement cost to take into account the school's overcapacity. The IPSASB's draft Consultation Paper (CP) *Public Sector Measurement* (expected to be published soon) includes the same school example as that in the IPSASB Conceptual Framework and proposes the same treatment (paragraphs D11 – D12 of the draft CP, as set out in paragraph C10 of Appendix C in this agenda paper).

Summary of Project Advisory Panel views

74 Members of the AASB'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. Panel members seemed more concerned about clarifying the misconceptions discussed in paragraph 63 above.

Staff recommendations

75 Staff recommend that the Board:

(a) provides public sector guidance on this issue and the aspects in paragraph 63, in the form of illustrative examples to AASB 13; and

(b) in relation to this issue:

(i) clarifies that, in the circumstances discussed in paragraph 63, apparent 'overcapacity' of a school does not indicate economic obsolescence if the 'overcapacity' is temporary, or occurs cyclically, in which case the 'overcapacity' is in fact standby capacity needed by the entity to cater for changes in demand for services; and

(ii) rejects the view that economic obsolescence of a school or similar community facility should not be identified until a formal decision has been made to reduce the physical capacity of the school/facility, including a plan for when that decision will be implemented—that is, View 2 should be adopted instead, for the reasons in paragraph 71 (especially paragraph 71(a)).

Questions for Board members

Q8 In relation to Issue 3, do Board members agree with the staff recommendation that apparent 'overcapacity' of a school does not indicate economic obsolescence if the 'overcapacity' is temporary, or occurs cyclically, in which case the 'overcapacity' is in fact standby capacity needed by the entity to cater for changes in demand for services?

Q9 Also in relation to Issue 3, do Board members agree with the staff recommendation that View 2 (a formal decision to reduce physical capacity should not be a pre-requisite for identifying economic obsolescence) conforms to the requirements of AASB 13 for applying the cost approach to measuring the fair value of an asset?

Q10 Do Board members agree with the staff recommendation that the AASB should provide public sector guidance on this issue?

Appendix C: Summary of IPSASB's proposed principles of 'Replacement cost'

C1. IPSASB is expected to issue a Consultation Paper (CP) *Public Sector Measurement* in April 2019. In its latest draft CP (updated on 14 March 2019), the IPSASB implies that it would be more appropriate for public sector entities to apply the 'replacement cost' measurement basis, rather than other measurement bases, to measure non-financial assets that have specialised features, restrictions in the use or sale of the asset or are of a historic nature. This Appendix provides a high-level summary of the proposed principles and guidance of the replacement cost measurement basis.

C2. Replacement cost as an entity-specific entry measure is a different valuation technique to the fair valuation technique listed in AASB 13 *Fair Value Measurement.* However, staff are of the view that the proposed principles and guidance of replacement cost might provide insights for the AASB in its Fair Value Measurement for Public Sector Entities Project.

Definition of replacement cost

C3. IPSASB has preliminarily defined 'replacement cost' (RC) as "the most economic cost required for the entity to replace the service potential of an asset (including the amount that the entity will receive from its disposal at the end of its useful life) at the reporting date" (Draft CP paragraph 20).

C4. "The replacement cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date, plus the transaction costs that would be incurred at the at date. Replacement cost, like historical cost, is <u>an entry value</u>. It reflects prices in the market in which the entity would acquire the asset. However, unlike historical cost, replacement cost reflects conditions at the measurement date" (emphasis added) (Draft CP paragraph 21).

Differences between RC and CRC

C5. The current replacement cost (CRC) in AASB 13 is a valuation technique that "reflects the amount that would be required currently to replace the service capacity of an asset". From the perspective of a market participant seller, the price that would be received (**ie. exit price**) 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…"(emphasis added) (AASB 13 paragraph B8-B9).

C6. IPSASB's RC is different to CRC. RC is an entity specific cost and it's an entry value. Whereas CRC is based on the perspective of a market participant seller and as an estimate of an exit price.

C7. IPSASB is of the view that there might be circumstances where a public sector entity requires the ability to measure an entry value or an exit value when valuing an asset at its current value in order to achieve the measurement objective. For example, depending on whether an entity is holding an asset for operational capacity or financial capacity impacts whether the measurement objective is to present the current value to replace the asset – an entry value – or the current value to sell the asset – an exit value (Draft CP paragraph 2.24).

C8. IPSASB also note that ‘market value’ is a neutral methodology that can be applied in calculating either current entry or exit values. IPSASB will seek to differentiate the term ‘market value’ and ‘fair value’ in the next phase of the project.

C9. AASB 13 requires that fair value measurement of a non-financial asset takes into account the highest and best use of the asset. However, IPSASB is of the preliminary view that there might be circumstances where it might not be appropriate for a public sector entity to apply the highest and best use in the current value measure (Draft CP paragraph 2.24).

Summary of key principles in IPSASB’s replacement cost [extract relevant to issues for discussion at the April 2019 Board meeting]

Consider the features of the asset in estimating replacement cost of an asset

C10. **Consider the service potential of the asset from the perspective of the entity** – IPSASB’s view is that the appropriate service potential of the asset 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. Therefore, the replacement cost of an asset reflects expected changes in required service capacity.

For example, if a school that accommodates 500 pupils but, because of demographic changes since its construction, a school for 100 pupils would be adequate for the current and reasonably foreseeable requirements, the replacement cost of the asset is that of a school for 100 pupils (Draft CP paragraphs D11–D12).

Other key principles will be set out in the agenda papers for the Board’s June 2019 meeting.