Basis for Conclusions on AASB 2016-4

This Basis for Conclusions accompanies, but is not part of, AASB 136. The Basis for Conclusions was originally published with AASB 2016-4 Amendments to Australian Accounting Standards – Recoverable Amount of Non-Cash-Generating Specialised Assets of Not-for-Profit Entities.

BC1 This Basis for Conclusions summarises the Australian Accounting Standards Board's considerations in reaching the conclusions in Accounting Standard AASB 2016-4 *Amendments to Australian Accounting Standards – Recoverable Amount of Non-Cash-Generating Specialised Assets of Not-for-Profit Entities*. Individual AASB members gave greater weight to some factors than to others.

Background

BC2 Under AASB 136 *Impairment of Assets* (July 2004 and August 2015), an impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount. The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs of disposal ('net fair value') and its value in use.

BC3 Paragraph Aus32.1 to AASB 136, required not-for-profit (NFP) entities to determine the value in use of an asset as its depreciated replacement cost (DRC) when the future economic benefits of the asset are not primarily dependent on the asset's ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits. Paragraph Aus6.2 to AASB 136 defined DRC as "the current replacement cost of an asset less, where applicable, accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset". Paragraph Aus32.2 explained that "The current replacement cost of an asset is its cost measured by reference to the lowest cost at which the gross future economic benefits of that asset could currently be obtained in the normal course of business".

BC4 The AASB previously concluded that the Aus paragraphs were needed in AASB 136 to help ensure impairments are not recognised for non-cash-generating assets held by NFP entities when they still embody future economic benefits of a value equal to, or greater than, their carrying amounts. This was based on the view that entities might inappropriately recognise impairment due to the focus of IAS 36 *Impairment of Assets*, which is incorporated into AASB 136, on cash-generating assets. The value in use of a non-cash-generating asset based on cash flows would be zero or close to zero and the net fair value of the asset could be regarded as relating to a scrap value for a specialised asset.

The need to issue AASB 2016-4

BC5 Clarifications were sought by some constituents about the interaction between the notion of DRC for determining the value in use of assets held by NFP entities in the circumstances described in paragraph BC3 and the notion of current replacement cost (CRC) as a measure of the fair value of an asset under the cost approach in AASB 13 *Fair Value Measurement*. AASB 13 (paragraphs B8 and B9) identifies the cost approach as a valuation technique for measuring fair value. Under AASB 13, the cost approach reflects the amount that would be required currently to replace the service capacity of an asset.

BC6 Some commentators argued that, consistent with the role of CRC as a measure of fair value under AASB 13 (reflecting the assumptions that market participants would use when pricing the asset), DRC should not be an entity-specific measure of recoverable amount under AASB 136. These commentators supported the objective of the existing requirements of AASB 136 of not basing the recoverable amount of primarily non-cash-generating assets held by NFP entities on discounted cash flows. They also noted that when DRC was included in AASB 116 *Property, Plant and Equipment* (July 2004), there was ambiguity as to whether it was a measure of fair value or a measure of value in use and that with the publication of AASB 13 and its exposition of the cost approach, it became clear that DRC under the AASB 116 is a measure of fair value as is CRC under AASB 13. Accordingly, for such assets, they argued that DRC should be used to determine fair value as a measure of recoverable amount and noted that its designation as a measure of value in use under AASB 136 might be a source of confusion.

BC7 Other commentators argued that DRC is identified as a measure of fair value in paragraph 33 to AASB 116 (July 2004) , in cases where there is no market-based evidence of fair value because of the specialised nature of the asset and the item is rarely sold, except as part of a continuing business. They noted that, with the publication of AASB 13, the cost approach plays a similar role as a measure of fair value when the market and income approaches to valuation are not applicable due to the specialised nature of the asset.

BC8 Further comments on the interaction between DRC under AASB 136 and CRC under AASB 13 were sought in AASB outreach with key stakeholders, such as preparers and auditors, and valuers of NFP entities' assets, particularly in regard to assets held by public sector entities.

BC9 Comments from some preparers in the public sector who participated in the outreach indicated that separate evaluations of CRC as a measure of fair value under AASB 13 and DRC as a measure of value in use under AASB 136 are not usually performed. These commentators noted that, although CRC as a measure of fair value under AASB 13 and DRC as a measure of value in use under AASB 136 are different in concept, for specialised assets where the market is typically inactive, the highest and best use is generally their current use. Accordingly, in their view the CRC of such assets under AASB 13 and their DRC under AASB 136 are, in practice, interchangeable. Some noted one reason for this outcome is that highest and best use requires consideration of reasonably possible uses, not every possible use.

BC10 Some valuers participating in staff outreach noted:

(a) in the case of a NFP entity where the fair value of a specialised asset is based on the cost approach, the entity acts as the 'buyer' and is competing with other market participants in order to acquire the asset. They argue that this means CRC under AASB 13 should not be different from DRC under AASB 136;

(b) CRC under AASB 13 and DRC under AASB 136 are regarded as similar measures of fair value and the existing use or alternative uses are considered and assessed on a case-by-case basis; and

(c) the highest and best use of an asset determines its fair value, but restrictions (such as legal restrictions) on the use of an asset often mean that the highest and best use of an asset is its current use.

The AASB's initial deliberations

BC11 The AASB noted that DRC is identified as a measure of fair value in paragraph 33 to AASB 116 (July 2004) in cases where there is no market-based evidence of fair value because of the specialised nature of the asset and the item is rarely sold, except as part of a continuing business. The AASB also noted that, with the publication of AASB 13, CRC plays a similar role for assets that are specialised in nature and are rarely sold, such as many assets held by public sector entities. The AASB further noted that the cost of disposal of such assets is not expected to be material.

BC12 The AASB noted that fair value under AASB 13 is defined as an exit price. Therefore, CRC under AASB 13 is conceptually different from DRC as a measure of value in use under AASB 136, being an entry price. The AASB noted, however, that:

(a) the description of the cost approach in AASB 13 indicates that CRC incorporates obsolescence as does the definition of DRC under AASB 136, where accumulated depreciation encompasses obsolescence;

(b) valuers use similar approaches in determining DRC and CRC. Factors such as physical obsolescence, functional obsolescence and economic obsolescence are all considered in determining each measure; and

(c) valuers' practice involves considering as a starting point whether the valuation is of a specialised asset in its current use or an alternative use and whether there are any restrictions on the use of the asset.

BC13 The AASB concluded that DRC as a measure of value in use of specialised assets that are rarely sold is unlikely to be materially different from DRC (or CRC) as a measure of fair value of such assets. This is because, for non-cash-generating specialised assets, the market is typically inactive and their highest and best uses would usually be their current uses rather than their sale, resulting in CRC of such assets being not materially different from their DRC, as the following example shows:

Example

An entity self-constructs a specialised facility. Because this is the entity's specific practice in its industry, it can construct the facility for $8.5 million, whereas the cost of construction of the facility to any other market participant would be $10 million. As the construction of the facility has just been completed, there is no obsolescence or depreciation.

The issues are: (a) whether the CRC of the facility should be measured at $10 million or $8.5m under AASB 13; and (b) whether the DRC of the facility should be measured at $10m or $8.5m under AASB 136.

Analysis

Paragraph B9 to AASB 13 states that "a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset". The implication of that statement depends on whether the market participant buyer includes, or has the attributes of, the vendor. Paragraph BC78 of the IASB's Basis for Conclusions on IFRS 13 *Fair Value Measurement* states that, in relation to a specialised non-financial asset, "In effect, the market participant buyer *steps into the shoes of the entity* that holds that specialised asset" (emphasis added). Based on that comment, it seems appropriate in the above example to regard the market participant buyer as being capable of self-constructing the asset for $8.5 million, in which case CRC should be measured at $8.5 million under AASB 13. Because value in use is an entity-specific measure, the DRC of the facility would also be measured at $8.5 million under AASB 136.

BC14 The AASB noted that, when the AASB 136 impairment model (as per IAS 36) is applied to non-cash-generating specialised assets that are rarely sold, the value in use of the asset is typically less than its net fair value because the asset is generally held for continuing use of its service capacity, not the generation of cash inflows. Further, because these assets are rarely sold, their cost of disposal is typically negligible. The AASB concluded that, in such circumstances, the recoverable amount of the asset would be materially the same as fair value determined under AASB 13.

BC15 The AASB noted that AASB 13 has addressed the concerns identified in paragraph BC4 above that the net fair value of an asset could be regarded as relating to a scrap value for a specialised asset leading to an inappropriate recognition of impairment. Paragraph BC78 of the IASB's Basis for Conclusions on IFRS 13 refers to the concerns that an exit price would be based on scrap value (particularly given the requirement to maximise the use of observable inputs, such as market prices) and not reflect the value that an entity expects to generate by using the asset in its operations. It notes that, in such circumstances, the scrap value for an individual asset would be irrelevant because an exit price reflects the sale of the asset to a market participant that has, or can obtain, the complementary assets and the associated liabilities needed to use the specialised asset in its own operations. In effect, the market participant buyer steps into the shoes of the entity that holds that specialised asset.

BC16 The AASB noted that, with the issuance of AASB 13, the fair value of non-financial assets is determined under that Standard. Accordingly, with the CRC measure being available under AASB 13, the notion of DRC included in AASB 116 (July 2004) would no longer be applicable in estimating the fair value of specialised non-financial assets.

ED 269 proposals

BC17 The AASB published ED 269 *Recoverable Amount of Non-cash-generating Specialised Assets of Not-for-Profit Entities* proposing that:

(a) references to DRC as a measure of value in use in AASB 136 be deleted from that Standard; and

(b) paragraph Aus5.1 be included in AASB 136 to clarify that, because primarily non-cash-generating specialised assets held for continuing use of their service capacity are rarely sold, their cost of disposal is typically negligible and, accordingly, the recoverable amount of such assets is expected to be materially the same as fair value, determined under AASB 13.

BC18 The Board noted with the removal of DRC as a measure of value in use from AASB 136, the recoverable amount of a primarily non-cash-generating specialised asset held by an NFP entity for continuing use of its service capacity is determined as the higher of value in use and net fair value. The recoverable amount would be fair value since the value in use of a primarily non-cash-generating asset would be small or close to zero.

BC19 The ED 269 proposals identified implications for assets held both under the revaluation model and under the cost model as outlined below:

Revaluation model

NFP entities that regularly revalue their primarily non-cash-generating specialised assets to fair value would find the application of the impairment model under AASB 136 redundant.

Cost model

If there are indicators of impairment, NFP entities applying the cost model to their primarily non-cash-generating specialised assets would need to determine their recoverable amounts at fair value to establish whether there is a need to recognise impairment.

Redeliberation of ED 269 proposals

BC20 The AASB considered comments on the ED 269 proposals received via submissions and further AASB targeted outreach. The AASB noted that commentators were generally supportive of ED 269 proposals and discussed concerns raised about some aspects of the proposals.

Clarifying CRC

BC21 Some valuation industry participants consulted in AASB outreach were of the view that some constituents continue to see CRC under AASB 13 as the gross replacement cost of a new asset rather than the CRC of the remaining service capacity of the asset. The AASB observed that:

(a) paragraph B8 to AASB 13 describes CRC as the amount that would be required currently to replace the service capacity of an asset. This is a reference to replacement cost of the service capacity of the asset and not a new asset; and

(b) paragraph B9 to AASB 13 further clarifies that the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence and that obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence.

BC22 The AASB concluded that the description of CRC in AASB 13 is clear that CRC is not a gross value reflecting the replacement cost of a new asset, rather it is replacement cost of the remaining service capacity of the asset.

BC23 The AASB also confirmed its view that DRC under AASB 136 is equivalent to CRC under AASB 13. It was noted that the description of the cost approach in AASB 13 indicates that CRC incorporates obsolescence as did the definition of DRC under AASB 136, where accumulated depreciation encompasses obsolescence. It also noted that valuation industry participants in AASB outreach generally were of the view that the description of CRC in AASB 13 is consistent with their current valuation practice for determining DRC under a cost approach in that the replacement cost or reproduction cost of a new equivalent asset is adjusted for all relevant types of obsolescence and the issue of overcapacity is also considered in arriving at an optimised value.

BC24 Some commentators noted that the capitalisation of borrowing costs assumed in the example in paragraph BC14 to ED 269 was not common for NFP public sector entities because the ABS GFS Manual prohibits capitalisation of borrowing costs. The AASB noted that capitalisation of borrowing costs would need to be addressed as part of another project.

Disposal costs associated with specialised assets

BC25 Some participants in AASB outreach noted the costs of disposal might not be negligible in some cases where non-cash-generating specialised assets are involved. Some had in mind a range of costs they considered potentially material that could be associated with making an asset saleable. As an example, they noted those costs might include material costs of rezoning land.

BC26 The AASB noted that IFRS 13, Illustrative Example 8, clarifies the type of costs that would need to be considered in determining the fair value of assets. In illustrating the determination of highest and best use, the example contrasts the value of land currently developed for industrial use with the land as a vacant site for residential use. In identifying the fair value of the land as a vacant site for residential use it considers the costs of demolishing the factory and other costs necessary to convert the land to a vacant site.

BC27 The AASB noted that disposal costs are costs incurred to sell the asset in its existing state (target asset). The AASB confirmed that, consistent with the example noted in paragraph BC26, costs incurred to enhance the use of an asset, change its nature, or make it marketable would be considered in fair valuing the enhanced asset. Such costs would not be disposal costs of the target asset for the purpose of calculating net fair value. Accordingly, land rezoned for residential or commercial use is a different asset from land with zoning as public land and costs such as decommissioning costs or rezoning costs that change the nature of the asset are not classified as disposal costs of the land in its public use.

BC28 The AASB also noted that disposal costs are ‘normal’ incremental costs directly attributable to disposal of an asset and are not intended to include excessive costs arising from the processes to sell particular assets.

Impairment of revalued assets

BC29 Some commentators expressed the view that it was not sufficiently clear whether the proposed paragraph Aus5.1 would apply only to NFP entities as it does not explicitly preclude application by for-profit entities. The AASB confirmed that paragraph Aus5.1 would apply only to primarily non-cash-generating specialised assets of NFP entities held for their service capacity and would not apply to assets of for-profit entities whether or not held for their service capacity.

BC30 Some participants in AASB outreach commented that ED 269 is not clear as to whether it would mean that consideration does not need to be had to whether revalued assets of NFP entities would still need to be tested for impairment if an impairment trigger were present.

BC31 The AASB noted that the objective of removing references to DRC from AASB 136 and determining recoverable amount as fair value is to reduce financial reporting costs to NFP entities holding specialised assets that are held for continuing use of their service capacity. The AASB considered that this is consistent with its *Process for Modifying IFRSs for NFPs* which notes that "In some cases, the context or increased or reduced prevalence of a transaction or event for PBE/NFP as compared with for-profit entities, may require modifications to the relevant IFRS to ensure that user needs are met while considering the balance between costs and benefits". The AASB noted that revaluation of non-financial assets in the Australian NFP public sector is more prevalent than in the for-profit sector. The AASB concluded that when non-cash-generating specialised assets of NFP entities that are held for the continuing use of their service capacity are revalued regularly to fair value under the revaluation model in AASB 116 and AASB 138 *Intangible Assets*, the entity no longer applies AASB 136 to such assets. This is because regular revaluation ensures such assets are carried at an amount that is not materially different from fair value and any impairment would be taken into account as part of revaluation. For such assets, the issue of determining recoverable amount of the asset and magnitude of disposal costs would not be relevant.

BC32 The AASB noted that an entity holding an asset with the intention of selling it would need to apply AASB 5 *Non-current Assets Held for Sale and Discontinued Operations* and AASB 136 would not apply.

BC33 The AASB decided to proceed with the ED 269 proposals with amendments based on the conclusion noted in paragraph BC31.

BC34 The AASB noted that AASB 101 *Presentation of Financial Statements* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* would apply in implementing the amendments and in respect of comparative information. The AASB also noted that it would not expect the amendments to AASB 136 to change current practice materially.