ACAG AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

16 November 2015

Ms Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
Collins St West
Melbourne Victoria 8007

Dear Ms Peach,

**ACAG submission on Exposure Draft ED 269 – Recoverable Amount of Non-cash-generating Specialised Assets of Not-for-Profit Entities**

The Australasian Council of Auditors-General (ACAG) supports the AASB's initiative to clarify an appropriate basis for valuation and impairment of specialised assets contained in the Exposure Draft ED 269 *Recoverable Amount of Non-cash-generating Specialised Assets of Not-for-Profit Entities*. ACAG agrees that, given the recent publication of AASB 13 *Fair Value Measurement*, the depreciated replacement cost concept (DRC) as it currently stands in AASB 136 *Impairment of Assets* causes confusion. However, ACAG encourages the AASB to exercise caution in doing so in order to avoid a situation where effectively it is impossible to impair specialised assets in both not-for-profit and for-profit entities.

ACAG's concerns relate more to the application of the current replacement cost concept in AASB 13 *Fair Value Measurement* in the valuation of specialised assets, than the removal of the DRC concept from AASB 136. However, the proposal to remove DRC from AASB 136 brings these underlying conceptual issues to the fore. ACAG recommends the AASB address the concerns outlined in this submission when considering possible changes to AASB 13 and AASB 136 and/or developing additional guidance to help with practical application.

ACAG also has a number of concerns with the proposed paragraph Aus5.1. These concerns are articulated in the attached submission.

The views expressed in this submission represent those of all Australian members of ACAG.

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The opportunity to comment is appreciated and I trust you will find this feedback useful.

Yours sincerely

A T Whitfield PSM
**Chairman**
**ACAG Financial Reporting and Auditing Committee**

**ATTACHMENT**

**AASB Specific Matters for comment:**

**The AASB would particularly value comments on the following:**

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

   ACAG shares the AASB's concern regarding the confusion amongst constituents about the difference between depreciated replacement cost (DRC) and current replacement cost (CRC). Accordingly, ACAG supports the AASB's initiative to clarify an appropriate basis for valuation and impairment of specialised assets used by not-for-profit (NFP) entities.

   ACAG supports the removal of the DRC references as proposed in paragraphs 5 and 6 of this Exposure Draft (ED). However, ACAG encourages the AASB to exercise caution in doing so in order to avoid a situation where entities can effectively argue a case to avoid impairment of specialised assets in both NFP and for-profit (FP) entities.

   ACAG agrees that having identical definitions in the valuation and impairment standards works well conceptually for assets with market based valuations. However, where CRC is based on entity specific information, valuation and impairment judgements are less conceptually sound.

   ACAG's concerns relate more to the current application of the CRC concept in the valuation standard than to the removal of the DRC concept from the impairment standard. If the proposals are implemented without amendment, ACAG strongly recommends the AASB expand the guidance in AASB 13 *Fair Value Measurement* to address the application of the CRC approach for specialised assets.

   Decisions about the fair value and impairment of specialised assets become more problematic over time. Information about inputs is less available and relevant, the utility of the asset declines, it may become possible to replace the service capacity of the asset with a lower cost, technologically superior alternative, the highest and best use may change, or the asset may move from a NFP to a FP entity.

ACAG recommends the AASB address the concerns outlined below when considering possible changes to AASB 136 *Impairment of Assets* and developing guidance within AASB 13 which may help with practical application and limit the circumstances in which CRC can be used in this manner. These concerns are:

a) clarity around certain definitions in AASB 13
b) expanded guidance in certain areas
c) clarity around the market based and entity based conceptual element
d) explicit limitation of the circumstances in which an entity specific CRC measure can be used in fair value or impairment calculations
e) explicit requirement for a deprival test to be satisfied
f) costs of disposal remain within AASB 136 for application by NFP entities

## a) <u>Clarity around certain definitions in AASB 13</u>

ACAG believes some definitions in AASB 13 require attention:

- CRC definition - there must be sufficient clarity about how the CRC fair value measurement for specialised assets will be derived under AASB 13, given the definitions in AASB 13 and AASB 136 point to each other (i.e. the definition of DRC in paragraph Aus 6.2 of AASB 136 refers to CRC). Without sufficient clarity about the application of CRC in AASB 13 for specialised assets, impairment assessments under AASB 136 in NFP entities, and recoverable amount tests (RATs) in FP entities may be compromised.

- Specialised assets definition - ACAG is of the view that 'specialised assets' requires a definition and where it relates to the NFP sector only, this reference should be stated. ACAG considers that a defining feature of specialised assets is that they are rarely traded and there are few, if any, market participants, which does not sit comfortably with the fair value definition in AASB 13.

## b) Expanded guidance in certain areas

- Unobservable Inputs - When an asset is first constructed, information about inputs is reasonably freely available (although it is generally engineers rather than valuers who will source this information). However, as time passes information about inputs becomes less available and relevant. Guidance and examples would be useful about the circumstances and extent to which unobservable inputs should be used in CRC valuations and impairment decisions, when it would be appropriate to consider other possible methods of delivering the service, or consider inputs that are less entity specific.

- Obsolescence Adjustments - Sometimes it becomes clear, that given a choice, an entity would not replace the asset as originally constructed either in part or at all. AASB 13 acknowledges at B8 and B9, that functional and economic obsolescence and physical deterioration of all or part of the asset adds layers of subjectivity and estimation to a method of estimation that already uses unobservable inputs to derive the CRC fair value estimate. Guidance on how the obsolescence adjustment should be determined and measured would be useful in AASB 13.

- Service potential - Traditionally, public services are provided in areas where the private sector would not operate due to the barrier of providing a minimum level of service delivery. Generally, the aim of optimal asset utilisation is not the sole factor that is considered when a government decides whether it will provide a public service or not. As a consequence, the utilisation of public sector assets is often sub-optimal to allow for a minimum and maximum level of service. For example, a road in a rural area may be underutilised but it still achieves its service delivery objective. Therefore, an asset's future economic benefits and value are linked to its ability to assist the entity to meet its objectives.

  A different fact pattern would be that the road is overdesigned with an excessive number of lanes. Guidance about the relationship between an asset's service potential (in the light of factors such as overdesign or overcapacity and the availability of newer/cheaper technology) and obsolescence would be helpful to identify situations where obsolescence adjustments are appropriate.

## c) Clarity around the market based and entity based conceptual element

Unhelpful confusion arises from the current definition of DRC at AASB 136 Aus 6.2, which refers to CRC. Consequently, in trying to define an entry based valuation technique, the standard points to an exit based valuation technique.

ACAG considers that, conceptually, CRC (a market-based measure) and DRC (an entity-specific measure) are not interchangeable. This view is supported by paragraph 33 of the AASB Staff Issues Paper 'The Relationship between Current Replacement Cost as a Measure of Fair Value and Depreciated Replacement Cost as a Measure of Value in Use'. Paragraph 33 of this paper states:

"… staff nevertheless think an asset's DRC has a different meaning in the context of measuring value in use under AASB 136 than the meaning of CRC as a measure of fair value under AASB 131. This is because:

(a) in paragraph Aus6.1 of AASB 136, DRC is explicitly referred to as a measure of value in use in the context of the deprival value notion (which, for Not-for-Profits (NFP)s, is invoked for each asset the future economic benefits of which are not primarily dependent on the asset's ability to generate net cash inflows).

Therefore, when applying paragraph Aus6.1 of AASB 136, DRC should be read as a current market buying price. An asset's current market buying price differs from its current market selling price, because those prices are obtained in different markets for the asset, even though their amounts might by coincidence be the same for a particular asset."

ACAG agrees with the AASB that many valuers widely substitute DRC information for market based CRC comparators for the specialised assets of both FP and NFP entities. Such valuations tend to be based on the entity constructing a replica of its existing asset, regardless of its utility. In essence, the entity is cast as its own market participant, in the expectation the asset would be replicated upon reconstruction, despite the profitability, efficiency or effectiveness (or lack thereof) of the asset in delivering service. ACAG recommends the AASB develop guidance on the use of entity specific CRC information in valuation and impairment decisions for FP as well as NFP entities.

[1] This is despite AASB staff thinking that DRC and CRC have essentially the same meaning when used to measure fair value.

In theory, CRC should support the value a market participant might pay for the lowest cost asset that would deliver similar utility (Refer to part (b) above). In a FP entity, if the service cannot be delivered to create profit, the asset is only worth what can be salvaged through disposal (Refer to part (d) below). A NFP entity may currently use DRC, but must first affirm it would replace the remaining service capacity of the asset, if deprived of its use, to deliver services in line with its corporate or legislative objectives (Refer to part (e) below).

If an entity based CRC is only to be available to NFP entities in the valuation and impairment of its specialised assets, an amendment to the standard should be explicit about the conceptual rationale and the reasons why its potential application is limited.

**d) <u>Explicit limitation of circumstances in which an entity specific CRC measure can be used in fair value or impairment calculations</u>**

CRC is a fair value concept currently available to both FP and NFP entities. Conceptually, entity specific entry based fair value measures, however defined, should only be available to the specialised assets of NFP entities, because market based data may not be available. FP entities should be obliged to use market based information maximising observable inputs. Guidance from the AASB will be necessary to ensure FP entities prioritise discounted cash flow (DCF) information when valuing or impairing specialised physical assets, as both DCF and CRC are level three inputs and presumably interchangeable. It would also be appropriate for the AASB's guidance to ensure FP entities do not rely on CRC information to support the carrying amounts of specialised intangible assets (carried at cost) in RATs.

**e) <u>Explicit requirement for a deprival test to be satisfied</u>**

As explained in part (c) above, AASB 13 conceptually defines CRC as a current buying price from the perspective of a market participant. However, because IFRS 13.BC78 states that "in effect, the market participant steps into the shoes of the entity", the current buying price can be from the entity's perspective. This is similar to DRC as a measure of value in use, although a difference is the deprival value notion, which is not explicit in the CRC definition.

The proposed changes will remove the deprival value notion from AASB 136. ACAG suggests that guidance would be useful on the similarities and differences between deprival value notion and the concepts of technical and functional obsolescence discussed at paragraph B9 of AASB 13. In ACAG's experience, the notion of deprival has been useful in evaluating whether it is proper to continue to value assets on an entity specific measurement basis, as the entity must affirm that it will, in fact extract value from the asset's continued use.

A poorly designed asset may remain in use, even though of marginal utility. Under AASB 136, the entity may currently determine it would not replace the economic benefits embodied in the asset if deprived of it, and fully impair the asset. However, if DRC is removed as a measure of value in use from AASB 136 and no deprival test is required, and the entity continues to use its poorly designed specialised asset, no impairment would be recorded, as under the proposed arrangements the entity may determine fair value as CRC (the full cost of reproduction).

This issue is demonstrated by a recent purchase and implementation of a highly specialised software asset in one jurisdiction. The system failed to deliver in significant respects. It was clear from the outset that given the choice, the entity would not replace certain modules. Significant costs would be incurred to bring the software to a standard acceptable to users. Whilst the asset was delivered to specifications; it was simply not fit for purpose. Arguably, it was not technically or functionally obsolete – it was designed using the latest technology to deliver poor results and that is exactly what it did. Would a test of functional and technical obsolescence under AASB 13 deliver the same outcome (impairment) as the deprival test?

ACAG's concerns are supported by paragraph 30 of the AASB staff issues paper mentioned above. This paper states:

"In contrast, where market participants would not be willing to replace an asset if they were deprived of it, AASB staff think it is more logical to conclude that CRC does not represent the fair value of the houses. In other words, AASB staff think that treating an asset's current market entry price as the equal of the asset's current market exit price (determined on a stand-alone basis), by calculating obsolescence based on replacement cost in such a manner that it yields the same measure of both current market and entry and exit prices, would be inconsistent with the fact that entry and exit prices for markets for an asset are different."

The above statement acknowledges that CRC may not always reflect an asset's fair value.

**f) Costs of disposal remain within AASB 136 for application by NFP entities**

ACAG has concerns over the assertion "Given these assets are rarely sold, their cost of disposal is typically negligible" in paragraph Aus5.1. In ACAG's experience, where a specialised asset is sold (either separately or as part of a cash generating unit (CGU)), the costs of disposal may be significant due to the difficulty of their disposal, the lack of market participants, significant barriers to entry of potential market participants, the need to observe due process and probity in their sale, and resolve issues with the associated workforce, customers and other stakeholders. For example:

- disposal of electricity assets in several jurisdictions has been subject to multiple expressions of interest / calls for tender at great cost
- demolition and decommissioning of certain assets where contamination is a factor can be extremely costly to remove prior to disposal or reuse.

The inclusion of an incorrect assumption regarding costs of disposal may see many NFP entities (and FP entities which carry specialised assets measured at CRC) ignore costs of disposal, even where they are significant.

The term "negligible" is not defined and is therefore open to different interpretations. This may present challenges from an audit perspective as NFP entities are likely to conclude the costs of disposal are indeed "negligible" to avoid having to calculate impairment.

If the term "negligible" proceeds to inclusion in the standard, ACAG recommends the AASB consider defining the term and include requirements for entities to disclose in the financial statements why selling costs are considered "negligible".

**Other Issues**

ACAG also brings the following to the AASB's attention:

- AASB 136 defines DRC twice - in paragraphs Aus32.2 and Aus6.2.
- The example in BC14 of the ED erroneously assumes the entity is the "most efficient operator in the industry". Due to the significant barriers of entry to the market, generally entities with specialised assets are the only operator (or one of very few similar operators) in the market. There is no need for a sole operator in a market to deliver service efficiency, and monopoly theory would indicate they do not.
- The example in BC14 of the ED capitalises borrowing costs. It is not common for NFP entities to capitalise borrowing costs because the GFS/ABS Manual prohibits capitalisation of borrowing costs.

**2. whether:**

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

ACAG believes paragraph Aus5.1 only partially clarifies the role of AASB 13 in determining the recoverable amount of primarily non-cash-generating specialised assets of NFP entities generally held for continuing use of their service capacity.

In ACAG's view, it is not sufficiently clear that paragraph Aus5.1 will apply only to NFP entities as it does not preclude FP entities. In ACAG's view, this lack of clarity may result in this paragraph being inappropriately applied by FP entities to their specialised assets, which they might also maintain are held primarily for their service capacity and not the generation of cash inflows.

FP entities, when applying the RAT, have generally recorded impairment against specialised assets on a pro-rata basis until the fair value of assets in the CGU no longer exceeds the DCF of the CGU. However, under the current proposals, impairment of specialised assets in both FP and NFP entities might be avoided. Arguably, so long as the fair value of the specialised asset is supported by its CRC, impairment need not be taken, even where the carrying amount of the asset (together with the related assets and liabilities in the CGU) exceeds the DCF of the CGU.

Entities may assert an entity specific CRC valuation is at least as valid as a valuation derived from an income model. Generally, both are level 3 within the fair value hierarchy, and whilst an income model has many unobservable inputs and assumptions, arguably CRC has at least some observable inputs.

CRC may also be used in impairment calculations for specialised intangible assets. For example, a specialised software asset, whilst measured at cost under AASB 138 *Intangible Assets*, will be subject to an impairment assessment (and the RAT, if part of a CGU). It is uncommon for an active market to exist for any intangible asset, and it is certainly challenging to identify a market participant for an IT system with a high degree of bespoke specialisation.

ACAG suggests that the AASB provides clarification of how these assets would be treated under an entity specific CRC approach in an impairment assessment, either as individual assets or as part of a CGU.

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

ACAG raises a potential issue with entities with specialised assets that are also subject to rate regulation. The regulated asset base is a key input to calculating the allowed rate of return. If CRC is interpreted as not requiring impairment, the asset base will be larger than it should be and may result in additional costs to consumers.

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

Subject to consideration of the matters raised in this response, ACAG believes that overall, the proposals would result in financial statements that would be useful to users.

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

ACAG has no comment to make on this question, except for the observation noted at (b) above.

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

ACAG believes the proposals are likely to result in long term cost savings for both preparers and auditors. Longer term savings will be achieved as NFP entities that hold primarily non-cash-generating specialised assets will no longer be required to measure their value in use as DRC. As a result:

- NFP entities that revalue these assets to fair value regularly will find the impairment model under AASB 136 redundant
- FP entities that hold significant specialised assets may elect to use CRC to support the value of specialised physical and intangible assets within CGUs in RAT, instead of seeking DCF valuations
- auditors will no longer have to review impairment calculations for these types of assets.

ACAG anticipates these savings are unlikely to be substantial as many NFP entities and valuers typically do not differentiate between DRC and CRC. However, as outlined in ACAG’s response to question 2(b) above, extra costs may be incurred by consumers if regulated assets carried at CRC are not subject to impairment.