Australian Government
Australian Accounting Standards Board

Staff Paper

Note 1 to Board members – Introduction

This working draft submission includes staff's proposed text regarding Specific Matters for Comment (SMC) 3–5 in IPSASB ED 76 *Conceptual Framework Update: Chapter 7*, Measurement of Assets and Liabilities in Financial Statements and SMC 5–9 in ED 77 *Measurement*.

At its August 2021 meeting, the Board considered draft text for some sections of the submission. That draft text is unshaded in this paper; any changes made to those sections since the version considered by the Board are marked in blue text, with deleted text struck through and new text underlined.

New notes to Board members and new sections of the draft submission that the Board has not yet considered are shaded in green. The shaded sections will be the focus of discussion at the September 2021 meeting.

Paragraph numbering is included in this paper for ease of reference during the Board meeting and will be removed in finalising the submission.

Note 2 to Board members

1. Draft text for the covering letter was presented to the Board, but not discussed, at its August 2021 meeting. Changes made to the draft text reviewed by the Board are marked in blue text.
2. A question for Board members is included below regarding the drafting of the covering letter.

Mr Ross Smith
Program and Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
(submitted via the IPSASB website)

XX October 2021

Dear Ross,

IPSASB Exposure Drafts 76 and 77

3. The Australian Accounting Standards Board (AASB) is pleased to provide its comments on Exposure Draft 76 *Conceptual Framework Update: Chapter 7*, Measurement of Assets and Liabilities in Financial Statements (ED 76) and Exposure Draft 77 *Measurement* (ED 77).
4. For ease of reference in this letter, non-financial assets held primarily for their operational capacity are referred to as 'operational capacity assets'.
5. The AASB commends the IPSASB for developing proposed updated measurement concepts for public sector entities and a proposed Measurement IPSAS applying those updated concepts to a variety of measurement issues public sector entities face. This submission includes the AASB's views on selected proposals in ED 76 and ED 77, primarily regarding the current operational value measurement and fair value measurement of operational capacity assets ~~measurement basis~~.
6. The AASB issued an Invitation to Comment (ITC 45) on ED 76 and ED 77 and received five comment letters, which are available on the AASB's website.

7. Since 2013, Australian public sector for-profit and not-for-profit (NFP) entities have been applying AASB 13 *Fair Value Measurement*, which incorporates IFRS 13 *Fair Value Measurement*. Those entities apply AASB 13 to measure the current value of all their non-financial assets. Other than some disclosure relief in AASB 13 para. Aus93.1, the AASB did not make amendments to IFRS 13 for application by NFP public sector entities. Appendix A includes an overview of the experience of Australian NFP public sector entities in applying IFRS 13/AASB 13.

8. The AASB is yet to be convinced that the current value of operational capacity assets should be measured under the current operational value basis instead of the fair value basis, because it considers that:

   (a) the measurement objective for current operational value is not stated with sufficient clarity in ED 76 and ED 77; and

   (b) the IPSASB's explanation of why it concluded that fair value is appropriate for assets held primarily for their financial capacity but inappropriate for operational capacity assets should be expanded to provide better justification of that conclusion.

9. Without detailed illustrative examples, it is difficult to identify how current operational value should be measured or the extent to which measurements of current operational value and fair value would differ. This lack of a clear distinction between current operational value and fair value is exemplified by the proposal in ED 76 and ED 77 that the market, income or cost approach (or a combination of those approaches) may be used to measure an asset's current operational value, which is also a feature of fair value. The AASB considers that ED 76 and ED 77 do not provide sufficient explanation of how the application of these three approaches would differ under current operational value and fair value.

10. Overall, there is insufficient information in the Exposure Drafts to explain why current operational value would be a better measurement basis than fair value for measuring the current value of operational capacity assets.

Question for Board members

Q1: Do Board members agree to state in the Board's submission that:

(a) the measurement objective of current operational value (COV) is not stated with sufficient clarity (paragraph 8(a));

(b) the IPSASB's explanation of why fair value is inappropriate for operational capacity assets should be expanded (paragraph 8(b));

(c) it is difficult to identify how COV should be measured or the extent to which it differs from fair value without detailed illustrative examples (paragraph 9);

(d) overall, there is insufficient information in the Exposure Drafts to explain why COV would be a better measurement basis than fair value for measuring the current value of operational capacity assets (paragraph 9); and therefore

(e) the Board is yet to be convinced that COV should be applied instead of fair value (stem of paragraph 8)?

11. In addition to comments received on ITC 45, the AASB obtained feedback about fair value measurement as part of its ongoing Fair Value Measurement for Not-for-Profit Entities project. A significant majority of stakeholders ~~including those who responded to AASB ITC 45—*draft comment subject to responses*]~~ across NFP public sector entities' financial statement preparers, auditors and valuers indicated that fair value under AASB 13 is appropriate for measuring the current value of non-financial assets held by NFP public sector entities and should remain the current value measurement basis. The Australian Federal Government and each State and Territory Government

has established policies and procedures to ensure consistent application of AASB 13 within a jurisdiction. Valuers have also established procedures in preparing valuation reports required for reporting under AASB 13.

12. These stakeholders also commented that they agree with applying the 'highest and best use' and 'market participants' concepts under fair value, although some stakeholders seek guidance to assist entities to understand better how these concepts should be applied in the NFP public sector context. They consider that applying the fair value basis to all non-financial assets, despite the need to exercise judgement in applying those concepts, would be preferable to applying two measurement bases, as proposed in the ED 76 and ED 77. This is because it would avoid:

    (a) the need for financial statement preparers, auditors and valuers to understand the requirements of two measurement bases;

    (b) imposing potential additional costs and effort to assess which measurement basis is appropriate for each asset or class of assets, or to reassess the appropriate measurement basis when there is a change in how an entity uses an asset; and

    (c) reporting to users of financial statements of NFP public sector entities current values based on mixed measurement bases, which would reduce the comparability and understandability of the totals reported.

Note 3 to Board members

13. The first two sentences of paragraph 14 were included in response to concerns expressed by some Board members at the June 2021 meeting that focusing the Board's submission on current value measurement might lead to misconceptions that the Board rejects the historical cost measurement basis.

14. The AASB supports the proposed retention of conceptual guidance supporting the usefulness of historical-cost-based measurements for decision-making and accountability purposes referred to in ED 76 paras. 7.28 and 7.31. However, the AASB focused its comments on the current value measurement of operational capacity assets. As such, this ~~This~~ submission does not include views on the historical cost measurement basis, ~~or~~ the current value measurement of liabilities ~~and~~ or assets held for their financial capacity (except in responding to Specific Matter for Comment 9 on ED 77).

15. Appendices B and C to this letter include the AASB's responses to selected Specific Matters for Comment in ED 76 and ED 77 related to:

    (a) the current operational value measurement basis; and

    (b) the removal of certain measurement bases from the IPSASB Conceptual Framework.

16. If you have any questions regarding this submission, please contact myself or Fridrich Housa, Deputy Technical Director (fhousa@aasb.gov.au).

Yours sincerely,

Dr Keith Kendall
AASB Chair

Question for Board members

Q2: Do Board members agree with the draft text in the covering letter?

APPENDIX A

Overview of the experience of Australian not-for-profit public sector entities in applying IFRS 13/AASB 13

Note 4 to Board members

17. At its August 2021 meeting, the Board decided the content in Appendix A. The Board decided that its submission to the IPSASB should include:

    (a) the IASB's explanation of the concepts of 'market participants in a hypothetical transaction' and 'highest and best use' in IFRS 13 as a basis for supporting the general view that fair value is appropriate even for specialised assets of NFP public sector entities; and

    (b) acknowledgment that additional guidance has been requested by Australian stakeholders to assist with the application of those concepts.

18. The draft text in Appendix A has been updated to reflect stakeholder feedback (see paragraph 23). Changes made to the draft text considered by the Board are marked in blue text.

19. **Stakeholder feedback:** Majority of respondents on ITC 45 support measuring the current value of operational capacity assets at fair value based on their highest and best use and disagree with COV (Topics A and K in Agenda Paper 13.2). Majority of stakeholders also commented that, for specialised assets or restricted assets, the asset's current use is its highest and best use in most cases (Topic D in Agenda Paper 13.2).

20. Since AASB 13 *Fair Value Measurement*, which incorporates IFRS 13 *Fair Value Measurement*, became effective in the 2013-14 financial year, Australian public sector entities have been applying fair value to measure the current value of all their non-financial assets. This is because the Federal, State and Territory Governments in Australia, and many of their controlled entities, have been applying the revaluation model option in Australian Accounting Standards to align with the requirements in Government Finance Statistics (GFS) to measure assets and liabilities at market value. Adopting the revaluation model option in Australian Accounting Standards requires an entity to regularly revalue non-financial assets to fair value.

21. In 2016, as part of the feedback received on the AASB's Agenda Consultation 2017–2019, the AASB received requests for guidance to assist application of AASB 13 in the not-for-profit (NFP) public sector. Therefore, the AASB added the Fair Value Measurement for Not-for-Profit Entities project (FVM project) to its work program.

22. Even though guidance is being requested to clarify certain principles in measuring the fair value of specialised operational capacity assets (such as identifying the market participants for the purchase or sale of an operational capacity asset that is specialised in nature, and the highest and best use of such an asset), a significant majority of stakeholders agree that the fair value measurement basis is appropriate for measuring the current value of operational capacity assets. These stakeholders noted that the fair value basis in AASB 13 – with its three approaches to measuring fair value – caters for all non-financial assets held by public sector entities (including its incorporation of the cost approach, which is particularly appropriate for the variety of specialised assets held by public sector entities, as discussed further below). They also commented that applying the fair value basis to all non-financial assets would be preferable to applying two measurement bases, as proposed in ED 76 and ED 77. This is because it would avoid:

    (a) the need for financial statement preparers, auditors and valuers to understand the requirements of two measurement bases;

    (b) imposing potential additional costs and effort to assess which measurement basis is appropriate for each asset or class of assets, or to reassess the appropriate measurement basis when there is a change in how an entity uses an asset; and

(c) reporting to users of financial statements of public sector entities current values based on mixed measurement bases, which would reduce the comparability and understandability of the totals reported.

23. Staff of the Australian Bureau of Statistics have informed the AASB that they consider fair value is the valuation basis most consistent with the GFS principle of market valuation. Any change from measuring assets at fair value might require data providers to keep separate records in order to provide the required GFS data.

Identifying market participants and the highest and best use of a specialised asset

24. Two of the key issues on which fair value guidance has been requested are:

(a) identifying the market participants for the purchase or sale of an operational capacity asset that is specialised in nature, in particular when an asset has legal restrictions (i.e. legal restrictions imposed on the use of an asset and/or the prices that may be charged for using an asset); and

(b) identifying the highest and best use of a specialised asset, including how the physical characteristics of an asset and legal restrictions should be considered when determining an asset's highest and best use.

25. The AASB has interpreted from ED 77 para. BC29 as indicating that the IPSASB decided fair value is not applicable to the current value measurement of operational capacity assets because it noted concerns from its constituents that the 'maximizing the use of market participant data'[1] and 'highest and best use' concepts are generally not applicable to such assets. However, the AASB observed that the IASB explained in its Basis for Conclusions on IFRS 13, in paras. BC78–BC79, how to consider market participant assumptions when measuring the fair value of a specialised non-financial asset, albeit in the context of a for-profit entity holding the asset for its financial capacity [emphasis added]:

BC78 Some respondents to the exposure draft 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. In such situations, 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 or with other assets and liabilities. Therefore, 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.

BC79 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

1 This phrase differs slightly from the words used in IFRS 13 para. 61, which refer to "maximising the use of relevant observable inputs".

asset (eg if that price represents the use of the asset on a stand-alone basis, not installed or otherwise configured for use, rather than in combination with other assets, installed and configured for use), 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.

26. Para. 29 of IFRS 13 and para. BC71 of the Basis for Conclusions on IFRS 13 provide guidance on identifying an asset's highest and best use [emphasis added]:

29 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.

BC71 IFRS 13 does not require an entity to perform an exhaustive search for other potential uses of a non-financial asset if there is no evidence to suggest that the current use of an asset is not its highest and best use.

27. Based on the IFRS 13 requirements and the Basis for Conclusions quoted above, the AASB made some observations regarding the 'hypothetical market participants' and 'highest and best use' concepts in respect of specialised assets and has yet to decide whether to develop fair value guidance based on these observations:

(a) because 'the market participant buyer steps into the shoes of the entity that holds that specialised asset', in the context of specialised assets, market-participants-based assumptions under fair value would be the same as the assumptions of the NFP public sector entity holding the specialised asset (interpreting IFRS 13 para. BC78). The AASB considered that a 'market participant buyer stepping into the shoes of the NFP public sector entity holding the operational capacity asset' obtains value from that asset:

i. by providing needed services to beneficiaries; and

ii. through financial support (in the form of rates, taxes, grants and appropriations) and through any user charges;

(b) the current use of a specialised asset is presumed to be its highest and best use, unless there is evidence that a different use by the NFP public sector entity holding the asset (as a market participant) would maximise the value of the asset (IFRS 13 paras. 29 and BC 71); and

(c) the income or the cost approach may be more appropriate than the market approach to measure the fair value of a specialised asset because a specialised asset should not be measured at its scrap value if the asset contributes more to an entity when used together with other assets. The market approach would reflect the selling price of the asset to an entity without the complementary assets (IFRS 13 paras. BC78 and BC79).

Other aspects of fair value

28. Australian NFP public sector stakeholders have also requested the AASB to provide guidance clarifying the following issues in measuring the fair value of operational capacity assets under AASB 13:

(a) how restrictions imposed on the use of an asset and/or the prices that may be charged for using an asset should be considered when measuring fair value;

(b) the assumed location of an operational capacity asset;

(c) the nature of component costs to include in an asset's current replacement cost;

(d) whether the current replacement cost of a self-constructed asset should include borrowing costs; and

(e) consideration of obsolescence.

29. The AASB noted that Appendix B of ED 77 proposes application guidance on these issues, albeit in the context of current operational value. The AASB has included its views on these issues in its response to the Specific Matters for Comment 5–6 of ED 77, which is contained in Appendix C of this submission.

Question for Board members

Q3: Do Board members agree with the draft text in Appendix A?

APPENDIX B

The AASB's responses to selected Specific Matters for Comment in ED 76

Note 5 to Board members

30. Draft text for SMC 3 and SMC 5 below was presented to the Board, but not discussed, at its August 2021 meeting. Only editorial changes were made to the draft text reviewed by the Board and are marked in blue text.

31. Draft text for SMC 4 is new and will be specifically discussed at the September 2021 meeting.

The AASB's views on Specific Matters for Comment 3–5 in ED 76 are set out below.

Specific Matter for Comment 3:

Do you agree with the proposed inclusion of current operational value as a measurement basis for assets in the Conceptual Framework?

If not, why not?

The Exposure Draft includes an Alternative View on current operational value.

Note 6 to Board members

32. The draft response to SMC 3 in paragraphs 34–37 focuses on the fundamental question of whether the IPSASB EDs made a convincing case for including the current operational value measurement basis in the IPSASB Conceptual Framework as an alternative to fair value and instead of replacement cost for operational capacity assets. The draft response to SMC 3 does not discuss in detail the definition of current operational value because that issue is the subject of SMCs 5–6 in ED 77.

33. **Stakeholder feedback:** Majority of stakeholders who commented on this issue did not support the IPSASB's view and consider that fair value is appropriate for measuring the current value of operational capacity assets. One stakeholder commented their preference to measure operational capacity assets, especially specialised buildings, at depreciated replacement cost (Topics A, E and K in Agenda Paper 13.2).

34. The inclusion of current operational value as a measurement basis, both in a revised IPSASB Conceptual Framework and in an IPSAS on Measurement, is premised on two IPSASB decisions about how to measure the current value of operational capacity assets on which the AASB wishes to comment, namely:

    (a) fair value is an inappropriate measurement basis; and

    (b) replacement cost would be an inappropriate alternative to fair value.

35. The AASB's comments on (a) are set out below. Its comments on (b) are included in its response to Specific Matters for Comment 4 and 5 on ED 76.

36. The AASB recommends that the IPSASB expands its explanation of why it concluded that fair value is appropriate for assets held primarily for their financial capacity, but inappropriate for operational capacity assets, to provide better justification for that conclusion. Without detailed illustrative examples, it is difficult to identify how current operational value should be measured (notwithstanding ED 77's proposed Implementation Guidance on the use of experts and the meaning of 'modern equivalent asset') and, particularly, how measurements of current operational value and fair value would differ.

37. Because of the insufficiency of the justification provided, the AASB is yet to be convinced that the current value of operational capacity assets held by public sector entities should be measured under the current operational value basis instead of the fair value basis. In particular:

    (a) the measurement objective for current operational value is not clearly stated in ED 76 and ED 77, particularly whether current operational value is meant to be limited to the entry price of an asset and, where not, what the nature of the measurement is;

    (b) if reflecting an asset's entry value is not the sole objective of current operational value, then fair value, which measures an asset's exit value and uses the same three measurement techniques as current operational value, could be applied. As discussed in Appendix A, the IASB provided guidance (in IFRS 13 and its Basis for Conclusions thereon) for identifying market participant buyers of a specialised asset and the highest and best use of an asset when measuring fair value; and

    (c) if reflecting an asset's entry value is the sole objective of current operational value, then applying replacement cost in the IPSASB's existing Conceptual Framework would appear to achieve this objective better than the proposed current operational value measurement basis (since para. 6 of ED 77 defines entry price as "the <u>price paid to acquire</u> an asset … in an exchange transaction" [emphasis added]. In this respect, the AASB considers that the alternative definition proposed in para. AV4 of ED 77 would appear to be a clearer and more accurate definition, because it clearly states that current operational value is "the cost to replace the service potential embodied in an asset at the measurement date".

Question for Board members

Q4: Do Board members agree to state in the Board's submission:

(a) the Board recommends that the IPSASB expands its explanation of why it concluded that fair value is appropriate for assets held primarily for their financial capacity, but inappropriate for operational capacity assets, to provide better justification for that conclusion (paragraph 36); and

(b) the reasons for that proposed Board comment set out in paragraphs 36–37?

<u>Specific Matter for Comment 4:</u>

It is proposed to substitute a general description of value in use (VIU) in both cash-generating and non-cash-generating contexts, for the previous broader discussion of VIU. This is because the applicability of VIU is limited to impairments. Do you agree with this proposed change?

If not, why not? How would you approach VIU instead and why?

Note 7 to Board members

38. ED 76 proposes to delete value in use (VIU) as a measurement basis from the IPSASB Conceptual Framework but to retain some limited discussion of VIU in paras. 7.57–7.62 of the updated Measurement chapter of the Conceptual Framework (VIU is retained in the IPSAS on impairment of assets).

39. Para. BC7.40 of the Basis for Conclusions on ED 76 indicates the reason for this proposal is that the applicability of VIU is limited to impairments of assets.

40. It might be noteworthy that para. BC7.38 highlights that the definition of VIU in the existing IPSASB Conceptual Framework differs from the definition in the IASB Conceptual Framework, and that the IPSASB has recently placed increased emphasis on consistent use of terminology and definitions by global standard setters.

41. Staff consider that impairment plays an important role in dealing with measurement of non-financial assets and VIU should be retained as a measurement basis in the IPSASB Conceptual Framework. In this respect, staff note that the IASB retained VIU when it revised its Conceptual Framework in 2018. The following table outlines the asset measurement bases that are being proposed in ED 76 and those included in the IASB's Revised Conceptual Framework.

Measurement bases for assets	
IPSASB ED 76	**IASB Revised Conceptual Framework**
Historical cost	Historical cost
Fair value (replacing 'market value')	Fair value
Current operational value (replacing 'replacement cost')	Current cost
N/A – propose to delete 'value in use'	Value in use

42. Staff's reasons for considering there is merit in retaining VIU as a measurement basis in the IPSASB Conceptual Framework are outlined in paragraph 44 below.

43. **Stakeholder feedback:** Of the three respondents on ITC 45 who commented on this topic, two agree and one disagrees with the proposed removal of VIU from the list of measurement bases in the IPSASB Conceptual Framework (Topic J in Agenda Paper 13.2).

44. The AASB considers there is merit in retaining value in use as a measurement basis in the IPSASB Conceptual Framework. The AASB's reasons for its views are:

(a) value in use is identified as a measurement basis in the IASB Conceptual Framework, despite also being limited in IFRS to impairments of assets. In fact, this is the only measurement basis in the IASB Conceptual Framework without a parallel or equivalent measurement basis in the proposed updated IPSASB Conceptual Framework;

(b) in relation to (a), the AASB is unaware of a public-sector-specific reason to differ from the IASB Conceptual Framework in this regard;

(c) impairment concepts (including value in use) play an important role in understanding the measurement concepts proposed in ED 77. For example, ED 77 para. B11 would require an entity to consider impairment in measuring an asset's current operational value when surplus capacity exists. Retaining value in use in the IPSASB Conceptual Framework would support developing any requirements for value in use measurements in other IPSAS based on consistent concepts; and

(d) it seems potentially confusing to exclude value in use from the measurement bases identified in the updated IPSASB Conceptual Framework but retain discussion of value in use in the Measurement chapter.

Question for Board members

Q5: Do Board members agree to state in the Board's submission:

(a) there is merit in retaining VIU as a measurement basis in the IPSASB Conceptual Framework; and

(b) the AASB's reasons for supporting retaining value in use as a measurement basis (points (a)–(d) in paragraph 44)?

Specific Matter for Comment 5:

Noting that ED 77, *Measurement*, proposes the use of the cost approach and the market approach as measurement techniques, do you agree with the proposed deletion of the following measurement bases from the Conceptual Framework:

- Market value—for assets and liabilities; and
- Replacement cost—for assets?

If not, which would you retain and why?

Note 8 to Board members

45. Draft text for SMC 5 below was presented to the Board, but not discussed, at its August 2021 meeting. Only editorial changes were made to the draft text reviewed by the Board and are marked in blue text.

46. As noted in the table in paragraph 41, ED 76 proposes to remove two asset measurement bases from the IPSASB Conceptual Framework based on its conclusion that those bases would become redundant as a result of adding fair value and current operational value as measurement bases.

47. The staff draft response (paragraph 50 below) supports the deletion of 'market value' from the IPSASB Conceptual Framework. This is because fair value is widely accepted as providing relevant current value information. The IASB Revised Conceptual Framework does not include 'market value' as a current value measurement basis.

48. In contrast, the staff draft response regarding the proposed deletion of replacement cost from the IPSASB Conceptual Framework (paragraphs 51–55 below) argues that a convincing case has not been made for replacing it with current operational value, for the reasons given in those paragraphs.

49. This topic has not been discussed with stakeholders.

Deletion of market value

50. The AASB agrees with the proposed deletion of 'market value' from the IPSASB Conceptual Framework as a measurement basis for assets and liabilities in light of the IPSASB's proposals to:

    (a) include fair value as a measurement basis in the Conceptual Framework; and

    (b) conform the definition of 'fair value' – both in the IPSASB Conceptual Framework and the Measurement IPSAS – to that used in IFRS 13, thus removing the need to use 'market value' to avoid potential confusion from including the IPSAS definition of 'fair value' in the Conceptual Framework rather than the definition in IFRS 13 (refer paras. BC7.31 and BC7.59–BC7.60 of the Basis for Conclusions on ED 76, and paras. BC51–BC54 of the Basis for Conclusions on ED 77).

Deletion of replacement cost

51. The AASB considers that the reasons given in ED 76 and ED 77 for proposing to remove replacement cost as a current value measurement basis should be expanded to provide better justification for that proposal. Based on the reasons presented, a convincing argument has not been provided for removing replacement cost. This AASB view reflects the following aspects:

    (a) current operational value is meant to reflect an entry price (ED 77 para. B9);

    (b) the IPSASB's proposals include using the cost approach as a measurement technique to estimate current operational value (ED 77 para. 38); and

    (c) the IASB includes current cost (as a complement to fair value and value in use)—which is similar to replacement cost—as a current value measurement basis in its Conceptual Framework.

52. ED 76 para. BC7.33 states that the IPSASB considered that replacement cost is an appropriate measurement basis for specialised assets, but also that current operational value is a more versatile measurement basis as it can be applied to both specialised and non-specialised assets. ED 76 para. BC7.27 states that the current operational value of a non-specialised asset can be supported by market-based measurement techniques with similarities to market value; whereas, the current operational value of a specialised asset can be determined using other measurement techniques.

53. The AASB interprets the IPSASB's rationale for not supporting 'replacement cost' as a measurement basis, noted in the first sentence of the paragraph immediately above, to imply replacement cost is inapplicable to assets valued using market techniques. That is, the IPSASB's rationale seems to regard replacement cost and market prices as mutually exclusive values. If that is the IPSASB's reasoning, the AASB would not support it.

54. The AASB considers the notion of replacement cost (whether measured under the cost approach to fair value or under another measurement basis) ~~to be derived solely from market transactions, some of which might not be~~ can be applied to any asset, even when the asset's price is observable in an active market ~~(e.g. where a specialised asset would be replaced through a multitude of individual purchases of materials and labour)~~. Prior to adopting IFRS in Australia, various Australian public sector entities adopted a current-cost-based revaluation model (using guidelines similar to, or concordant with, Statement of Accounting Practice SAP 1 *Current Cost Accounting*), under which the 'current cost' of some assets was measured using observable market prices or other observable market inputs. Therefore, the AASB considers that the notion of replacement cost is sufficiently robust to be applied to assets that are, or are not, traded in an active market.

55. An important advantage of retaining replacement cost as a current value measurement basis in the IPSASB Conceptual Framework, and including it in the IPSAS on Measurement, would be that many preparers, valuers and auditors of financial statements of public sector entities are familiar with replacement cost in the existing IPSASB Conceptual Framework and the existing role of depreciated replacement cost as a measure of fair value[2] in IPSAS 17 *Property, Plant and Equipment* (para. 48). Adopting a new measurement basis such as current operational value would involve developing new measurement techniques and identifying exactly how current value measurements of operational capacity assets would change. This would be difficult in the absence of detailed illustrative examples of how to measure an asset's current operational value. In addition, if current operational value was intended to measure an asset's current entry value, it would seem that its differences from replacement cost should be minimal, in which case it is difficult to envisage how the benefits of changing to a subtly different current value measurement basis for operational capacity assets would exceed the resulting costs.

Questions for Board members

Q6: Do Board members agree to state in the Board's submission:

(a) the comment that the IPSASB's proposal to delete 'market value' from the measurement bases in the IPSASB Conceptual Framework is supported (paragraph 50); and

(b) the comment that the reasons given in ED 76 and ED 77 for proposing to remove 'replacement cost' from the IPSASB Conceptual Framework should be expanded to provide better justification for that proposal (paragraph 51)?

Q7: Do Board members agree with the draft text in paragraphs 50–55?

2 Albeit, applying the cost approach involves using 'current replacement cost' (CRC) rather than 'depreciated replacement cost' (DRC). Replacing 'DRC' with 'CRC' would remove the potential for confusion regarding the distinction between those terms.

APPENDIX C

The AASB's responses to selected Specific Matters for Comment in ED 77

Note 9 to Board members

56. At the August 2021 meeting, the Board agreed the content of staff's draft text included in Part A of its submission to the IPSASB on SMC 5 and SMC 6. The Board had only requested editorial changes to be made to that draft text. Changes are marked in blue text to indicate revisions made to the draft text considered by the Board in paragraphs 60–93.

57. New sections to be considered by the Board at the September meeting are shaded in green. They relate to:

    (a) Part B of SMC 5 and SMC 6, regarding the cost approach under COV;

    (b) SMC 7, regarding the assumed location of an asset used to measure its current value;

    (c) SMC 8, regarding the use of the income approach in measuring an asset's COV; and

    (d) SMC 9, regarding fair value measurement.

The AASB's views on Specific Matters for Comment 5–9 in ED 77 are set out below.

<u>Specific Matter for Comment 5:</u>

Do you agree current operational value is the value of an asset used to achieve the entity's service delivery objectives at the measurement date?

If not, please provide your reasons, stating clearly what principles more appropriate for the public sector, and why.

The Exposure Draft includes an Alternative View on current operational value.

<u>Specific Matter for Comment 6:</u>

Do you agree the proposed definition of current operational value and the accompanying guidance is appropriate for public sector entities (Appendix B: Current Operational Value)?

If not, please provide your reasons, stating clearly what definition and guidance is more appropriate, and why.

The AASB's comments on the proposed core principle of current operational value (Specific Matter for Comment 5) and how the proposed definition of current operational value encapsulates that core principle (Specific Matter for Comment 6) are set out jointly below in Part A of the AASB's comments on those Specific Matters for Comment.

The AASB's comments on the proposed accompanying guidance on the cost approach under current operational value in Appendix B of ED 77 (Specific Matter for Comment 6) are set out below in Part B of the AASB's comments on those Specific Matters for Comment.

Part A: Proposed core principle and definition of 'current operational value'

Measurement objective and definition of current operational value

Note 10 to Board members

58. In respect of the measurement objective and definition of COV, the Board decided at its August meeting that its submission to the IPSASB should:

(a) state that ED 76 and ED 77 are unclear whether:

(i) COV is a measure of the cost required to replace the service potential of an asset or an intrinsic value to the entity of an asset's remaining service potential; and

(ii) COV is meant to be limited to the entry price of an asset and, where not, what the nature of the measurement is; and

(b) mention the observation noted in the Alternative View in ED 77 para. AV14 that, if reflecting an asset's entry value is the sole objective of COV, permitting the use of the income approach in estimating current operational value would mean that the resulting valuation might not reflect an entry price.

59. **Stakeholder feedback:** Majority of stakeholders who commented on this topic disagree with measuring the current value of operational capacity assets at COV and thus disagree with the two proposed definitions (Topic B in Agenda Paper 13.2).

60. The AASB considers that the meaning of current operational value warrants further clarification. Without further clarification, including detailed illustrative examples, it is difficult to identify the measurement objective of current operational value and how it should be applied in all circumstances. Consequently, the AASB is unable to provide a definite answer on whether it agrees with current operational value. However, as mentioned in the covering letter in this submission, the AASB is not convinced that current operational value is preferable to fair value as a current value measurement basis for operational capacity assets.

61. ED 77 para. 25(a) states that current operational value is an entry value. Similarly, ED 77 para. B2(a) states that: "… current operational value reflects the amount an entity would incur at the measurement date to acquire its existing assets to be able to continue to achieve its present service delivery objectives …" [emphasis added]. This states that current operational value reflects an asset's replacement cost.

62. However, ED 76 and ED 77 rejected replacement cost (and current cost in the revised IASB Conceptual Framework for Financial Reporting) as a possible alternative current value measurement basis to fair value for operational capacity assets. This indicates a measurement basis other than replacement cost would sometimes be used, but the Exposure Drafts do not identify the extent to which (or the circumstances in which) current operational value measurements would differ from replacement cost. It also implies a measurement objective other than replacement cost for some operational capacity assets, without identifying what that alternative objective might be. This is because the proposed definition of current operational value, as stated in ED 77 para. 6 ("the value of an asset used to achieve the entity's service delivery objectives at the measurement date") does not specify the type of 'value'.

63. Because the stem of ED 77 para. B2 states that "current operational value measures the value to the entity of an asset …" [emphasis added], and ED 76 and ED 77 reject fair value (a market exit price) and replacement cost (a market entry price) as the current value measurement basis for operational capacity assets, a potential implication is that Exposure Drafts propose some kind of intrinsic value measure of service potential for operational capacity assets. The AASB would not

support using an intrinsic non-market current value measure because it would be inherently subjective and difficult for users of financial statements to understand.

~~(a) any transactions undertaken by an entity to sell or replace its assets will occur at market prices; and~~

~~(b) it would be inherently subjective.~~

~~For the reasons in paragraphs 60–63, the AASB considers that:~~

~~(a) ED 76 and ED 77 appear to contain some inconsistencies in respect of the measurement objective of current operational value; and~~

~~(b) the meaning of current operational value warrants further clarification. Without further clarification, including detailed illustrative examples, it is difficult to identify the measurement objective of current operational value and how it should be applied in all circumstances.~~

64. Having regard to paras. 25(a) and B2(a) of ED 77, if current operational value is intended by the IPSASB to be solely an entry value, the AASB would consider the permissibility of using the income approach to estimate an asset's current operational value to be potentially inconsistent with that intention. The AASB supports the observations ~~noted~~ in the Alternative View in ED 77 (paras. AV11 and AV13) that using the income approach would result in an exit value that is generally inconsistent with the concept of the cost to replace the service potential embodied in the asset. ~~para. AV14 that permitting the use of the income approach in estimating current operational value would mean that the resulting valuation might not reflect an entry price.~~ Para. 6 of ED 77 defines entry price as " the price paid to acquire an asset … in an exchange transaction" [emphasis added]. ~~In the context of an operational capacity asset, it is difficult to understand how the use of the income approach, which is a measurement based on the cash flows generated by an asset, would reflect its entry price.~~

65. If the sole measurement objective of current operational value is to reflect an entry value of the asset, ~~then~~ it would appear that the alternative definition proposed in para. AV4 of ED 77 might be closer aligned to that measurement objective ~~would appear to be a clearer and more accurate definition~~, because ~~it~~ the alternative definition clearly states that current operational value is "the cost to replace the service potential embodied in an asset at the measurement date" [emphasis added].

Question for Board members
Q8: Do Board members agree with the draft text in paragraphs 60–65, particularly the amended rationale in the second sentence of paragraph 63 that an intrinsic non-market current value measure would be inherently subjective and difficult for users of financial statements to understand?

Current value measurement disregards an asset's potential alternative uses

Note 11 to Board members
66. At its August 2021 meeting, the Board decided to recommend in its submission that the IPSASB clarifies whether an asset's COV incorporates its residual value.
67. **Stakeholder feedback**: Stakeholders did not comment on whether an asset's residual value should be included in an asset's COV. Majority of stakeholders agree that operational capacity assets should be measured at fair value based on their highest and best use that is legally, financially and

physically feasible. They are also of the view that, for specialised assets or restricted assets, the asset's current use is its highest and best use in most cases (Topic D in Agenda Paper 13.2).

68. Another potential ~~inconsistency the AASB noted is~~ ambiguity that might warrant clarification concerns the proposals that current operational value:

(a) disregards potential alternative uses and any other characteristics of the asset that could maximise its market value (ED 77 para. B4); yet

(b) "… provides a useful measure of the resources available to provide services in future periods …" (ED 76 para. 7.53, emphasis added).

69. The AASB recommends the IPSASB clarifies whether the phrase "resources available to provide services in future periods" in ED 76 para. 7.53 ~~would logically~~ is meant to include the asset's residual value (i.e. its potential to be sold for cash at the end of its useful life and be reinvested in other stores of service potential). ~~This viewpoint is consistent with~~ Such an interpretation might be construed from the IPSASB's replacement cost measurement basis in its existing Conceptual Framework, which the IPSASB treats in ED 76 para. BC7.33 as appropriate for specialised assets. Para. 7.37 of the IPSASB Conceptual Framework states that an asset's replacement cost includes the amount that an entity will receive from disposal of the asset at the end of its useful life. ~~The AASB recommends the IPSASB clarifies whether an asset's residual value is included in its current operational value.~~

70. For example, those who interpret "resources available to provide services in future periods" in ED 76 para. 7.53 as including the asset's residual value might consider that the current operational value of a post office (an operational capacity asset) in the centre of a large city with the potential to be used as a commercial building with a high resale value should exceed the current operational value of another post office located in an outer suburb with no potential alternative uses and a low resale value. Even if the two post offices have an identical capacity to provide postal services and identical remaining useful lives, the post office located in the city centre ~~has~~ might be regarded as having the potential to provide more services (directly and indirectly) to the entity because the entity could choose to sell it and reinvest the cash in other post offices.

71. ~~In addition,~~ A related issue is that some may regard ~~if~~ the stated objective of current value measurement in ED 76 para. 7.53, namely, ~~is~~ to provide a "useful measure of the resources available to provide services in future periods" ~~(ED 76 para. 7.53)~~, as implying that the current measurement of an operational capacity asset should be based on the use of the asset that would maximise the value of the asset to the entity, in contrast with the rejection of the 'highest and best use' concept in ED 77. For example, a non-specialised building with harbour views currently being used by a public sector entity as a storage space has an alternative use as a residential property without requiring a change of permitted use. ~~Under~~ If the market approach were applied to measure the building's current operational value, the ~~current value of this~~ building would ~~be likely to~~ be measured ~~based on~~ having regard to market prices of comparable buildings, which would be likely to be residential buildings.

Question for Board members

Q9: Do Board members agree with the draft text in paragraphs 68–71?

Current operational value of restricted operational capacity assets

Note 12 to Board members

72. In respect of current value measurement of restricted operational capacity assets, the Board considered at its August 2021 meeting options for the content of its submission to the IPSASB in the context of fair value, rather than COV, because the objective of COV is unclear.

73. The Board decided that the draft text should:

(a) include a summary of feedback received from stakeholders regarding fair value measurement of restricted assets;

(b) include the rationale for the Board's previous tentative decision in 2019-20 to mandate the use of the cost approach when measuring restricted assets under certain circumstances (which aligns with ED 77 para. B14); but

(c) subject to considering further feedback on AASB ITC 45, express a revised view that the selection of the measurement approach to measure the fair value of restricted operational capacity assets should be in accordance with the general principles in IFRS 13, without imposing further constraints.

74. The Board had considered a draft response on this topic at the August 2021 meeting. Only editorial changes have been made to that draft text, which are marked in blue text below.

Stakeholder feedback

75. Agenda Paper 5.2 for the August 2021 meeting reminded the Board of the feedback it had received from stakeholders during 2019-21 about fair value measurements of restricted assets.

76. Feedback on ITC 45 is largely consistent with the feedback the Board received in its FVM project, and indicated that a majority of stakeholders are of the view that the fair value of specialised buildings situated on restricted land should be measured at current replacement cost, but restricted land should be valued based on market prices reflecting the restrictions (Topic E in Agenda Paper 13.2).

77. ED 77 para. B14(b) proposes that, if an equivalent restricted asset is not obtainable in an orderly market at the measurement date for a price supported by observable market evidence, the asset is measured using the cost approach, at the price of an equivalent unrestricted asset without a reduction for the restrictions. Without detailed illustrative examples, the AASB cannot identify the extent to which such a restricted asset's fair value would differ from its COV. The AASB's comments regarding the current value measurement of restricted assets are expressed in the context of fair value.

78. The topic of fair value measurement of restricted land held by an NFP public sector entity for its operational capacity has attracted extensive debate in the AASB's FVM project. Therefore, although this submission is specific to the proposals in ED 76 and ED 77, the non-mandatory implementation guidance in IPSASB ED 78 *Property, Plant and Equipment* regarding measurement of land under or over specialised assets – applicable to both current operational value and fair value – is also relevant to this topic.

79. The AASB observed that the guidance in ED 78 para. IG19 would suggest that the current value (whether current operational value or fair value) of land under or over specialised assets should be measured using the cost approach [emphasis added]:

IG19. [Draft] IPSAS [X] (ED 78) is clear that:

(a) Land should be separately accounted for. This requirement applies to all land, including land under or over infrastructure assets; and

(b) Land under or over infrastructure assets accounted for under the current value model should be valued at current operational value or fair value. Because the infrastructure asset itself is a specialized asset, it will often be the case that the market approach will be challenging to apply, and that the asset will be more easily valued using the cost approach.

80. Consistent with ED 77 para. 14(a), if an equivalent restricted asset is obtainable in the marketplace at the measurement date for a price supported by observable market evidence, most Australian stakeholders agree that the market approach should be applied in measuring the current value of the restricted asset.

81. Where equivalent restricted land is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence, based on targeted outreach with valuers, financial statements preparers and auditors ~~[and comments received on AASB ITC 45—*draft, subject to responses*]~~, the AASB noted that:

(a) land and improvements on land are recognised as separate classes of assets;

(b) a minority of stakeholders consider that restricted land is a specialised asset, and the fair value of restricted land should be measured in a manner similar to that described in ED 77 para. B14(b). That is, the cost approach should be applied and the current value of restricted land should not be reduced for the effect of restrictions; however,

(c) a clear majority of fair value measurements of restricted land are measured using the market approach. Under the market approach, the fair value measurements are less than the market price of equivalent unrestricted land[3] because of the effect of the restrictions. That is, the fair value of restricted land is measured at an amount less than the sales price of equivalent nearby unrestricted land.

82. Stakeholders applying the majority approach described in (c) above would disagree with ED 78 para. IG 19(b) about applying the cost approach to measure the fair value of land under or over specialised assets (e.g. land under a hospital) because:

(a) they do not consider land under or over specialised assets to be a specialised asset; and

(b) although an equivalent parcel of land with the same restrictions (with the same zoning restrictions as the specialised assets over or under the land) might not be obtainable in the marketplace at the measurement date for a price supported by observable market evidence, there are market transactions for other parcels of land that are suitable reference assets. Therefore, those stakeholders consider there are more observable inputs for applying the market approach than the cost approach in measuring the fair value of restricted land (consistent with the proposal in para. B23 of ED 77 to maximise the use of relevant observable inputs and minimise the use of unobservable inputs).

83. In respect of specialised improvements on land (e.g. a hospital building), a majority of Australian stakeholders would support the proposal regarding infrastructure in para. IG19(b) and apply the cost approach to measure the fair value of specialised improvements. This is because identical or comparable assets might not be available in the marketplace and, as stipulated in IFRS 13 para. BC79 (discussed in Appendix A), a market price (using the market approach) – if available – might not capture the characteristics of the specialised asset and therefore would not represent fair

3 That is, not restricted for the public-sector-specific purpose of holding the entity's parcel of land being valued. The equivalent 'unrestricted' land might be restricted in use by zoning other than for a public-sector-specific purpose (e.g. it might be zoned for residential, commercial or light industrial use) or by an easement providing access to other services.

value. This treatment is applied regardless of whether the market approach or the cost approach is applied to measure the fair value of restricted land.

84. Australian stakeholders have also advised the AASB that different valuers use different methods in calculating the adjustments to be deducted from the market price of equivalent unrestricted land, for example:

(a) using the price of nearby unrestricted land and explicitly deducting an adjustment for the effect of the restriction (explicit adjustment); and

(b) using the price of land with a much lower intensity of use – and, consequently, a much lower value – than that of nearby unrestricted land and not explicitly deducting an adjustment for the effect of the restriction because it is implicitly taken into account by using cheaper land in a lower-intensity-of-use location as a reference asset (implicit adjustment).

85. ~~The AASB is of the view that many restricted assets might have little value if sold for scrap, but would have a significant value when used together with other non-financial assets. In this regard, based on the interpretation of~~ Consistent with the IASB's view in IFRS 13 para. BC 78 (quoted in Appendix A), the AASB considers ~~considered~~ that many restricted assets might have little value if sold for scrap, but would have a significant value when used together with other non-financial assets, and that a 'market participant buyer stepping into the shoes of the NFP public sector entity holding the restricted asset' obtains value from that asset:

(a) by providing needed services to beneficiaries; and

(b) through financial support (in the form of rates, taxes, grants and appropriations) and through any user charges.

86. ~~The AASB notes that the~~ The IASB also acknowledged in IFRS 13 para. BC79 that the cost or income approach might be more appropriate in measuring an asset's fair value when ~~a market price does not capture the characteristics of the asset. The example the IASB noted in that basis for conclusion is when~~ the market price of the asset represents the use of the asset on a stand-alone basis rather than in combination with complementary assets.

87. IFRS 13 defines the cost approach as "a valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset …" [emphasis added]. Consistent with the IPSASB's view explained in ED 77 paras. B17 and BC44–BC45, if the cost approach is applied, the current value measurement of restricted land would not be reduced for the effect of restrictions. This is because if equivalent restricted land is not obtainable in the marketplace, the entity would need to purchase unrestricted replacement land to continue delivering services and the existence of restrictions does not affect the price of this purchase. ~~Therefore, under the cost approach, if an entity needs to purchase an unrestricted asset to replace the service capacity of an asset, then the fair value should be based on the price for the replacement unrestricted asset, which should not be reduced for the effect of restrictions.~~

88. The AASB notes that, conceptually, ~~Conceptually,~~ if an equivalent restricted asset is not obtainable at the measurement date, the market approach cannot be applied. This is because IFRS 13 defines the market approach as "a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets ..." [emphasis added]. However, the AASB also noted that views may differ regarding the meaning of 'identical or comparable assets' from an exit price perspective. Many stakeholders have expressed the view that an identical or comparable asset to a restricted asset, from an exit price perspective, is another restricted asset providing similar services (and not an equivalent unrestricted asset as proposed in ED 77 para. B14(b)). This is because those stakeholders consider that the price that market participant buyers would pay for the entity's restricted asset or for the reference asset providing observable inputs is reduced by the effect of the restriction.

89. ~~The AASB has reached a tentative view that the fair value of restricted assets should be measured using the cost approach without a reduction for the effect of the restrictions, if an equivalent restricted asset is not obtainable in the marketplace at the measurement date for a price supported by observable market evidence.~~

90. Notwithstanding the observations noted in IFRS paras. BC78–BC79 about the cost approach might be more appropriate in measuring an asset's fair value under certain circumstances, the AASB observed that para. B23 of ED 77 proposes to require an entity to select measurement techniques:

    (a) that are appropriate in the circumstances;

    (b) for which sufficient data are available to measure current operational value; and

    (c) maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

91. IFRS 13 para. 61 has the same requirement for measuring an asset's fair value. A majority of Australian stakeholders ~~[who responded to ITC 45: *draft, subject to comment letters received*]~~ commented that the ability to apply judgement in the circumstances in choosing among the market approach, income approach and cost approach (or a combination of those approaches) works well for measuring the fair value of an asset.

92. Despite the debate, feedback from most Australian stakeholders in targeted outreach or ad hoc feedback on tentative Board decisions indicated that, in practice, the fair value of each class of assets is being measured using a largely consistent approach – that is:

    (a) for restricted land, an adjustment is deducted (explicitly or implicitly) from the market price of equivalent unrestricted land to reflect the effect of restrictions because the market approach is used (although, as noted above, different methods are being used); and

    (b) for restricted improvements on land, an adjustment is not deducted to reflect the effect of restriction because the cost approach is used.

93. Although the AASB reached a tentative view in 2019-20 to provide further guidance on the fair value measurement of restricted assets that the cost approach should be used under certain circumstances, the AASB considers that determining appropriate valuation techniques for measuring the current value of an asset ~~that is restricted, or integrated with a specialised asset,~~ is best regarded as belonging within the province of valuation professionals and should not be mandated in accounting standards. Unless there is significant diversity in applying accounting principles in practice, there is no clear case for mandating the use of a particular valuation technique in measuring the current value of a particular asset or asset class.

Question for Board members

Q10: Do Board members agree with the draft text in paragraphs 77–93?

Part B: Proposed accompanying guidance on the cost approach under current operational value

Note 13 to Board members – Introduction to Part B of draft text in SMC 5–6

94. At its June 2021 meeting, the Board decided that its submission should include comments on all aspects of COV, including the measurement issues that the Board has previously reached tentative views on, but in the context of fair value.

95. Staff's draft text in Part B of SMC 5–6 below concerns three issues about the cost approach in AASB 13 that the Board has reached tentative views on in 2019-20 as part of its FVM project. They relate to:

(a) the nature of component costs to include in an asset's current replacement cost (paragraphs 97–115);

(b) whether the current replacement cost of a self-constructed asset should include borrowing costs (paragraphs 116–124); and

(c) consideration of obsolescence (paragraphs 125–145).

96. It is expected that the Board will consider in November whether to confirm its tentative views on these topics in its FVM project.

Nature of component costs to include in an asset's current replacement cost

Note 14 to Board members

97. ED 77 para. B35 proposes that the following costs should be ignored when considering the cost of a modern equivalent asset to estimate the COV of an asset. It states:

"(b) Additional costs arising from extending an existing property – These costs should be ignored, since the norm is that the valuation will be of a modern equivalent asset.

(c) Contract variations – Additional construction costs because of design or specification changes should be ignored. The modern equivalent asset being valued will have the same service capacity as the existing asset in its current use."

98. In addition, ED 77 para. B18 requires that a COV measurement using the cost approach (consistent with the cost approach under AASB 13) assumes the amount the entity would incur at the measurement date is incurred in the least costly manner.

99. AASB 13 does not specify the nature of the component costs to include when considering the cost of a modern equivalent asset when measuring an operational asset's fair value using the cost approach. The guidance in AASB 13 on the cost approach is confined to the following:

(a) "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)" (para. B8); and

(b) "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, 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 … 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 or with other assets and liabilities." (para. B9).

100. Australian NFP public sector stakeholders have requested the Board to provide guidance to clarify the types of costs to be included when measuring an asset's current replacement cost (CRC) under the cost approach in AASB 13.

101. During the FVM project, some stakeholders commented that the CRC of a self-constructed facility should exclude any components of the facility that will not require replacement in the future because their service capacity does not expire over time.[4] For example, they commented that, in relation to a road, the 'once-only' costs of land, design work, earthworks and formation costs do not wear out or become obsolete and therefore do not require replacement in the future.

102. The Board was also requested by ACAG (in its letter to the Board dated 23 September 2019) to provide guidance on how to measure disruption costs. ACAG stated that (in relation to Issue 3, para. 3, within the Appendix to that letter): "The inclusion of disruption costs is an area of significant judgement and insufficient guidance will lead to inconsistent interpretations and practice: … for instance, it may be cheaper to construct assets during regular hours, but because of concerns, largely political, regarding traffic congestion and commuter inconvenience, many road works are constructed at night at higher rates. … It is unclear to what extent these costs should be included in a subsequent valuation of these assets and how they should be measured. Also, there are different views as to whether to include disruption costs in the CRC as they don't represent the lowest cost to replace the asset with a substitute" [emphasis added].

The Board's tentative decisions

103. In 2019-20, during its FVM project, the Board observed that the IASB has provided some guidance:

(a) AASB 13 paras. B8-B9 state that [emphasis added]:

(i) the cost approach to measuring an asset's fair value reflects the amount that would be required currently to replace the asset's service capacity; and

(ii) from the perspective of the market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence; and

(b) para. BC30 of the Basis for Conclusions on IFRS 13 assumes a hypothetical exchange transaction. The Board previously interpreted that to mean that fair value is not limited to actual replacement transactions expected to occur in the future. The Board considered that the implicit assumption is that the market participant buyer does not possess the asset and is measuring the cost currently needed to be incurred to acquire or construct an asset of equivalent service potential.

104. The Board also considered that in a situation where a self-constructed asset is being sold, a market participant buyer would be prepared to pay for all necessary costs (recurring and non-recurring) intrinsically linked to the construction of that asset, subject to any obsolescence, because acquiring the asset from the holder saves the buyer incurring those costs itself.

105. The tentative views the Board has reached in the context of fair value basis are described in paragraphs 112–115 of the draft text below.

106. **Stakeholder feedback:** Two of the respondents on ITC 45 commented that the IPSASB's proposed guidance noted in paragraph 97 (that some costs are sometimes excluded from an asset's CRC) and the Board's tentative view (that all necessary costs intrinsically linked to the construction of that asset should be included) are not mutually exclusive. Based on the feedback received in the FVM project in 2019-21, a majority of stakeholders agree that a Standard should

set out the principles of replacement cost, and that all necessary costs intrinsically linked to acquiring or replacing an asset should be included (Topic G in Agenda Paper 13.2).

Basis of staff's draft text below

107. Staff recommend that the Board provides comments to the IPSASB on these issues in the context of current value measurement, rather than limiting its comments to either fair value or COV. This is because the Board's tentative views would apply regardless of whether the purpose of the current value measurement is to measure an asset's exit price or entry price.

108. Staff consider merit in including the following in the submission:

(a) the request from Australian stakeholders to provide fair value guidance on this issue (paragraph 110);

(b) a note to the IPSASB to consider including general principles in its Measurement standard for how to address these issues (paragraph 111); and

(c) the Board's tentative views reached in 2019-20, in the context of fair value (paragraphs 112–115).

109. ED 77 paras. B35(b)–B35(c) propose that some costs might not need to be included when considering the cost of a modern equivalent asset to estimate the current operational value of an asset.

110. The AASB has received requests from Australian stakeholders for more general guidance on the nature of the component costs to include in the calculation of an asset's current replacement cost in the context of fair value. This includes guidance on whether:

(a) once-only costs (e.g. formation costs for constructing a road) should be included;

(b) the 'the least costly manner' concept (consistent with the proposal in ED 77 para. B18) would include higher costs than those theoretically achievable where a more costly mode of replacement is necessary to meet community expectations;

(c) it should be assumed that the site on which an asset would be replaced in the hypothetical replacement transaction is in an area with a similar degree of development, with other facilities that would be disturbed upon replacement of the asset being taken into account (e.g. drainage works disturbed upon replacing a road), necessitating the incurrence of make-good costs for those disturbed facilities; and

(d) in relation to (c), if it were concluded that an asset's current replacement cost should include make-good costs for disturbing other facilities, whether the answer would depend on whether the facilities being disturbed are controlled by the public sector reporting entity or another entity.

111. The AASB considers that the IPSAS on Measurement should include general principles and illustrative examples for how to address these issues, in view of their pervasiveness in the NFP public sector. The AASB also considers that these issues affect the measurement of current replacement cost under the cost approach in the context of either a fair value measurement or a measurement of current operational value.

112. In view of the ambiguous nature of the concepts underlying current operational value, the AASB is unsure whether the treatment of the issues noted above should be the same for current

4 Issue 4 of Agenda Paper 6.1 for the November 2019 meeting includes a high-level summary of comments made by stakeholders.

replacement cost measurements under fair value and current operational value. The AASB notes below the tentative conclusions it has reached in the context of fair value about these issues regarding operational capacity assets (as part of its FVM project). The AASB has yet to decide whether to develop fair value guidance based on these tentative views:

(a) the current replacement cost of an asset includes all necessary costs intrinsically linked to acquiring the asset at the measurement date (which would include those costs mentioned in ED 77 paras. B35(a)–B35(c)); and, consequently

(b) a not-for-profit public sector entity should assume that the asset presently does not exist and needs replacing in its current environment. Therefore, the asset's current replacement cost should:

   (i) take into account any make-good costs that must be incurred for surrounding assets of another entity disturbed when the entity's asset is replaced; and

   (ii) include costs for land or permanent works, despite those components not being expected to be replaced, because current replacement cost assumes hypothetical replacement of the asset being measured, and is not limited to costs of replacements actually expected to be incurred in the future.

113. The AASB considers that 'once-only' costs should be included in the measurement of current replacement cost. This is because estimates of current replacement cost assume a hypothetical replacement transaction, in which the implicit assumption is that the entity (or a market participant buyer in the context of fair value) does not possess the asset and is measuring the cost currently needed to be incurred to acquire an asset of equivalent service potential. Therefore, the components of an asset's current replacement cost are not limited to actual replacement transactions expected to occur in the future. To conclude otherwise would logically imply that the current value of an asset would be zero if, at the measurement date, the asset is not expected by the entity (or a market participant buyer, in the case of current replacement cost in a fair value measurement) to be replaced at the end of its useful life.

114. The AASB also considers that in the measurement of current replacement cost, the 'least costly manner' principle should be applied in the context of the entity's mode of replacement in the ordinary course of operations, which would take into account community expectations, operational mandates or other imperatives to incur costs additional to the theoretically cheapest-legally-permitted costs to maintain an adequate quality of services.

115. For example, where a replacement of the surface of a road would, in the ordinary course of operations, occur at night rather than during daytime to minimise disruption to drivers, the more costly night costs should be included in the asset's replacement cost rather than the lower daytime costs. This is because replacement of the surface of the road in the daytime would be incompatible with community expectations on continuity of service.

Questions for Board members

Q11: Do Board members agree to state in the Board's submission:

(a) the request from Australian stakeholders to provide fair value guidance regarding the nature of costs to be included in an asset's current replacement cost (paragraph 110);

(b) a note to the IPSASB to consider including general principles in its Measurement standard for how to address these issues (paragraph 111); and

(c) the Board's tentative views reached in 2019-20, in the context of fair value (paragraphs 112–115)?

Q12: Do Board members agree with the draft text in paragraphs 109–115?

Whether the current replacement cost of a self-constructed asset should include borrowing costs

Note 15 to Board members

116. In relation to considering the cost of a modern equivalent asset to estimate the current operational value of an asset, ED 77 para. B35(a) states:

" … A large site may have been developed in phases. The cost of a modern equivalent asset would normally be based on a single-phase development, and this should be measured at the building cost at the measurement date. A single-phase development may still occur over an extended period of time. If the entity does not capitalize borrowing costs in accordance with IPSAS 5, *Borrowing Costs*, the entity should disregard any financing costs in measuring the modern equivalent asset" [emphasis added].

117. Australian stakeholders have advised the Board that for NFP public sector entities, borrowing costs typically are excluded from the CRC of an asset. They have requested the Board to provide guidance, in the context of the cost approach under AASB 13, to:

(a) clarify whether borrowing costs should be included in the CRC of an asset; and

(b) identify who the market participant buyers are for an asset (in order to determine the interest rate to apply), particularly specialised operational capacity assets financed by private sector entities, because the cost of borrowing in the public sector is generally significantly less than in the private sector.

The Board's tentative decisions

118. In 2019-20, the Board tentatively decided that the issue of whether to include borrowing costs in CRC affects for-profit and NFP entities alike. In light of the IASB not specifying the treatment of borrowing costs for fair value measurements by for-profit entities, the Board reached the tentative view that it would be inappropriate to mandate a particular treatment for NFP entities applying AASB 13. Therefore, staff recommend that the Board's submission does not express a view on whether borrowing costs should be included in the CRC of a qualifying asset.

119. The Board has also reached a tentative view that an entity's accounting policy choice for borrowing costs under AASB 123 *Borrowing Costs* at initial recognition is irrelevant to how those costs should be treated when measuring the fair value of an asset at subsequent measurement. This is because the price that market participant buyers would pay for an asset is unaffected by accounting policies adopted for the initial recognition of the asset. The capitalisation of costs and the measurement of current value are fundamentally different and independent processes. Therefore, there should be no presumption that the treatment of borrowing costs should be consistent for both.

Stakeholder feedback

120. The Board received mixed views on this issue during the discussion in its FVM project.

121. The comments received on ITC 45 are also mixed (Topic H in Agenda Paper 13.2). Of the three respondents who commented on this issue in ITC 45:

(a) one respondent and a majority of HoTARAC members agree with the Board's tentative view that the accounting policy choice concerning the capitalisation of borrowing costs is irrelevant to how those costs should be treated when measuring the current value of the asset; and

(b) one other respondent and two HoTARAC members agree with the IPSASB's view that, if an entity does not capitalise borrowing costs, the entity should disregard any financing costs when measuring the current value of the asset.

122. **Basis for staff's draft text below:** Staff's draft text does not express a AASB view about whether borrowing costs should be included in an asset's current replacement cost. Rather, it mentions the Board's tentative view that the accounting policy choice concerning capitalisation of borrowing costs at the asset's initial recognition is irrelevant to how those costs should be treated when measuring the subsequent measurement of the asset.

123. The AASB disagrees with the statement in ED 77 para. B35(a) that: " … A large site may have been developed in phases. … If the entity does not capitalize borrowing costs in accordance with IPSAS 5, *Borrowing Costs*, the entity should disregard any financing costs in measuring the modern equivalent asset." The AASB considers that the accounting policy choice regarding capitalisation of borrowing costs at the asset's initial recognition under IPSAS 5 is irrelevant to how those costs should be treated when measuring the subsequent measurement of the asset that necessarily takes a substantial period of time to get ready for its intended use.

124. The current value of an asset is a current market phenomenon, which is not affected by an entity's accounting policy choices concerning capitalisation of borrowing costs.

Questions for Board members

Q13: Do Board members agree to state in the Board's submission the Board's tentative view noted in paragraph 123 that the accounting policy choice regarding capitalisation of borrowing costs at the asset's initial recognition is irrelevant to how those costs should be treated when measuring the subsequent measurement of the asset?

Q14: Do Board members agree with the draft text in paragraphs 123–124?

Consideration of obsolescence when determining current operational value

Note 16 to Board members

125. This issue concerns the clarity and consistency of the proposed guidance in ED 77 regarding the interrelated issues of surplus capacity, COV and obsolescence. It has two components (discussed separately below):

(a) surplus capacity in general; and

(b) surplus capacity that is severable from the asset.

(a) Surplus capacity in general

126. ED 77 para. B10 provides an example of surplus capacity. It states: "Surplus capacity exists when an asset is <u>not used to its maximum capacity</u>. For example, an entity owns a building, but only utilizes 80% of the space available. The remaining 20% is left vacant" [emphasis added].

127. ED 77 para. B11 states that: "Since current operational value reflects the value of the asset consumed in providing the service at the prevailing prices, current operational value <u>assumes the asset is used to its full capacity</u>, subject to any <u>tests for impairment</u> in accordance with IPSAS 21 or IPSAS 26" [emphasis added].

128. However, ED 77 para. B36(c) also states that, when measuring an asset's COV under the cost approach, deductions are made for economic (or external) obsolescence. It describes 'economic obsolescence' as relating to "<u>any loss of utility</u> caused by economic or other factors outside the control of the entity" [emphasis added].

129. Staff observed that ED 77 is unclear whether a loss of utility of an asset should be treated as:

(a) surplus capacity, as described in ED 77 paras. B10 and B11 (which is not adjusted for when measuring the asset's COV); or

(b) an indication of economic obsolescence, as described in ED 77 para. B36(c) (which is deducted when measuring the asset's COV); or

(c) an indication of impairment.

130. In regard to point (b) and (c) in paragraph 129, it is not clear from the EDs whether a loss of utility is treated:

(a) as giving rise to an impairment loss – under which the asset's COV excludes the effect of the loss of utility, with that effect treated separately as an impairment loss; or

(b) as obsolescence – under which the asset's COV is reduced to reflect the effect of the loss of utility.

131. The Alternative View in ED 77 para. AV16 (quoted in paragraph 140 below) also noted this observation.

(b) Surplus capacity that is severable from the asset

132. The Alternative View also noted another concern in ED 77 para. AV17 regarding the implications of an operational capacity asset having surplus capacity:

"Furthermore, they consider it is important to clarify that when an asset includes surplus capacity that is <u>severable from the asset</u> (e.g. surplus land that <u>could be sold or leased</u> separately), the unit of account for measurement should be bifurcated – with the severable part of the asset that is surplus to operating requirements classified and measured as an <u>asset held for its financial capacity</u>" [emphasis added].

133. That is, the Alternative View expressed the view that, if a part of the asset is severable from the rest of the asset and could be sold or leased separately, then the current value measurement of that part should be measured under fair value, and not COV, and be treated as an asset held for its financial capacity.

134. **Stakeholder feedback:** Two respondents on ITC 45, API and HoTARAC, commented on this issue. They conditionally agreed (subject to significant caveats) with ED 77 para. AV17, but expressed views in the context of fair value. API is of the view that surplus capacity of an asset should only be bifurcated when the entity has declared it as surplus capacity. HoTARAC considers that surplus capacity of an asset should only be bifurcated when the entity has a plan to sell the asset (Topic I in Agenda Paper 13.2).

The Board's tentative view on economic obsolescence

135. At its April 2019 meeting, the Board has reached a tentative view that, when measuring an asset's current replacement cost under fair value, economic obsolescence should not:

(a) be identified if the asset has apparent 'excess capacity' that is temporary or occurs cyclically; and

(b) be limited to circumstances in which a formal decision has been made to reduce the asset's physical capacity (see the minutes of the April 2019 meeting).

Basis of staff's draft text below

136. Because part (b) of the issue (the issue of severable surplus capacity) is not an issue raised previously by Australian stakeholders during the Board's FVM project, the Board has not discussed this topic in that project. Staff consider that this issue would not be a concern if the entire asset, including the part that is being held for its operational capacity, is measured at fair value.

137. Since the Board did not express support for COV, one of the questions for Board members in this section is whether they wish to comment on the issue noted in ED 77 para. AV17. The draft response to the IPSASB below has been prepared on the basis that the Board decides to

comment on parts (a) and (b) of this issue, but refrains from opining on how part (b) (the issue of severable surplus capacity) should be treated.

138. In regard to part (b), staff consider that it would be useful for the IPSASB to note the comments made by API and HoTARAC that surplus capacity of an asset should not be bifurcated merely because the entity has the right to sell the surplus capacity.

139. In light of the Board's tentative decision noted in paragraph 135(b), staff consider it appropriate to note related concepts from para. 8 of AASB 5 *Non-Current Assets Held for Sale and Discontinued Operations* that an asset should not be classified as 'held for sale' until (among other criteria) management has committed to a plan to sell the asset and the asset is actively marketed for sale. IPSASB ED 79 *Non-Current Assets Held for Sale and Discontinued Operations* para. 13 proposes the same criteria for identifying an asset as 'held for sale'.

140. The AASB concurs with the comments in para. AV16 of the Alternative View of Mr. Beardsworth and Mr. Blake on ED 77, particularly their comments that they:

> "… are concerned that ED 77 does not provide guidance on (a) how to classify a reduction in an asset's use resulting from a reduction in demand for its services as either a potential source of impairment or a potential reduction in the asset's current operational value, and (b) whether a difference in classification might cause a difference in the asset's carrying amount. … [and] consider that this lack of clarity could lead to current operational value being overstated or understated, depending upon how an entity interprets the proposed requirements."

141. The AASB recommends that the IPSASB provides greater clarity regarding whether a loss of utility of an asset should be treated as:

(a) surplus capacity, as described in ED 77 paras. B10 and B11 (which is not adjusted for when measuring the asset's COV); or

(b) an indication of economic obsolescence, as described in ED 77 para. B36(c) (which is deducted when measuring the asset's current operational value); or

(c) an indication of impairment.

142. Specifically, in the example in ED 77 para. B10, the AASB requests the IPSASB to clarify why the 20% of the building left vacant would not be considered an indication of economic obsolescence or an indication of impairment; and thus, why the current operational value of the asset should not be reduced accordingly. ED 77 has not adequately explained why current operational value of an asset assumes that the asset is used to its full capacity when there is an apparent excess capacity.

143. Regarding the comments in the Alternative View about severable surplus capacity in para. AV16 of their Alternative View on ED 77:

(a) the AASB observes that, if fair value is the only current value measurement basis applied across all types of assets, the issue would not arise because the current value of all non-financial assets would be measured at exit price; and

(b) if a different measurement basis is applied to measure the current value of operational capacity assets, it would be important to clarify in the IPSAS whether and, if so, when surplus capacity should be bifurcated from the asset. Some Australian stakeholders have commented that this should occur only if and when:

(i) the surplus capacity is presently severable from the rest of the asset; and

(ii) the entity has a plan to sell or lease that severable surplus capacity part of the asset (and does not merely have the right to sell or lease the asset, as indicated in ED 77 para. AV17).

144. Point (b)(ii) above appears to be similar to the proposed requirement in para. 13 of IPSASB ED 79 *Non-Current Assets Held for Sale and Discontinued Operations* that an asset should not be classified

as 'held for sale' until (among other criteria) management has committed to a plan to sell the asset and the asset is actively marketed for sale.

145. The AASB recommends that any consideration of severable surplus capacity addresses the relationship between the timing of identifying obsolescence in respect of non-severable surplus capacity and bifurcating severable surplus capacity, to ensure 'mismatches' do not occur.

Questions for Board members

Q15: Do Board members consider that the Board's submission should comment on:

(a) surplus capacity in general only (i.e. only include draft text in paragraphs 140–142); or

(b) also comment on surplus capacity that is severable from the asset (i.e. including draft text in paragraphs 143–145?

Q16: Do Board members agree with the draft text in paragraphs 140–145?

Specific Matter for Comment 7:

Do you agree the asset's current operational value should assume that the notional replacement will be situated in the same location as the existing asset is situated or used?

If not, please provide your reasons, stating clearly why the asset should be measured at a different value.

Note 17 to Board members

146. Paragraph B6 of ED 77 states: "the asset's current operational value assumes that the entity will continue to meet its service delivery objectives from the same location in which the asset is currently situated or used" [emphasis added].

147. AASB 13 does not specify whether fair value measurements should assume the asset (e.g. land) would continue to be used in its existing location. In stakeholder consultations, the Board was requested to provide guidance on this topic.

148. In 2019-2020, the Board made a tentative decision that, when measuring the CRC of an operational capacity asset under fair value, it should be assumed that the asset is being replaced at its existing location. The Board's rationale is summarised in paragraph 152 of the draft response below. This view is consistent with the IPSASB's view in the context of COV noted in paragraph 146.

149. ED 77 describes current operational value as a current entry price (paras. B8–B9). Staff consider it appropriate for the Board to express a view on the assumed location of an asset when measuring its current entry price, regardless of whether the current entry price is a measure of fair value or a current entry value in its own right (e.g. COV). This would demonstrate that adopting the fair value measurement basis (cost approach) would often result in similar outcomes to adopting the COV measurement basis.

150. **Stakeholder feedback:** Majority of stakeholders agree that a non-financial asset's current value should assume that the notional replacement will be situated in the same location as the existing asset is situated or used (Topic F of Agenda Paper 13.2).

151. The AASB agrees that an asset's current operational value should assume that the notional replacement will be situated in the same location as the existing asset is situated or used. The AASB also holds this view for any current entry value, such as a fair value measurement calculated by applying the cost approach in IFRS 13/AASB 13.

152. The AASB supports this view because:

(a) if property has a higher market value in its current location than feasible alternative locations, from the perspective of market participant buyers, the property provides superior services. That is, market participant buyers are prepared to pay a premium for the service capacity of the property in its existing location (e.g. office space in a central business district location provides greater service capacity than office space in an inner suburb by, for example, having greater proximity to stakeholders and urban infrastructure, and by assisting the entity to attract and retain staff);

(b) it would generally be very difficult to identify which location, of a potential variety of alternative locations with possibly significantly different market prices of land, might be used as the assumed alternative location; and

(c) the additional cost of potentially preparing multiple valuations and due diligence assessments would be unlikely to be justified by the benefits to users of the financial statements, particularly because an asset or facility would normally be situated in its most (or virtually most) economic location.

153. The AASB notes that, in stakeholder outreach, it was advised that the majority of public sector stakeholders measuring non-financial assets at fair value by applying the cost approach in AASB 13 assume that the notional replacement will be situated in the same location in which the existing asset is situated or used.

Questions for Board members

Q17: Do Board members agree to state in the Board's submission that:

(a) an asset's current operational value should assume that the notional replacement will be situated in the same location as the existing asset is situated or used (paragraph 151); and

(b) the Board also holds this view for any current entry value, such as a fair value measurement calculated by applying the cost approach in IFRS 13/AASB 13 (paragraph 151)?

Q18: Do Board members agree with the draft text in paragraphs 151–153?

<u>Specific Matter for Comment 8:</u>

Do you agree the income approach is applicable to estimate the value of an asset measured using the current operational value measurement basis?

If not, please provide your reasons, stating clearly why the income approach is not applicable for measuring current operational value.

The Exposure Draft includes an Alternative View on current operational value.

Note 18 to Board members

154. ED 77 states that three measurement techniques can be used to estimate an asset's COV. They are the same three techniques used to estimate fair value: the market approach, the cost approach and the income approach.

155. Consistent with the requirements for measurement techniques used to measure fair value in para. 61 of AASB 13, para. B23 of ED 77 states in respect of COV that: "An entity uses measurement techniques that are appropriate in the circumstances and for which sufficient data are available to measure current operational value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs."

156. Para. B38 of ED 77 notes that the income approach may be applicable to estimate the COV of an operational capacity asset (i.e. an asset that is not held primarily to generate net cash inflows) under some circumstances.

157. In contrast, Mr. Beardsworth and Mr. Blake disagree that the income approach would be an appropriate measurement technique to use to estimate an operational asset's COV.

158. As noted in paras. AV5–AV12 of ED 77, these IPSASB members consider that:

(a) public sector entities often hold and use assets for their service potential, even though the cash flows (or revenue and expense flows) to be generated from each asset are less than the asset's cost or fair value. Allowing an entity to use the income approach for operational assets runs the risk that the assets will be measured at inappropriately low amounts, making it difficult for users to identify the remaining service potential of such assets;

(b) ED 77 would require an entity to maximise the use of observable inputs and minimise the use of unobservable inputs. Although more observable inputs might sometimes be available for the income approach than for the other techniques, it might result in an amount not reflecting the remaining service potential embodied in the asset; and

(c) COV should focus on the cost to replace the service potential embodied in the asset. The income approach is generally inconsistent with this concept because applying the income approach results in an amount that reflects the cash flows (or revenue and expenses) expected to be generated by the asset. In many cases, such an amount would not represent the cost of replacing the service potential embodied in an asset, particularly if (due to restrictions affecting the entity or the entity's own policy) the entity does not charge for the services provided by using the assets, or if the charges for these outputs are below-market charges, and the entity bases the asset's measurement on the entity's expected cash flows.

159. Stakeholder feedback: Majority of stakeholders agree that the income approach should be permitted as a valuation technique for measuring current value of an asset (Topic C in Agenda Paper 13.2).

Basis of staff's draft response

160. The draft response in paragraphs 161–164 includes the following comments:

(a) the Board's views (decided at the Board's August 2021 meeting) that fair value should be the current value measurement basis applicable to operational capacity assets, and the general principles of IFRS 13 should be applicable without imposing any further constraints on when any of the market, income or cost approaches should be applied;

(b) the Board's view that it is unclear whether COV is solely intended to represent an operational capacity asset's entry value; and

(c) if COV is solely intended to represent an operational capacity asset's entry value, then the Board would share the concerns raised by Mr. Beardsworth and Mr. Blake in the Alternative Views, that the use of the income approach might sometimes not reflect an asset's entry value.

161. As indicated in its response to Specific Matter for Comment 3 for ED 76, the AASB is not convinced that current operational value should be adopted as an alternative to fair value to measure the current value of operational capacity assets. The AASB also considers that, if fair value were adopted to measure operational capacity assets, an entity's selection of either the market approach, income approach or cost approach (or a combination of those approaches) should not be circumscribed in any way beyond the constraints of the general principles of IFRS 13.

162. As noted in Part A of the response to Specific Matters for Comment 5 and 6, the AASB considers it is unclear whether current operational value is solely intended to represent the asset's current entry value (paras. 25(a), B2(a) and B9 of ED 77) or to also include another value in particular circumstances.

163. If current operational value were solely intended to represent the asset's current entry value, the AASB would share the concerns raised by Mr. Beardsworth and Mr. Blake in para. AV14 of ED 77 that the valuation resulting from applying the income approach might not reflect an entry price.

164. Para. BC47 of the IPSASB's Basis for Conclusions on ED 77 indicates the income approach would play a limited role in estimating an asset's current operational value. The AASB considers that this should be noted in the IPSAS on Measurement and not only acknowledging it in the Basis for Conclusions.

Question for the Board members

Q19: Do Board members agree with the draft text in paragraphs 161–164?

Specific Matter for Comment 9:

In response to constituents' comment letters on the Consultation Paper, *Measurement*, guidance on fair value has been aligned with IFRS 13, *Fair Value Measurement* (Appendix C: Fair Value). Do you agree the guidance is appropriate for application by public sector entities?

If not, please provide your reasons, stating what guidance should be added or removed, and why.

Note 19 to Board members

165. ED 77 proposes that fair value is the appropriate current value measurement basis for non-financial assets held primarily for their financial capacity. The guidance on fair value currently contained in IPSAS is based on pre-IFRS 13 guidance. ED 77 proposes to align with the fair value definition and guidance in IFRS 13.

166. Staff recommend that the Board responds to IPSASB SMC 9, to express support for conforming the IPSAS guidance on fair value to that in extant IFRS, but also to reiterate that (as mentioned in the Board's draft response to ED 76 SMC 3) the AASB suggests not to limit the application of fair value to non-financial assets held primarily for their financial capacity.

167. The AASB agrees with the IPSASB's proposals in ED 77 that:

(a) fair value is the appropriate current value measurement basis for non-financial assets held primarily for their financial capacity (although the AASB would not limit the application of fair value to those assets: this separate issue is addressed in the AASB's comments on Specific Matter for Comment 3 on ED 76); and

(b) the definition of 'fair value' in IPSAS should conform to the definition of 'fair value' in IFRS 13 and guidance thereon should be consistent with the guidance on fair value in IFRS 13.

168. The AASB's reasons for supporting the IPSASB proposal noted in (a) above are that:

(a) there does not appear to be a public-sector-specific characteristic of non-financial assets held primarily for their financial capacity that warrants differing from the current value measurement basis generally applicable in IFRS for non-financial assets (fair value); and

(b) the experience of Australian public sector entities in applying fair value as the current value measurement basis for non-financial assets held primarily for their financial capacity is that it reports useful information for users of financial statements without creating issues involving diverse interpretation.

169. The AASB's reasons for supporting the IPSASB proposal noted in (b) above are that, as noted in para. BC54 of the IPSASB's Basis for Conclusions on ED 77:

(a) it would avoid confusion about the meaning of 'fair value'; and

(b) it would support high quality current value measurements.

Question for the Board members

Q20: Do Board members agree with the draft text in paragraphs 167–169?

Other Matters

Note 20 to Board members

170. Taking into account feedback from outreach activities, staff have noted two aspects of COV in ED 77 that may warrant further clarification by the IPSASB. Therefore, staff recommend adding the following text in the submission as 'Other Matters'.

171. As mentioned in its response to SMC 5–6, the AASB considers that determining appropriate valuation techniques for measuring the current value of an asset is best regarded as belonging within the province of valuation professionals and should not be mandated in accounting standards. Therefore, the AASB does not support the proposals in ED 77 regarding current value measurement of restricted assets. However, if the IPSASB adopts those proposals in the IPSAS on Measurement, the following concepts in ED 77 para. B13–B17 may benefit from further clarification.

Meaning of 'restricted assets' and 'equivalent restricted assets'

172. The AASB recommends clarifying:

(a) whether the restrictions referred to in ED 77 paras. B13–B17 are intended to include restrictions that would apply to any holder of the asset or restrictions relating only to a public-sector-specific purpose. Since all land is subject to some form of zoning restrictions, arguably the reference to 'equivalent <u>unrestricted</u> asset (i.e. land)' in ED 77 para. B14(b) might have no practical application, if the meaning of 'equivalent <u>unrestricted</u> asset' excludes assets with zoning restrictions that restrict the use or sale of an asset for any holder of the asset;

(b) the meaning of 'equivalent' in relation to the references to equivalent restricted or unrestricted assets in ED 77 para. B14(b). The AASB has received stakeholder comments on ED 77 expressing concern that, in the case of land held and zoned for a specialised purpose (e.g. education), where other nearby land zoned for that purpose is unavailable, it is unclear whether the 'equivalent' unrestricted land referred to in para. B14(b) might be nearby land zoned for residential, commercial or industrial purposes. The market values of these differently-zoned types of nearby land could vary widely; and

(c) the contaminated asset example noted in ED 77 para. B15. Using a contaminated asset as an example of an 'equivalent asset', without elaboration, might cause confusion. If a provision for restoration of the asset is recognised as a liability, the contamination should not be taken into account when measuring the current operational value of the contaminated asset. Doing so would double-count the effect of the contamination. The AASB recommends clarifying this aspect.

The use of the market approach is applicable only when an equivalent restricted asset is obtainable in an 'orderly market'

173. ED 77 para. B14(a) stipulates that the current operational value of a restricted asset shall be measured using the market approach only if that equivalent restricted asset is obtainable in an orderly market for a price supported by observable market evidence.

174. Consistent with para. 7.28 of the existing IPSASB Conceptual Framework, ED 76 paragraph 7.40 describes an orderly market as "one that is run in a reliable, secure, accurate and efficient manner. Such markets deal in assets that are identical and therefore mutually interchangeable, such as commodities, currencies, and securities where prices are publicly available. In practice few, if any, markets fully exhibit all of these characteristics, but some may approach an orderly market" [emphasis added].

175. In relation to restricted land, one could argue that no land is identical or interchangeable because each parcel is distinct from another parcel[5]. Under this view, it would mean that the current operational value of restricted land would not be measured using the market approach under any circumstance, because ED 77 para. B14(a) cannot be met as there is no identical or mutually interchangeable land. The AASB recommends that the IPSASB clarifies this proposed requirement.

176. From a consistency perspective, this appears to be the only proposed measurement requirement in ED 77 for which market evidence is required to be found an in 'orderly market', which also seems more restrictive than any requirement in IFRS 13. The IASB did not adopt the notion of orderly market in IFRS 13 (the definition of 'orderly transaction' in IFRS 13 does not refer to identical assets).

Question for the Board members

Q21: Do Board members agree with the draft text in paragraphs 172–176?

5 For example, International Valuation Standard IVS 400 *Real Property Interests* states that: "Property interests are generally heterogeneous (ie, with different characteristics). Even if the land and buildings have identical physical characteristics to others being exchanged in the market, the location will be different." (para. 50.1)