



**Valuers & Asset
Management**

Changes to AASB13: Fair Value Measurement (Nov 2022)

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Table of contents

About APV	3
Introduction.....	4
Background.....	5
Changes to AASB13.....	6
Clarification of existing requirements	7
Implications.....	8
Audit Evidence to Support Assumptions	8
Valuation of Restricted Land	10
Determining Replacement Cost using Cost Approach	12
Determining Depreciation Expense.....	16
Depreciated Replacement Cost (DRC) is Non-Compliant.....	18
Determining the Current Replacement Cost (CRC)	19
Accounting to reflect Asset Management Reality	20
Contacts	21

About APV



What we do

APV provides specialist valuation, asset management and asset accounting services for a wide range of organisations and sectors. We enjoy close partnerships with our clients across Australia, including hundreds of local councils, state government agencies, manufacturing and transportation businesses, universities and not-for-profit organisations.

Our services include:

- Fair Value valuations: land, buildings, plant, equipment, roads, water, sewerage
- Asset accounting: valuation and depreciation methodologies, compliance reviews
- Asset management: asset management frameworks, plans and systems
- Customised training and professional development: asset accounting and asset management.

As leaders in our field, we are proud of our unblemished record of audit approval. However, uncompromising quality is simply our starting point: *we deliver more than just figures*. We tailor our services to meet client needs, helping them get the most from their assets and plan effectively for the future.

And while valuation and depreciation can be complex, we keep it simple. We're constantly evolving to offer customers more flexibility and control. We use leading methodologies and custom-built valuation tools that are compliant, comprehensive, logical and truly relevant.

Introduction

Following five years of research by the AASB special project for fair value in the public and NFP sectors, the AASB in September 2022 approved a number of changes to AASB13 Fair Value Measurement. The amendment to AASB13 also provide clarification of existing requirements that were not being interpreted consistently across the jurisdictions.

This paper provides a summary of the key implications, from our perspective, flowing from these changes and include –

- Audit Evidence to Support Assumptions
- Valuation of Restricted Land
- Determining Replacement Cost using Cost Approach
- Determining Depreciation Expense
- Depreciated Replacement Cost (DRC) is Non-Compliant
- Determining the Current Replacement Cost (CRC)
- Accounting to reflect Asset Management Reality

The underlying object of this review of AASB13 was to remove ambiguity and achieve more consistent application across the various jurisdictions.

We encourage the various Treasuries, Offices of Local Government and Audit Offices to take time to digest the changes and reflect on whether their traditional jurisdictional practices are consistent with these changes. Where there is inconsistency, we further encourage them to provide leadership and guidance ensuring such inconsistencies with AASB13 are eliminated over the two-year transition period.

Background

Since the implementation of accrual accounting in the public sector in the early 1990's and subsequent adoption of the revaluation model there has been significant inconsistencies regarding the interpretation and association application of a range of valuation related aspects of the Australian Accounting Standards (AASBs).

Over the past 20 years the level of inconsistency has been exacerbated as a number of jurisdictions mandated the revaluation model for the first time and issued guidance which was not consistent with practices adopted in other jurisdictions or jurisdictions had not updated their guidance despite significant changes in the accounting standards. In some cases, the requirements issued by State Treasuries / Departments responsible for local governments or interpretations mandated by Auditors-General in some States were in direct opposition to the mandated requirements in other States.

In recognition of the inconsistencies and implementation of AASB13 which included a new definition and concept for fair value, CPA Australia developed detailed guidance material in 2013 and 2016 which was developed through an extensive collaborative process including representatives from all jurisdictions and across a wide range of different roles including valuers, auditors and financial statement preparers.

The subsequent 'guides to the valuation and depreciation of public and NFP sector assets' (which can be downloaded from the CPA Australia website) were subsequently peer reviewed and published free of charge. The guidance material in the CPA guide is consistent with the updated AASB13 Fair Value Measurement.

Despite development and publication of such guidance by CPA Australia, the various jurisdictions continued to promote practices inconsistent with the peer reviewed guidance.

With the continued adoption of inconsistent practices and in response to the growing concerns from practitioners the AASB established a special project for 'Fair Value in the Public Sector' in 2017. An initial meeting was held in Nov 2017 which resulted in the identification of a range of issues that the AASB and the special project team felt needed to be addressed.

Following relevant discussion and review of technical papers developed by the AASB technical staff with some support provided by members of the special project team guidance on a range of issues was issued by the AASB in April, June and November 2019. The relevant decisions and guidance has now been considered by the AASB and in Sept 2022 the AASB approved a range of enhancements to AASB13. This includes some additional guidance as well as clarifications regarding the existing requirements.

Changes to AASB13

This amendment to AASB 13, included adding authoritative implementation guidance and providing related illustrative examples, for application by not-for-profit public sector entities.

Specifically, in respect of fair value measurements of non-financial assets of not-for-profit public sector entities not held primarily for their ability to generate net cash inflows, this Standard:

- (a) specifies that the asset's current use is presumed to be its highest and best use unless it is highly probable at the measurement date that the asset will be sold, distributed, or used for an alternative purpose to its current use;*
- (b) clarifies that an asset's use is 'financially feasible' if market participants would be willing to invest in the asset's service capacity, considering both the capability of the asset to be used to provide needed goods or services to beneficiaries and the resulting cost of those goods or services;*
- (c) specifies that, if both the market selling price of a comparable asset and some market participant data required to measure the fair value of the asset are not observable, an entity uses its own assumptions as a starting point and adjusts those assumptions to the extent that reasonably available information indicates that other market participants would use different data; and*
- (d) provides guidance on how the cost approach is to be applied to measure such an asset's fair value.*

These changes apply prospectively to annual periods beginning on or after 1 January 2024 with earlier application permitted.

Clarification of existing requirements

In addition to the changes, the AASB also clarified that a range of the existing requirements (that have often been applied inconsistently) did not require amendment because the existing requirement was already very clear.

These were covered in the Basis of Conclusion paragraphs which included –

Distinguishing obsolescence from depreciation

BC212 *Some stakeholders asked the Board to clarify in Australian Accounting Standards that obsolescence for fair value measurement is different from depreciation. Since AASB 13 paragraph B9 specifies that obsolescence for fair value measurement under the cost approach is different from depreciation under AASB 116, the Board decided that additional guidance is not warranted. AASB 13 paragraph B9 states that: “Obsolescence ... is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives).”*

BC213 *The Board observed that aspects in addition to the depreciation of an asset need to be considered in measuring the fair value of an asset. AASB 13 paragraph 11 specifies that fair value measurements take into account characteristics of an asset that market participants would take into account, including, for example, the condition and location of the asset, and any restrictions on the sale or use of the asset.*

Method of depreciation

BC214 *Regarding comments by some stakeholders that many entities are applying the straight-line depreciation method by default, the Board considers that AASB 116 addresses this issue adequately. AASB 116 paragraph 60 states that: “The depreciation method used shall reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity.”*

In the Exposure Draft (ED320) the AASB also discussed issues relating to depreciation calculations. Specifically, that –

- if apply the straight-line approach to depreciation that, due to Example 3 of IAS8, that the correct formula was $(\text{Carrying Amount} - \text{Residual Value}) / \text{Remaining Useful life}$.
- AASB116 requires that all assets be appropriately disaggregated so that each part that has a different useful life is depreciated separately.

These aspects were not specifically mentioned in the updated AASB13. However, the AASB noted that there was no gap of flaw in existing pronouncements and guidance issued by the AASB. For example: the May 2015 Residual Value decision and AASB116.

BC208 *In addition, two respondents to ED 320 reiterated their requests for guidance on issues (a), (b) and (j), and on the appropriate disaggregation of parts of an asset to ensure the correct calculation of depreciation expense.*

BC209 *The Board noted that none of the issues in paragraphs BC207 and BC208 represent a justifiable circumstance under the AASB Not-for-Profit Entity Standard-Setting Framework that would require not-for-profit-specific modifications or guidance. This is because:*

- (a) those issues are not specific to not-for-profit entities and the IASB did not provide any further guidance on those issues; and*
- (b) there does not appear to be any gap or other flaw in existing pronouncements that would cause financial statements of not-for-profit public sector entities to inadequately reflect the objectives and qualitative characteristics of financial reporting or not reflect economic reality.*

Implications

While these changes and clarifications seem relatively innocuous, the inclusion of specific guidance (included in Appendix F: Australian implementation guidance for not-for-profit public sector entities) regarding specific scenarios has significant implications about how to apply the principals of AASB13 in practice.

These implications have been summarised in the following sections –

- Audit Evidence to Support Assumptions
- Valuation of Restricted Land
- Determining Replacement Cost using Cost Approach
- Determining Depreciation Expense
- Depreciated Replacement Cost (DRC) is Non-Compliant
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- Accounting to reflect Asset Management Reality

Audit Evidence to Support Assumptions

Perhaps one of the biggest issues from the changes is a perceived change in expectation about the evidence required to support assumptions and how assumptions are to be derived.

The changes require that –

if both the market selling price of a comparable asset and some market participant data required to measure the fair value of the asset are not observable, an entity uses its own assumptions as a starting point and adjusts those assumptions to the extent that reasonably available information indicates that other market participants would use different data

This makes common sense in that if there is available market evidence (such as costs of construction) that the assumptions should use that evidence.

The reality of course, is that in assessing the value of an asset using the cost approach, the valuer needs to apply a wide range of assumptions as part of the methodology. This might for example include setting assumptions about –

- Estimates of the variance in utility between the existing asset and the reference asset. This may be because of different design, dimensions, location, etc.
- Estimates of decommission dates or the impact of obsolescence
- The relationship between condition and remaining value
- The perceived pattern of consumption of the future economic benefit (even if straight-line is selected) for both valuation and depreciation expense profiles.
- Estimated remaining useful life assumptions for the estimate of projected depreciation expense

However, the new guidance is quite clear that when they use assumptions, they –

- Start with their own assumptions and adjust where there is market evidence of what other market participants would apply
- They do not need to identify specific market participants
- Importantly, an entity need not undertake exhaustive efforts to obtain information about market participant assumptions
- In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data
- Furthermore, that exhaustive efforts need not be undertaken to identify whether relevant information about other market participant assumptions is reasonably available or whether the entity's own data should be adjusted

This obviously has implications for the level of assurance required over assumptions to support the valuation. In recent years, auditors have become increasingly demanding in the level of assurance required to support valuation assumptions. However, the AASB have now quite explicitly indicated that where assumptions are made, the entity (or valuer) need not undertake exhaustive research to support the assumptions. In short, they only need to adopt their own assumptions and make changes to those assumptions if there is 'reasonably available' information about the assumptions that would be applied by other market participants.

In recognition of the significant impact of professional judgement require in determining the relevant assumptions, we see these changes as recognition that there is need to balance the cost of compliance against the benefit received.

In recent years, we have experienced an increasing number of instances where the cost of audit of the valuation is more than four times higher than the actual cost of the valuation. Either the cost of valuation is far too low (we suspect our clients would argue this is not the case) or auditors need to reassess the level of assurance they require over key assumptions and improve their knowledge of the accounting standards.

Unfortunately, we suspect that audit expectations over assumptions is only going to continue to increase despite the AASBs guidance on this issue.

Key sections for AASB13 are -

Australian guidance F2 paragraph 22 requires -

- F2 an entity to measure the fair value of an asset using the assumptions that market participants would use when pricing the asset, assuming that market participants act in their economic best interest. Paragraph 23 states that, in developing those assumptions, an entity need not identify specific market participants; and paragraph 89 states that (in relation to unobservable inputs for an asset) an entity need not undertake exhaustive efforts to obtain information about market participant assumptions.*
- F3 Unobservable inputs are defined as inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability. Paragraph 87 states that unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Paragraph 89 states that, in developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy).*
- F6 For the purposes of paragraph F5, if no relevant information about other market participant assumptions is reasonably available, the entity shall use its own assumptions in measuring the fair value of the asset. Exhaustive efforts need not be undertaken to identify whether relevant information about other market participant assumptions is reasonably available or whether the entity's own data should be adjusted. However, when information about market participant assumptions is reasonably available, an entity cannot ignore that information.*

Valuation of Restricted Land

The valuation of land which is either restricted in use or restricted from sale has over the past twenty-five years caused the most debate and variation in practices across jurisdictions. Some jurisdictions mandated practices requiring the value of the land to be 'discounted' whereas others adopted practices where no discount was to be applied.

The argument for discounting was based on the argument that any restrictions would result in a lower price than other market participants as the restrictions resulted in the land not being at its 'highest and best use'. In some jurisdictions this was referred to as a community service obligation which was expressed as the difference between the cost of acquire the land assuming no restrictions and the market value given the restrictions.

Those who did not apply a discount argued that –

- Because the land could not be traded there was no open and active market and therefore adoption of the 'market approach' was inappropriate. Instead, the valuation should be based on the 'cost approach'
- Any perceived community service obligation represented service potential (no different to how infrastructure assets deliver services free of a direct user fee) and therefore the value of the service potential needs to be included in the value of the asset.

The issue of what constitutes 'Highest and Best Use' is a concept that many practitioners have found to be confusing and to some extent has been a factor in the different interpretations applied to the valuation of restricted land.

The AASB have now included paragraph Aus28.1, to explain a financially feasible use as one that generates sufficient services to justify a not-for-profit public sector market participant buyer incurring the asset's current replacement cost.

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

Furthermore, that such presumption can only be rebutted when it is highly probable that it will be sold, distributed or used for an alternative purpose.

Aus29.1 Notwithstanding paragraph 29, for a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, the asset's current use is presumed to be its highest and best use unless at the measurement date it is highly probable that the asset will be sold, distributed, or used for an alternative purpose to its current use.

Aus29.2 For the purposes of paragraph Aus29.1, it is highly probable that the asset will be:

- (a) *sold or distributed when it is classified as held for sale or held for distribution in accordance with AASB 5 Non-current Assets Held for Sale and Discontinued Operations; and*
- (b) *used for an alternative purpose to its current use when all of the following conditions are met:*
 - (i) *the alternative purpose for the asset is physically possible, legally permissible and financially feasible in accordance with paragraphs 28 and Aus28.1;*
 - (ii) *the appropriate level of management is committed to a plan to change the usage of the asset to that alternative purpose, and an active programme to complete the plan has been initiated;*
 - (iii) *the asset is immediately available to be used for the alternative purpose in its present condition;*
 - (iv) *any approvals required to change the asset's usage have been obtained;*
 - (v) *actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn; and*

- (vi) *the change in the asset's use is expected to be completed within one year from the measurement date.*

In the April 2019 AASB meeting the board decided that –

'for specialised or restricted public sector assets not held primarily for their ability to generate net cash inflows, the approach to determine their fair value should be current replacement cost.'

However, in the updated AASB13 the board specifically noted that the accounting standards are principal based and it would be inappropriate to specify which method to use.

BC196 Notwithstanding the interpretation of paragraphs BC78 and BC79 of IFRS 13 in paragraphs BC191 and BC192 by a minority of stakeholders, in which they concluded that the cost approach would often be appropriate in measuring the fair value of land subject to public-sector-specific legal restrictions, the Board noted that AASB 13 paragraph 61 requires an entity to select measurement techniques:

- (a) that are appropriate in the circumstances;*
- (b) for which sufficient data are available to measure fair value; and*
- (c) that maximise the use of relevant observable inputs and minimise the use of unobservable inputs.*

BC197 Therefore, the Board considered that determining appropriate measurement techniques for measuring the fair value of an asset is best regarded as relating to detailed valuation assessments and should not be mandated in Australian 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 fair value of a particular type or class of assets.

The board also clarified that no discount should be applied to restrictions that would not pass from the hypothetical seller to the hypothetical buyer.

BC66 Consistent with the IASB's analysis in the illustrative example quoted in paragraph BC65, the Board noted that the fair value measurement of an asset:

- (a) would not take into account a restriction that is specific to the entity holding the asset, ie would not transfer to market participants in a hypothetical sale transaction (eg the restriction on the use of land in the IASB's example); but*
- (b) would take into account the effect of restrictions that would transfer to market participants in a hypothetical sale transaction (eg the easement restriction in the IASB's example).*

Typically, when a public sector entity divests itself of land it will go through a process of seeking Ministerial approval to change the land classification from Community Land to Operational Land (freehold) and then changing zoning to maximise the return from sale. Unless the existing use (e.g. park, reserve, cemetery) is a restriction that would pass from the hypothetical seller to the hypothetical buyer, the current restricted use is to be excluded from the analysis. i.e. No discount would be applied.

Based on this the AASB13 Fair Value determined under either market or cost approach would theoretically be the same. i.e. The market price that would be paid to acquire land in the same location with same characteristics excluding the purpose for which it is currently used.

This would also ensure that when land is acquired at market price, to then be used for a community purpose (park, land under road), that the fair value is calibrated to the transaction price as required by AASB13.64.

Determining Replacement Cost using Cost Approach

Traditionally there has been confusion around what costs need to be included in the calculation of the replacement cost and inconsistent interpretations around whether to base the cost of current location or an optimised location or design.

In short, the Replacement Cost is to be determined by –

- Identifying whether if the asset would be replaced via a modern equivalent or reproduction (reference asset)
- Calculate the gross replacement cost ensuring –
 - The asset would be constructed in the same location
 - Use its own assumptions as a starting point and adjust those assumptions to the extent that reasonably available information indicates that other market participants would use different data
 - The costs reflect those costs that would be incurred in the normal course or operation rather than the minimum legally required
 - Include in the costs
 - costs required to restore another entity's asset, if the asset that would need restoration existed at the measurement date and would be disturbed in a hypothetical acquisition or construction of the reference asset
 - other disruption costs that would hypothetically be incurred when acquiring or constructing the reference asset
 - site preparation costs for the reference parcel of land unless those site preparation costs are reflected (explicitly or implicitly) in the fair value measurement of the subject parcel of land
- Adjusting for the difference in utility between the existing asset and reference asset as well as for any permanent over-capacity or obsolescence

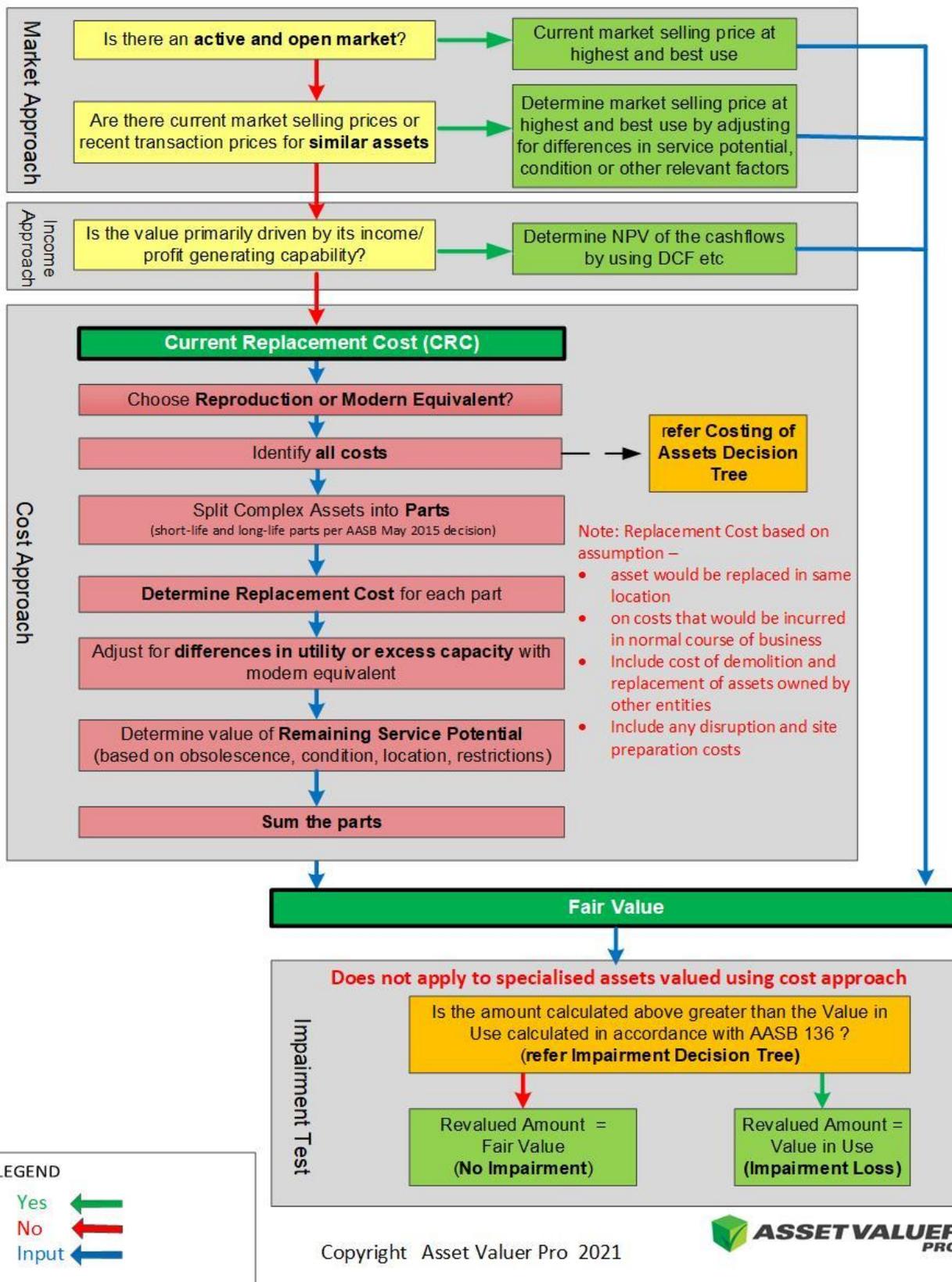
This clarifies that –

- Replacement costs based on 'greenfield' or 'brownfield' approaches are inconsistent with AASB13 because they either exclude costs that need to be included or not based on the costs associated with normal operations.
- Costs that relate to the demolition and replacement of assets controlled by other entities need to be taken-into-account
- The estimate of replacement costs should reflect actual costs experienced by the entity (market evidence and normal course of operations) rather than hypothetical first principal estimates.
- Replacement costs need to take account for the difference in utility between the asset and the reference asset as well as the impact of over-capacity or obsolescence.

This process is summarised in the following Decision Tree.

AASB 13 “Fair Value Measurement” Selection of Valuation Technique Decision Tree

As at 3 November 2022



Relevant sections from AASB13 are –

F11 For the purposes of paragraph F9, when estimating the cost currently required for a market participant buyer to acquire or construct a reference asset, an entity:

- (a) assumes the reference asset will be acquired or constructed at the subject asset's existing location; and*
- (b) where paragraph F5 applies, shall use its own assumptions as a starting point in measuring the costs currently required to acquire or construct a reference asset and adjust those assumptions to the extent that reasonably available information indicates that other market participants would use different data.*

F12 When applying paragraphs F9 and F11, the entity shall, subject to paragraph F14, include the following costs (among other costs) in the reference asset's replacement cost if they would need to be incurred upon the hypothetical acquisition or construction of a reference asset with the same service capacity (including condition) as the subject asset at the measurement date:

- (a) costs required to restore another entity's asset, if the asset that would need restoration existed at the measurement date and would be disturbed in a hypothetical acquisition or construction of the reference asset. However, such costs are excluded if they relate to restoration of an asset of another entity included in the consolidated group (if any) to which the entity belongs;*
- (b) other disruption costs that would hypothetically be incurred when acquiring or constructing the reference asset at the measurement date (eg costs of redirecting traffic when replacement of the asset, such as a drainage pipe, disrupts the operation of a road); and*
- (c) if the subject asset is fixed to a parcel of land, site preparation costs for the reference parcel of land on which the reference asset would hypothetically be constructed, unless those site preparation costs are reflected (explicitly or implicitly) in the fair value measurement of the subject parcel of land.*

F13 For the purposes of paragraph F12(c), site preparation costs include, but are not limited to:

- (a) costs required to prepare the land (eg earthworks and decontamination) for the hypothetical construction of the reference asset; and*
- (b) costs required to remove and dispose of any unwanted existing structures on the land to make way for the hypothetical construction of the reference asset.*

F14 An entity need not undertake exhaustive efforts to obtain information about the costs referred to in paragraphs F12 and F13. However, an entity shall include all such costs for which data are reasonably available.

F15 When applying the cost approach in accordance with paragraph F9 to measure the fair value of a heritage asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows, to the extent that its heritage features are an essential part of its service capacity, replacement cost generally means the cost of replicating those features of the subject asset (ie reproduction cost). Replication would assume reconstruction using modern cost-effective materials and processes, but sympathetic with the original heritage design and structure to the extent feasible.

F16 When a non-financial asset of a not-for-profit public sector entity not held primarily for its ability to generate net cash inflows has suffered a reduction in demand for its services, the identification of 'economic (ie external) obsolescence' (referred to in paragraph B9) does not require a formal decision to have been made to reduce the physical capacity of that asset.

F17 When an asset described in paragraph F16 apparently has surplus capacity in view of current demand for its services, economic obsolescence is not identified for that asset if that 'surplus capacity' is necessary for stand-by or safety purposes (eg to deal with contingencies), even if it seldom or never is actively utilised. An example of an asset with stand-by capacity that is necessary for operational purposes, and would be replaced in full by a market participant buyer, is an electricity generation plant that maintains a generating capacity buffer that is typical of the industry to cater for periods of peak demand.

F18 An example of a strong indicator that economic obsolescence of assets would be identified when applying the principles in paragraphs F16 and F17 is a public school's buildings that have a

capacity for 500 students but, due to demographic changes, a school for 100 students would meet current and reasonably foreseeable requirements, including a buffer needed for any temporary or underestimated student demand. In this example, based on these assumed facts alone (for simplicity), the school buildings' gross replacement cost would be based on the school's needed capacity (for 100 students), from which any other accumulated obsolescence related to the condition of the school buildings (eg physical obsolescence) would be deducted. Consistent with paragraph F16, the conclusion reached would not depend on whether a formal decision has been made to reduce the school buildings' capacity.

F19 Where an asset or a facility that is not held primarily for its ability to generate net cash inflows suffers a significant reduction in demand for its services, any economic obsolescence identified would not necessarily (and frequently would not) exhibit a linear relationship with that reduced level of demand. This is because some parts of an asset or a facility might need to be replaced in full, or almost in full, despite a significant fall in demand for the services provided by the asset or facility (eg in the school example, the administration office, cafeteria, toilet blocks, library and gymnasium might need replacing even for 100 students, although perhaps on a slightly smaller scale).

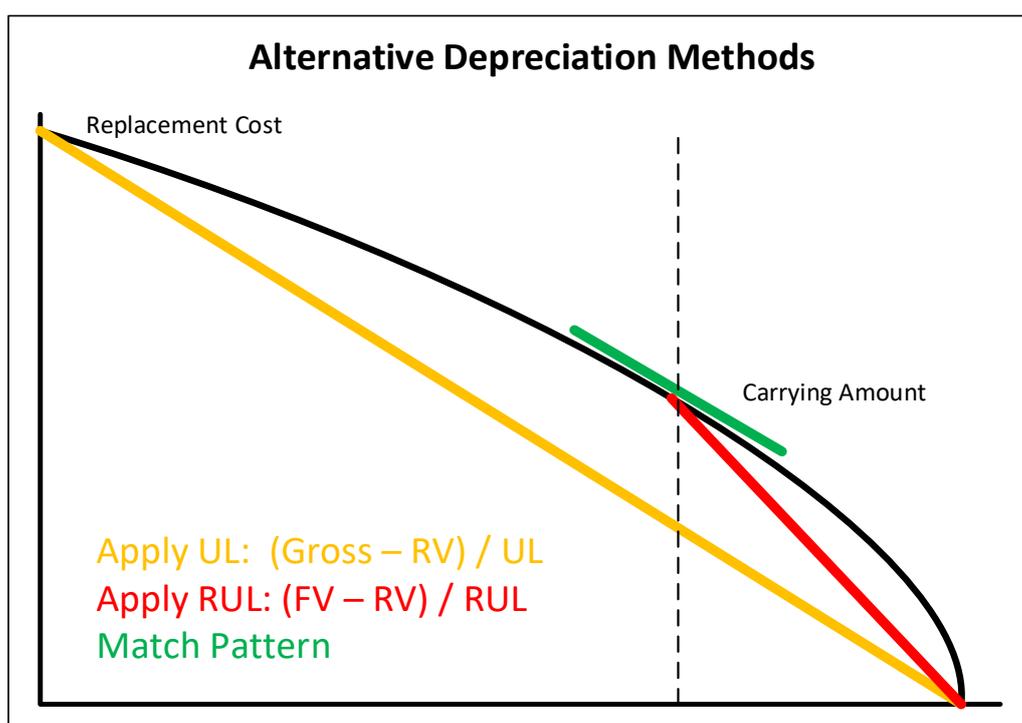
BC155 Application of the cost approach assumes implicitly a hypothetical acquisition or construction of the subject asset occurs in the most economical manner. However, stakeholders informed the Board that in many cases, not-for-profit public sector entities would incur costs additional to the cheapest legally permitted costs in order to maintain an adequate quality of services to the public or to adhere to unlegislated Government policies that direct or limit replacement options, eg in relation to Australian industry content or security. Where the entity or another market participant replaces an asset, and it would necessarily incur greater costs than the cheapest legally permitted costs, the more expensive costs would be those most likely to be included in the pricing assumptions of the market participant and to be incurred in the ordinary course of operations. This view was included in ED 320 and was supported by a majority of respondents.

Determining Depreciation Expense

For many entities, the straight-line method of depreciation is selected as a default. However, when the depreciation method is different to the pattern of consumption used to determine the value, this will result in material misstatement of depreciation expense.

The diagram below demonstrates the three most common approaches to depreciation expense. Assuming the black line represents the expected pattern of consumption of the assets future economic benefit –

- The green line (tangent to the curve) represents the technically correct estimate of depreciation expense
- The yellow line represents the most commonly applied method which in the pre-IFRS adoption of accounting standards was referred to as the 'non-conforming' method
- The red line highlights the risk that depreciation expense will be significantly over-stated because it does not match the expected pattern of consumption of the future economic benefit.



As noted by the AASB –

BC214 Regarding comments by some stakeholders that many entities are applying the straight-line depreciation method by default, the Board considers that AASB 116 addresses this issue adequately. AASB 116 paragraph 60 states that: "The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity."

The standards require –

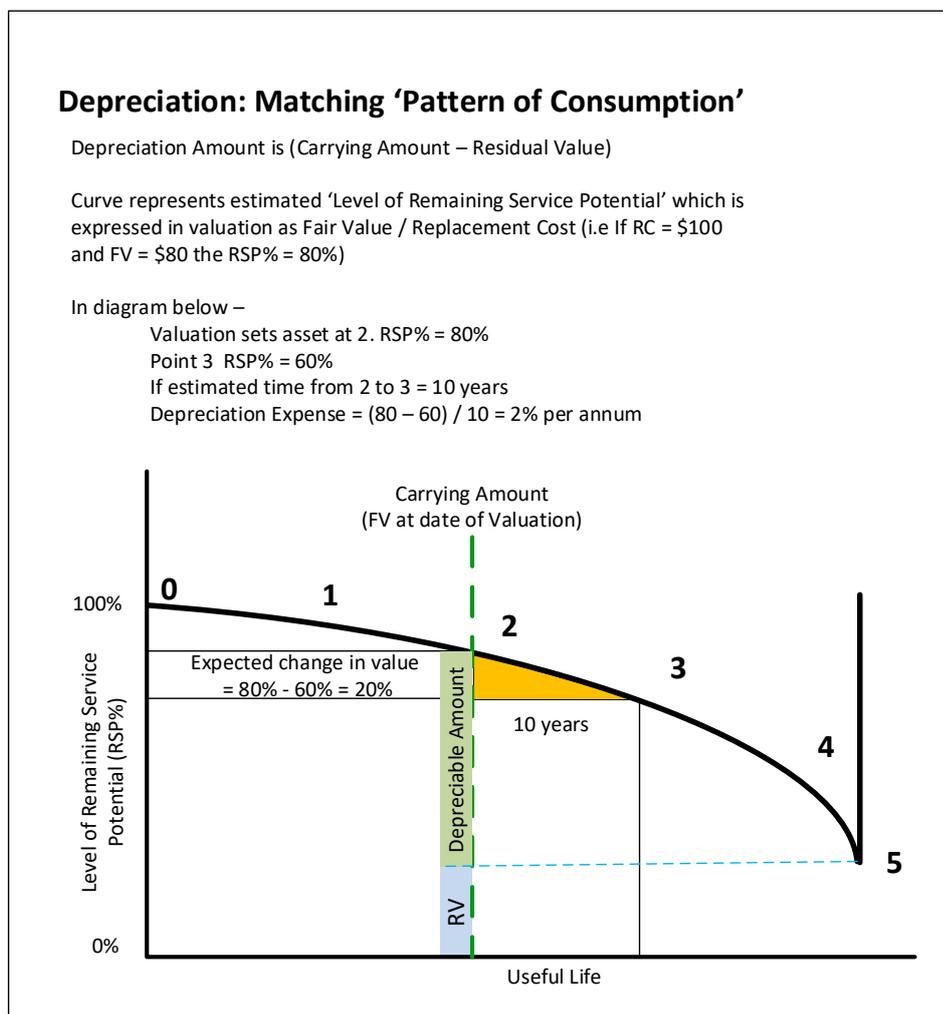
- The fair value first be determined based on the key characteristics relevant to market participants. These are listed as condition, location and restrictions
- The carrying amount then be depreciated down to the residual value using a method that matches the expected pattern of consumption of the future economic benefit.

It should be noted that the use of the straight-line method was removed from the then AAS4 Depreciation standard in 1997. Since then, as the fair value represents the level of remaining future economic benefit in

the asset, the depreciation method should reflect the expected reduction in relative value of the asset over the period.

Just as the reducing balance method is often used to calculate depreciation expense for motor vehicles because they drop significant value as they leave the showroom floor and the ensuring drop in value flattens out, the pattern of consumption for public sector assets should reflect the expected change in relative value over the remaining useful life.

While most entities adopt the straight-line method for depreciation as a default, to ensure correct calculation of depreciation expense, there is a need to review what really is the expected pattern of consumption and, if required, make any necessary changes.



Depreciated Replacement Cost (DRC) is Non-Compliant

Perhaps one of the biggest non-compliance issues identified during the special project for fair value in the public sector is the continued use of the Depreciated Replacement Cost (DRC) by many entities. This is despite it being removed from the accounting standards in 2013.

Valuation based on depreciation concepts (such as useful life and RUL) rather than an assessment for obsolescence (based on the key characteristics) are fundamentally flawed and can result in material misstatement.

When AASB13 was introduced, it changed the definition and concept of Fair Value, removed DRC as an appropriate measure and replaced it with Current Replacement Cost (CRC). The fundamental difference between the two concepts is that DRC is entity specific and based on depreciation concepts whereas CRC is non-entity specific, market based and is based on the key characteristics relevant to market participants (condition, location and restrictions).

AASB13 B9 further clarifies that when calculating the CRC the valuer must deduct from the replacement cost an allowance for obsolescence and that that adjustment is conceptually different and not the same as an adjustment for depreciation.

BC212 Some stakeholders asked the Board to clarify in Australian Accounting Standards that obsolescence for fair value measurement is different from depreciation. Since AASB 13 paragraph B9 specifies that obsolescence for fair value measurement under the cost approach is different from depreciation under AASB 116, the Board decided that additional guidance is not warranted. AASB 13 paragraph B9 states that: "Obsolescence ... is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives)."

BC213 The Board observed that aspects in addition to the depreciation of an asset need to be considered in measuring the fair value of an asset. AASB 13 paragraph 11 specifies that fair value measurements take into account characteristics of an asset that market participants would take into account, including, for example, the condition and location of the asset, and any restrictions on the sale or use of the asset.

Determining the Current Replacement Cost (CRC)

As noted above, the DRC method is non-compliant with AASB13 and, to calculate CRC an allowance for 'obsolescence' must be deducted from the replacement cost. This allowance is to be based on the key characteristics (condition, location and restrictions) as well as take into account general market considerations (such as technical, functional and economic obsolescence).

However, because depreciation expense is required to be calculated based on the carrying amount of each part of the asset with a different useful life, it is necessary for the valuation to provide a fair value for each part with a different useful life.

The issue of about how to determine what constituted a 'different part' was covered by the AASB May 2015 Residual Value decision. This decision clarified that if the cost of renewal of a component of the asset was less than the cost of the component then this indicated that the component consisted of two different parts with each having a different useful life.

The net result is that the valuation process needs to –

- Determine the replacement cost for the asset. This may be determined either at whole-of-asset level or at component level
- To align asset management registers with financial accounting registers – split the asset into the various components used for asset management modelling and planning
- Disaggregate each component into the short-life (renewal) and long-life (recyclable) parts
- Use general obsolescence, condition, location and restrictions to determine the fair value for each part
- Determine the Remaining Useful life (RUL) for each part based on relevant key characteristics so that the correct depreciation expense can be calculated for each part of the asset with a different useful life. The calculation for each part can be used to calculate a weighted average depreciation rate which can then be applied against the component in the asset register.

As a result, any existing valuation delivered using a DRC approach (calculated on useful life rather than the key characteristics relevant to market participants) will require re-working to ensure the valuation basis is CRC. If the over-riding replacement cost is sound, the process to convert from DRC to CRC is relatively straight-forward providing the relevant data has been correctly captured.

Accounting to reflect Asset Management Reality

While not specifically highlighted in the changes to AASB13, our view is that the changes and clarifications support the position of many of the Auditors-General that there is a dire need for asset valuations to reflect more closely the entity's asset management reality.

The purpose of the financial statements is to provide general purpose users with information about the position and performance of the entity so that they can make informed decisions.

Many public and not-for-profit entities are asset intensive, and as a result, the value of their assets and estimate of depreciation expense are often the most material and subjective figures presented in their financial statement.

It is therefore critical that the values and depreciation expense estimates reflect the asset management reality of the entity. i.e. The underlying assumptions and inputs to these figures are consistent with the entity's understanding of how their assets are performing, what the future renewal or replacement strategies are and what costs may be involved.

When AASB13 was implemented in 2013 it provided the mechanism to ensure that the asset management data and financial reporting were fully integrated. The combination of AASB13 and AASB116 provides a clear-cut integration in that –

- Assets need to be split into the different parts consistent with the asset management strategies, experiences and costs
- Based on asset management drivers, the RUL can be estimated for each part. This in turn provides for both calculation of depreciation expense as well as the ability model future renewal funding needs
- As a result, the same data is used to drive both asset valuation and depreciation estimates as well as asset management planning.



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