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ED320 and its Implications

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Agenda

- Background to ED320
- Key aspects and potential implications for Vic LGs
- What needs to be done
- Compliance strategies

Background to ED320

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Released 31 March 2022
Responses closed 30 June 2022

What we are proposing

This Exposure Draft proposes authoritative implementation guidance on AASB 13, and illustrative examples, for application by not-for-profit public sector entities.

Specifically, this Exposure Draft proposes implementation guidance in respect of non-financial assets not held primarily for their ability to generate net cash inflows, regarding:

(a) the market participant assumptions to use in measuring the asset's fair value;

(b) the asset's highest and best use; and

(c) the application of the cost approach if used to measure the asset's fair value.

Application date

It is proposed that this amending Standard would be applicable to annual periods beginning on or after 1 January 2024, with early application permitted.

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Key aspects and potential implications for Vic Local Gs

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Key Issues

- Basis of Conclusions: some are not changes!
- Market Participant Assumptions
- Highest and Best Use
- Application of ‘cost approach’

BC151 – Restricted Assets

- Big issue for Victoria
- Existing practice assumes current use is not highest and best use and applied a range of theoretical market value discounts

BC151 – Restricted Assets

- BC151 Consistent with the reasons noted in paragraph BC38 and BC53–BC55, the Board noted that the fair value measurement of an asset :
- (c) would not take into account a legal restriction that is specific to the entity holding the asset, that is, it would not transfer to a market participant in a hypothetical sale transaction (e.g. the restriction on the use of land that is specific to the entity, in the IASB's example in paragraph IE29 of the Illustrative Examples accompanying IFRS 13 quoted in paragraph BC37); but
- (d) would take into account the effect of restrictions that would transfer to a market participant in a hypothetical sale transaction (e.g. the easement restriction in the IASB's example) regardless of whether in that example the land's highest and best use is as a playground or as a site for residential development, because such legal restrictions are considered characteristics of land that a market participant would consider when pricing the land

BC151 Restricted Assets

- No discount to be applied to the valuation of restricted assets unless the same restriction would pass to a hypothetical buyer.
- It is extremely rare for a local government not to remove such restrictions to then sell land and therefore it would typically be inappropriate to discount for such a restriction.

BC173 & 174: CRC is not same as DRC

This is not a change !

- Also a big issue for Victoria
- Many valuations based on DRC approach using depreciation to calculate the Fair Value
- This is not consistent with CRC approach as required by AASB13

BC173 & 174: CRC is not same as DRC

- BC173 Some stakeholders asked the Board to clarify in Australian Accounting Standards that obsolescence for fair value measurement is different from depreciation. Since AASB 13 para. 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 para. B9 states that: “Obsolescence … is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (using specified service lives).”

BC173 & 174: CRC is not same as DRC

- BC174 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 para. 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.

BC173 & 174: CRC is not same as DRC

- Cost approach valuations based on the theoretical calculation of accumulated depreciation based on RUL and UL are not compliant with AASB13.
- This is because the adjustment should be for ‘obsolescence’ which is conceptual different and much broader than ‘depreciation’ and such approach would not be taking into account the key characteristics as set out para 11.
- Need to work out FV first and then depreciate down to RV

BC175: Method of Depreciation

This is not a change !

- National issue
- Despite AASB116.60 and changes to AAS4 in 1997 most jurisdictions are still effectively mandating a straight-line approach
- Approach can result in misstatement
- Urgent need for all jurisdictions and Audit Offices to update their understanding and expectations

BC175: Method of Depreciation

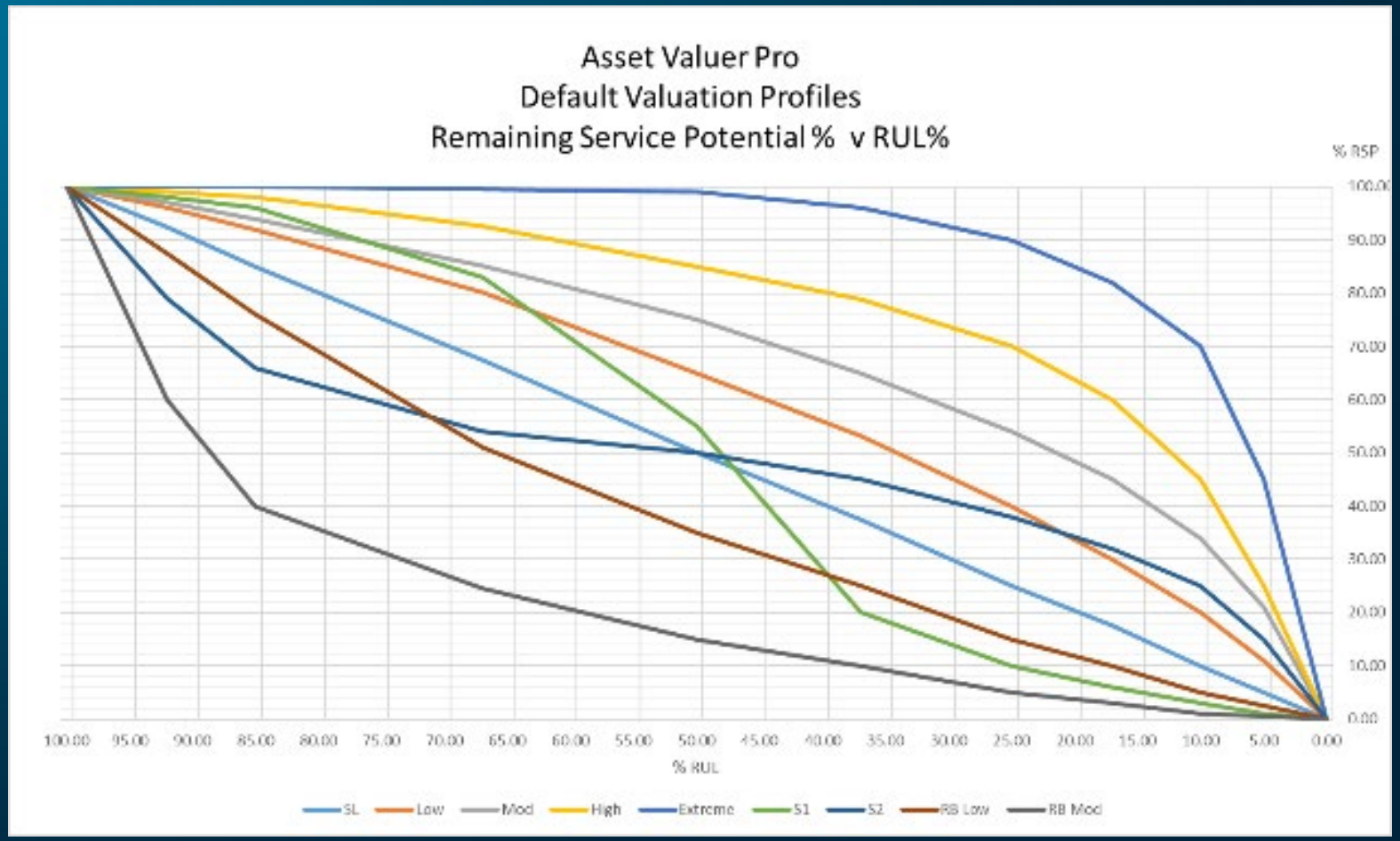
- BC175 Regarding comments by some stakeholders that many entities are applying the straight-line depreciation method by default, the Board considers that AASB 116 addresses this issue adequately. AASB 116 para. 60 states that: "The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity."

BC175: Method of Depreciation

- The straight-line method of depreciation should not be adopted as a default method.
- This is because AASB116 requires the adoption of a method that matches the expected pattern of consumption of the future economic benefit. i.e. If you expect to consume 10% of the assets remaining service potential over the next 5 years and then 20% of the following 5 years then the depreciation method should reflect the same expected pattern of consumption.
- The profile used for depreciation calculations should be consistent with the profile used for valuation.
- Note: Straight-line as a default or fall-back approach was removed from AAS4 Depreciation in 1997 (25 years ago)

Must match pattern of consumption

- Typically, the longer the useful life the greater the impact of obsolescence on value as the asset ages
- Need to select profile that matches market participants expectations of value verses age and condition



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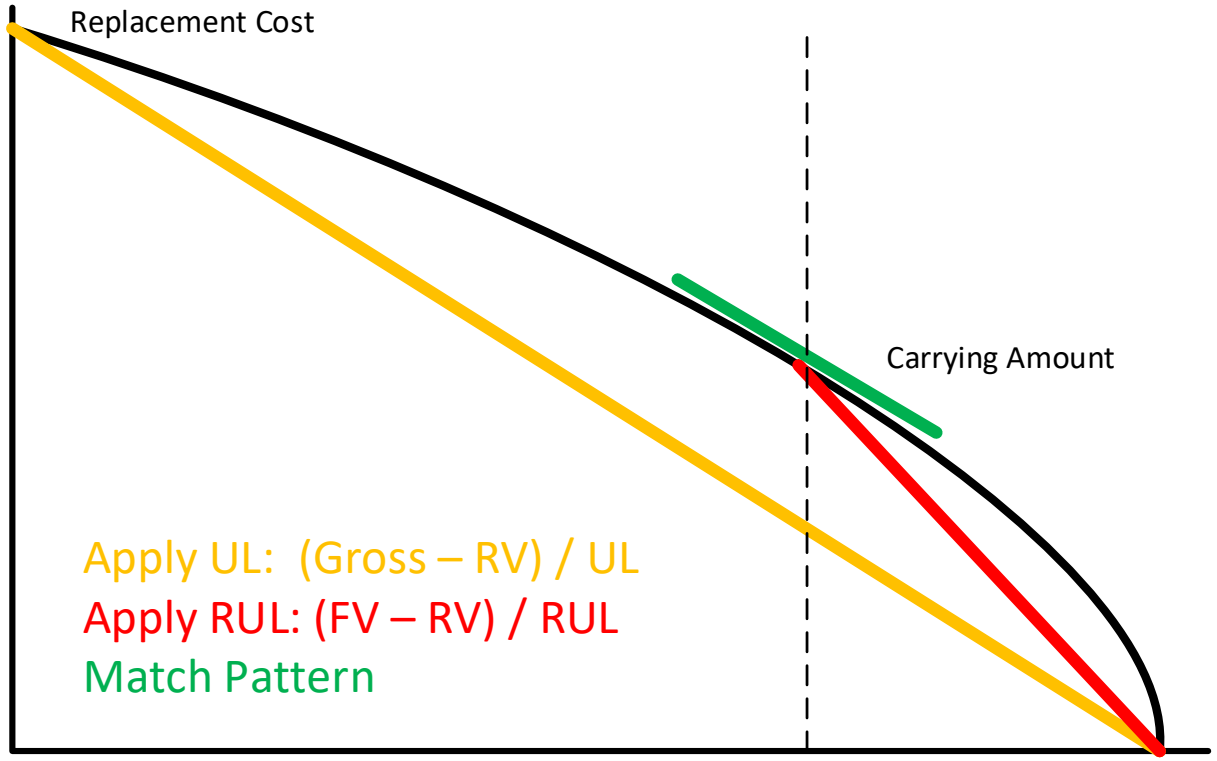
Alternative Depreciation Methods



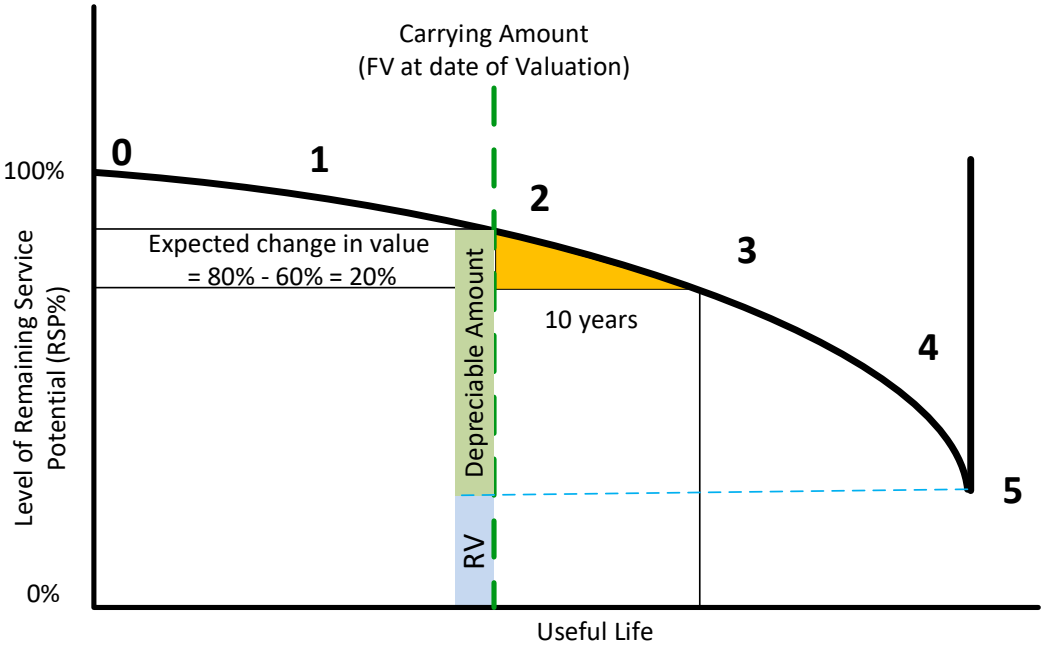
Depreciation: Matching 'Pattern of Consumption'

Depreciation Amount is (Carrying Amount – Residual Value)

Curve represents estimated 'Level of Remaining Service Potential' which is expressed in valuation as Fair Value / Replacement Cost (i.e If RC = $100 and FV = $80 the RSP% = 80%)

In diagram below –

Valuation sets asset at 2. RSP% = 80%
Point 3 RSP% = 60%
If estimated time from 2 to 3 = 10 years
Depreciation Expense = (80 – 60) / 10 = 2% per annum



BC176: Depreciation based on Carrying Amount not Gross

This is not a change !

- National issue
- Many finance systems incorrectly based on (Gross – RV) / UL

BC176: Depreciation based on Carrying Amount not Gross

- BC176 In addition, the Board observed that Example 3 in the Implementation Guidance (January 2012) accompanying IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors illustrates how the change in carrying value and depreciation of a property, plant and equipment (and its related deferred tax) are calculated
- (Carrying Amount – RV) / RUL

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Delta's tax rate is 30 per cent.

	CU
Property, plant and equipment at the end of 20X1:	
Cost	25,000
Depreciation	(14,000)
Net book value	11,000
Prospective depreciation expense for 20X2 (old basis)	1,500
Some results of the engineering survey:	
Valuation	17,000
Estimated residual value	3,000
Average remaining asset life (years)	7
Depreciation expense on existing property, plant and equipment for 20X2 (new basis)	2,000

BC176: Depreciation based on Carrying Amount not Gross

- Some finance systems will need to be changed (if using straight-line depreciation) to ensure the calculation of depreciation expense is based on the carrying amount (less residual value) divided by the RUL rather than the replacement cost (less residual value) divided by the useful life.
- Due to impact of AASB May 2015 Residual Value decision, this in turn means that valuers will need to provide a fair value for each 'part' (short-life and long-life) of each component of each asset that has a different useful life

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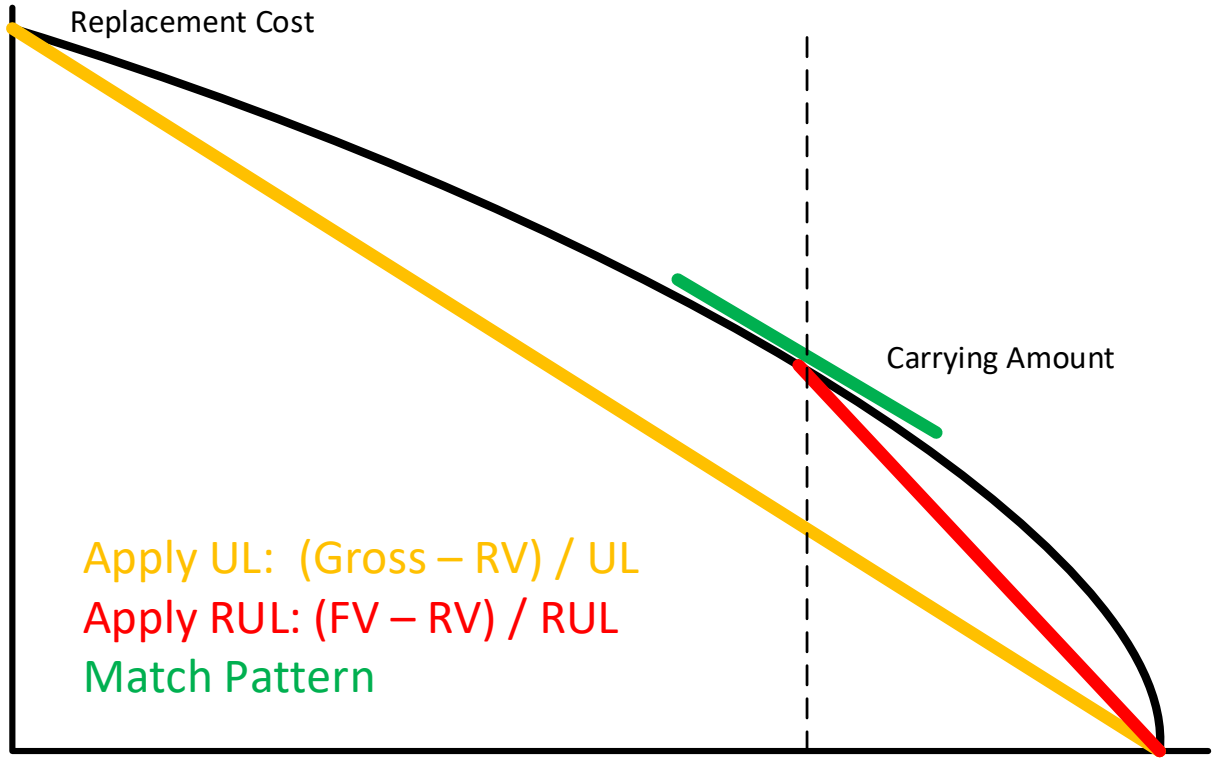
Alternative Depreciation Methods



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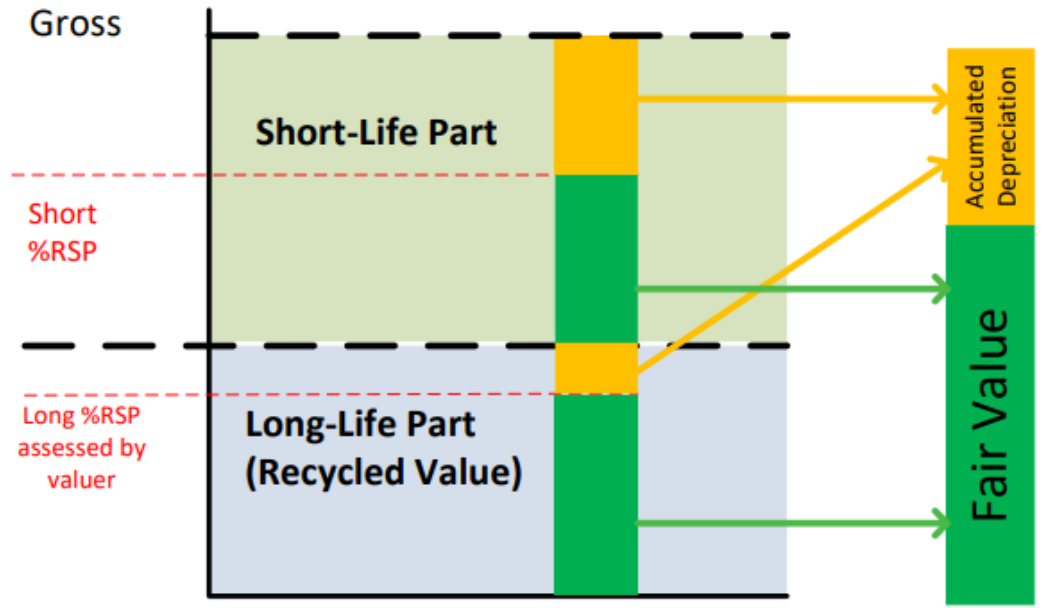
Valuation Methodology (Recyclable Assets)

Fair Value = %RSP of Short-Life Part
+%RSP Long-Life (Recyclable) Part



Market Participant Assumptions

- Paragraph F4
- If selling price of identical asset is observable use that price as the Fair Value
- Otherwise –
  - Explicitly estimate the pricing assumptions that market participants would use by maximising the use of relevant observable inputs and minimising the use of unobservable inputs

Market Participant Assumptions

- Paragraph F5
- If all relevant information about market participants assumptions is available, then use that assumption to adjust for the difference
- Otherwise use the entity's own assumptions

Highest and Best Use

- Paragraph F8
- a use is financially feasible if market participants would be willing to invest in the asset's service capacity, considering both the asset's ability to be used to provide needed goods or services to beneficiaries and the resulting cost of those goods or services.

This is a huge divergence from traditional Vic practices

Highest and Best Use

- Paragraph F9
- highest and best use is rebutted when, and only when, at the measurement date, the appropriate level of the entity's management has committed to a plan to locate a buyer of the asset (or transfer the asset to another entity) or to use the asset for an alternative purpose.
- The presumption can be rebutted even if the committed-to-plan has not yet been initiated as at the measurement date.

Application of Cost Approach

- Big issue for Victoria
- Brownfield and Greenfield are non-compliant
- Need to recognize one-off costs such as road formation

Application of Cost Approach

- Paragraphs F11 – F12
- Assumes –
  - Will be replaced in same location
  - The asset does not exist but would be replaced with the replacement cost incorporating all necessary costs intrinsically linked to acquiring or constructing the subject asset at the measurement date
  - Adjusts the replacement cost for the difference in utility (service capacity and standard of finish) between the existing asset and the reference asset

How to calculate the
Gross Replacement Cost
not Current Replacement Cost

Determining Replacement Cost

- Paragraph F12
- Includes ‘one-off’ costs
- Apply judgement with respect to –
  - costs of removal and disposal of any unwanted existing structures
  - any disruption costs that would hypothetically be incurred
- Uses the costs necessarily incurred in the context of the entity’s mode of replacement in the ordinary course of operations, rather than using only the cheapest legally permitted costs to the entity

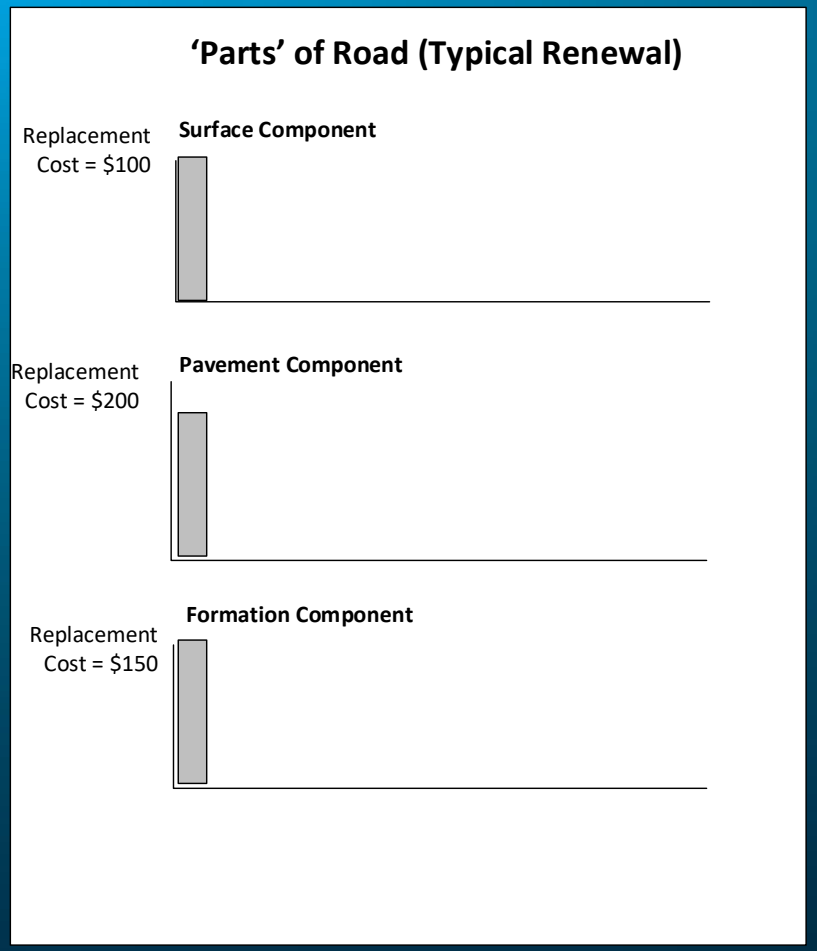
Economic Obsolescence

- Paragraphs F13 – F15
- Does not require formal decision
- economic obsolescence is not identified if ‘surplus capacity’ is necessary for standby or safety purposes
- E.g. school only has 100 students now but has capacity for 500. If long-term only needs capacity for 100 then obsolescence adjustment required. If expect that will need 500 in long-term then no obsolescence adjustment required.

What needs to be done

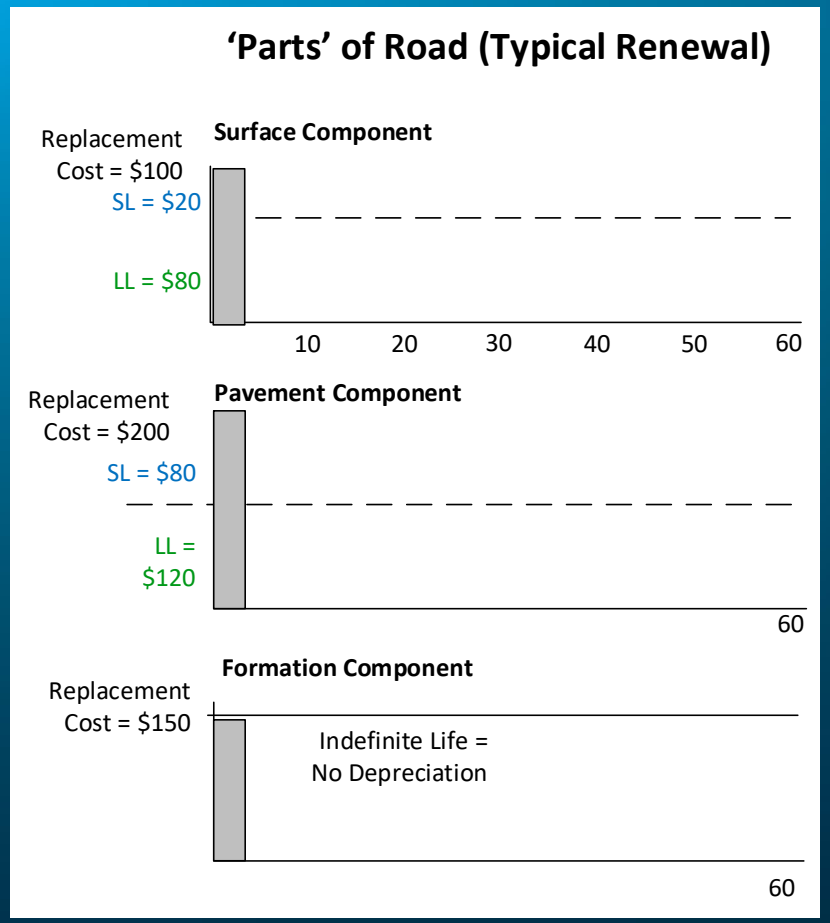
- **Market or income approach**
  - Determine market value
  - Split into components and parts
  - Allocate value across each part
  - Determine RUL for each part
  - Calculate depreciation expense for each part

Cost approach - How should it be done?



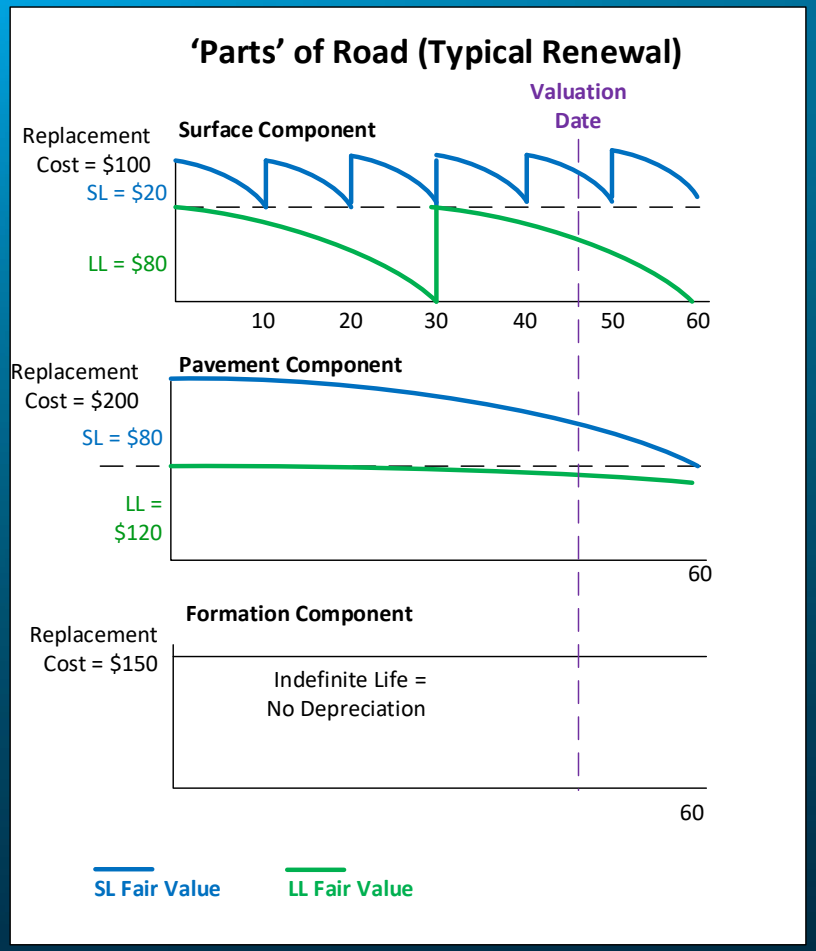
- Determine Replacement Cost correctly
- Split into components

Cost approach - How should it be done?



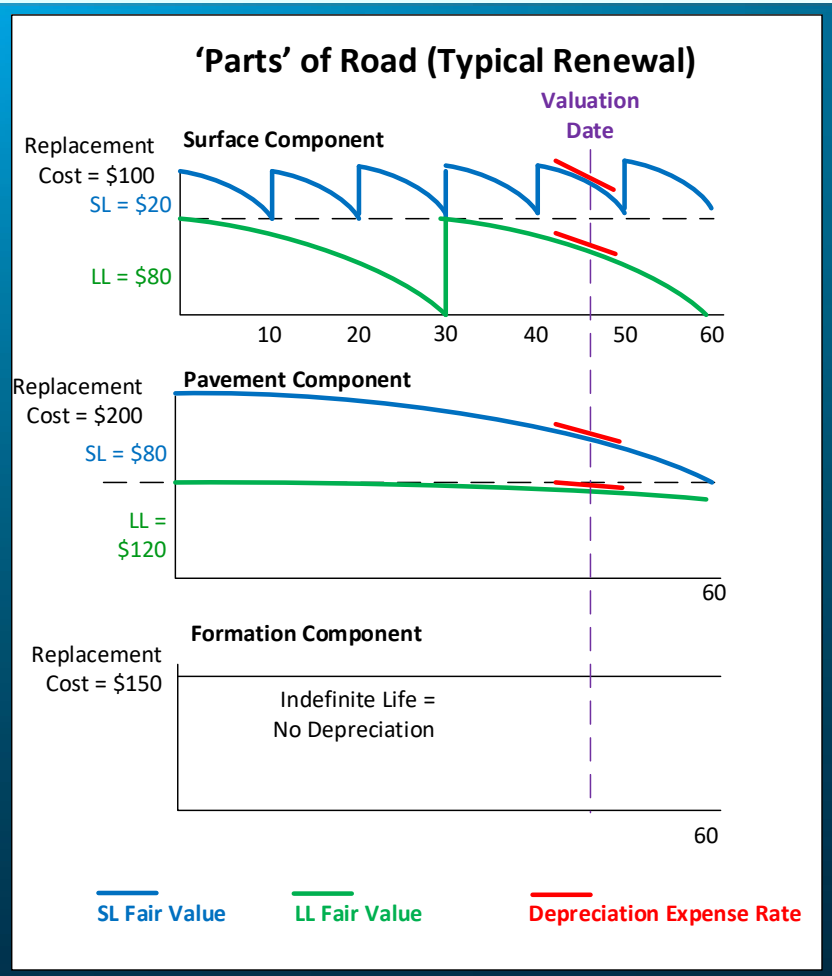
- Determine Replacement Cost correctly
- Split into components
- Split component into SL and LL parts

Cost approach - How should it be done?



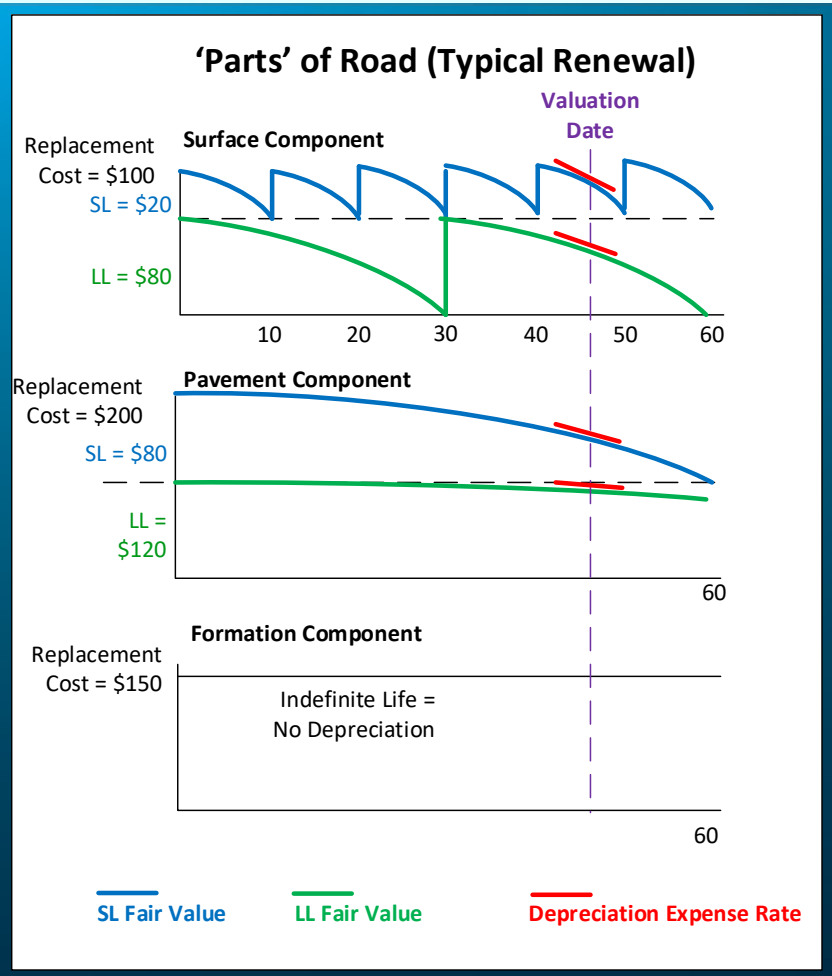
- Determine Replacement Cost correctly
- Split into components
- Split component into SL and LL parts
- Determent FV for each based on obsolescence, condition, location, restrictions

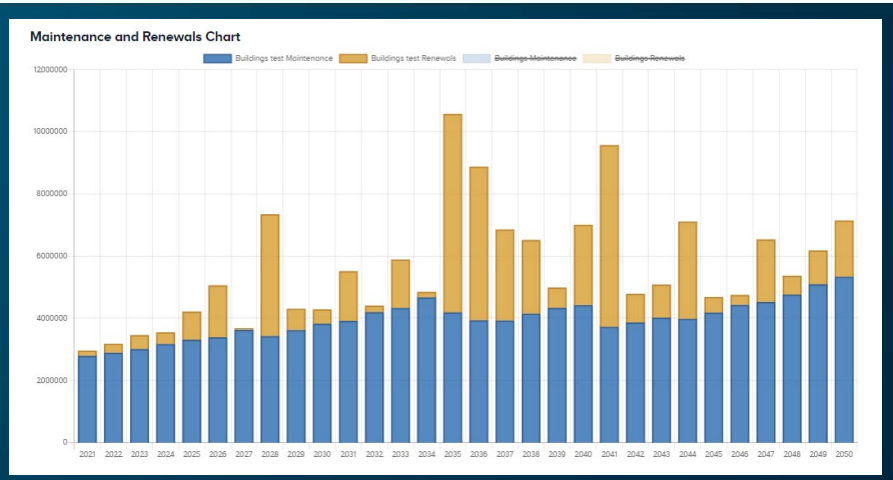
Cost approach - How should it be done?

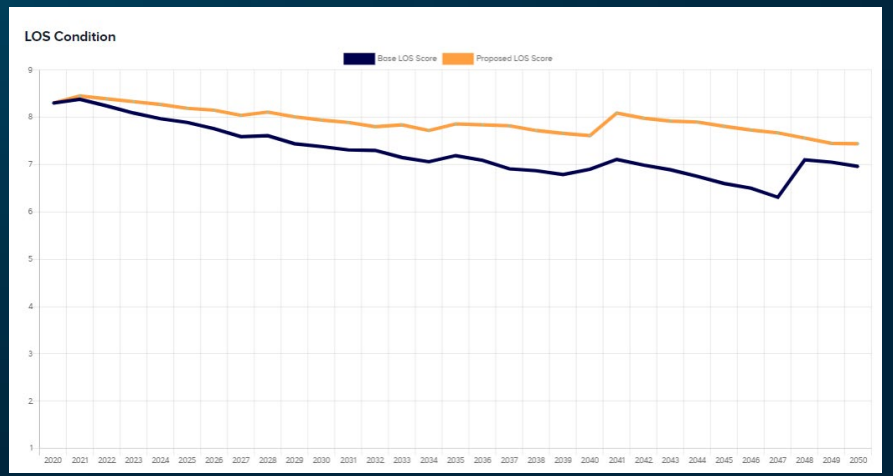


- Determine Replacement Cost correctly
- Split into components
- Split component into SL and LL parts
- Determent FV for each based on obsolescence, condition, location, restrictions
- Depreciate each FV over RUL to RV with method that matches pattern of consumption

Use consistent data for asset management







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Example: Valuation

Gross	Current Value	Depn Expense	WA UL	WA RUL
$553,465	$379,151	$12,719	44 yrs	30 yrs

NAME	GROSS	CURRENT VALUE	DE	WA UL	WA RUL
01 Sub-Structure	$33,208	$25,822	$235	141 yrs	110 yrs
02 Structure	$96,856	$71,439	$790	123 yrs	90 yrs
03 Floor Coverings	$27,673	$13,837	$1,384	20 yrs	10 yrs
04 Fit-Out	$91,322	$51,603	$1,735	53 yrs	30 yrs
05 Roof	$91,322	$53,657	$905	101 yrs	59 yrs
61 Serv - Mechanical	$107,926	$86,340	$5,996	18 yrs	14 yrs
62 Serv - Fire	$11,069	$8,855	$615	18 yrs	14 yrs

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Component Valuation

05 Roof

Concrete - Tile Typical Life

Sep 25, 1988 → ?

Edit

Consumption Score	Depreciation Policy	Valuation Policy
3	Apply RUL	Apportionment Cost

TYPE	GROSS	CURRENT VALUE	REMAINING SERVICE POTENTIAL	DEPRECIATION EXPENSE	USEFUL LIFE	REMAINING USEFUL LIFE	RESIDUAL VALUE	PROFILE
Short Life 50%	$45,661	$18,264	40%	$601	76 yrs	30 yrs	$0	AVP Default SL
Long Life 50%	$45,661	$35,392	78%	$304	150 yrs	116 yrs	$0	AVP Default SL
	$91,322	$53,657		$905	101 yrs	59 yrs	$0	

Example: Asset Management Planning

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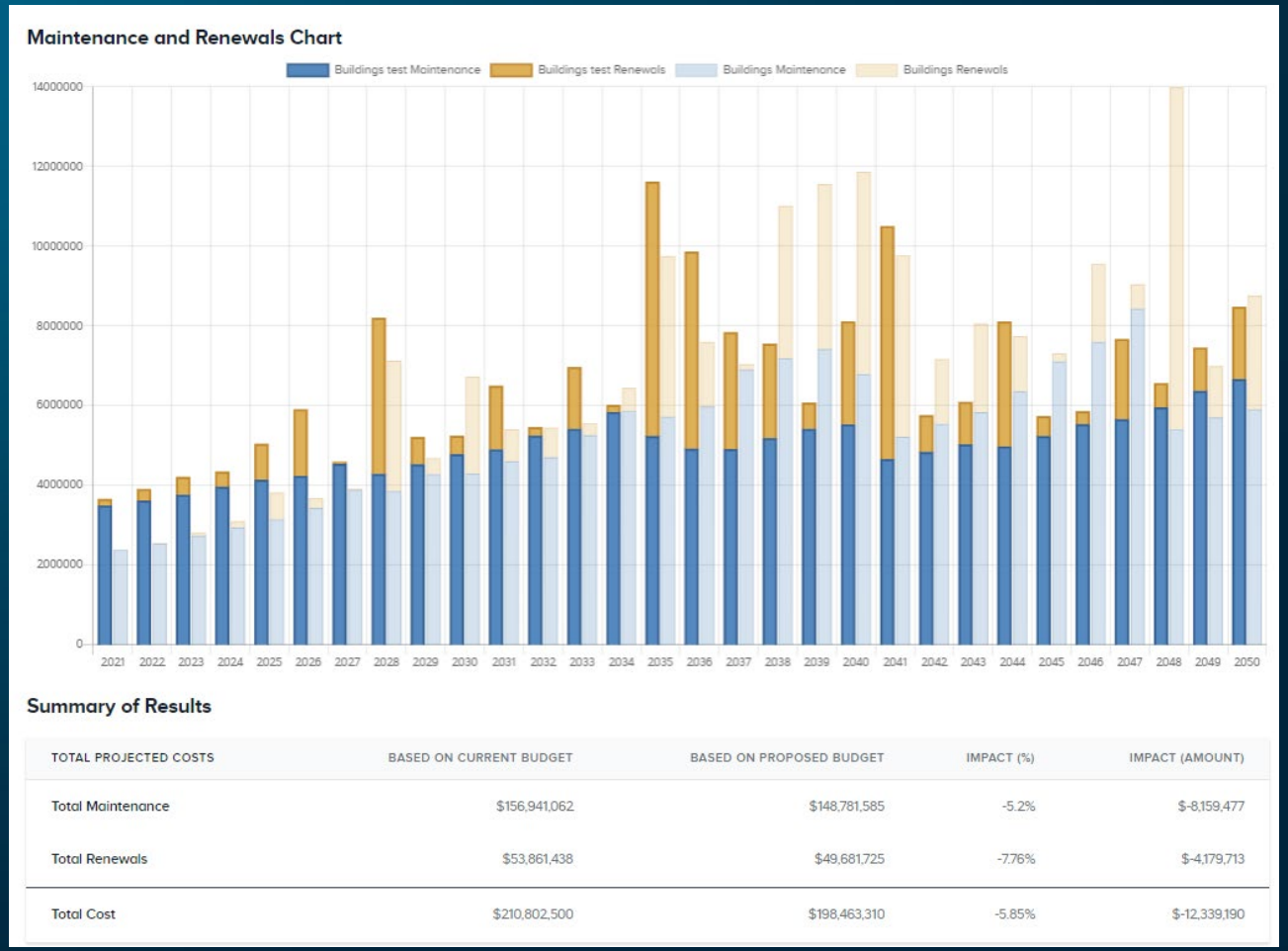

Summary of Results

TOTAL PROJECTED COSTS	BASED ON CURRENT BUDGET	BASED ON PROPOSED BUDGET	IMPACT (%)	IMPACT (AMOUNT)
Total Maintenance	$156,941,062	$148,781,585	-5.2%	$-8,159,477
Total Renewals	$53,861,438	$49,681,725	-7.76%	$-4,179,713
Total Cost	$210,802,500	$198,463,310	-5.85%	$-12,339,190

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Summary: Existing Requirements

- No discount for restrictions if restriction will not likely pass to buyer
- Must use CRC approach based on key characteristics and adjust for obsolescence. DRC approach in non-compliant
- Depreciation must match pattern of consumption.
- Depreciation based on carrying amount of each ‘part’
  - RUL not UL
  - Components split into SL and LL parts

Summary: Proposed Clarifications (2 years to fix)

- Use market-based assumptions if available
- In public sector, there is a presumption that current use is the H&B use. Need ‘commitment’ from management to rebut
- Replacement Cost
  - Include all costs assuming replacement in same location
  - Adjust for permanent obsolescence and difference in utility

Compliance strategies

- Restricted Land – fix with next revaluation (2 year transition)
- Market / Income
  - Fix with comprehensive revaluation (valuers or software) or
  - Upload to software to do components and SL/LL split to determine appropriate depreciation
- Cost approach
  - If RC OK….
    - Use software to fix methodology and do SL/LL
    - Or do comprehensive revaluation
  - IF RC of concern …..
    - Comprehensive revaluation (valuer or software)

Workshops

	20 Tue Sep	How to do internal valuations - Melbourne VIC / The Hub @ Docklands	Register Now
	04 Tue Oct	How to do internal valuations - Albury NSW / SS&A Club Albury	Register Now

www.assetvaluer.net/events

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Questions / Discussion

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