30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**December 2008, London**
Project:	**Fair Value Measurement**
Subject:	**Highest and best use: Application of a 'change of use option' (Agenda paper 3G)**

Introduction

1 At its September 2008 meeting, the Board discussed whether a fair value measurement should reflect the highest and best use of an asset. The Board tentatively decided that, when an entity measures an asset at fair value and currently uses the asset together with another asset in a use that differs from their highest and best use, the entity may need to split the fair value into two components: (a) the fair value of the asset assuming its current use and (b) a 'change of use option' reflecting the entity's ability to switch the asset to its highest and best use.

2 This issue could arise in either of the following situations:

- a when the assets are being measured at fair value in a business combination, or
- b when the assets are being re-measured at fair value under the revaluation model in IAS 16 *Property, Plant and Equipment* or IAS 40 *Investment Property*.

3 This paper addresses the Board's decision to require the recognition of a 'change of use option' asset. The staff thinks this is applicable in either of the situations listed above.

Staff analysis

4 Consider the following example:

> *Background*
> Entity A acquired land and a factory building in a business combination. The land is currently zoned for industrial use. Nearby parcels of land are being rezoned to residential use and developers have begun building high-rise condominiums in the area. Entity A determines that the highest and best use of the land is residential use for high-rise condominiums. Therefore, the fair value of the land assumes that the factory is demolished and the land will be made available to build the condominiums.
>
> On this basis, the fair value of the site as a whole is CU300,000, net of costs to demolish the factory. The value of the factory, assuming its current use, is CU100,000. The value of the land, assuming its current use, is CU30,000.
>
> *Application of highest and best use*
> The fair value of the land is CU300,000 and the fair value of the factory is nil. Entity A cannot value the land at CU300,000 and the factory at CU100,000 because the total of CU400,000 is more than the fair value of the site as a whole.

5 Since the September meeting, the staff has become aware of three approaches currently seen in practice for accounting for the assets in this situation. [The Board's agreed approach does not appear to be one of the approaches used.] These approaches are documented in the accounting manuals for some of the large accounting firms. Some of the accounting firms do not address this situation because it happens so infrequently.

Potential approaches

6 The approaches observed in practice are:

a **Approach 1**: value the land as the difference between the total site in its highest and best use (in this case CU300,000) and the value of the factory in its current use (CU100,000), or CU200,000.

b **Approach 2**: apportion the value of the site to the land and related building on the basis of their relative values. In this case the land would be valued at CU225,000 (300,000 ÷ 400,000 x 300,000) and the factory would be valued at CU75,000 (100,000 ÷ 400,000 x 300,000).

c **Approach 3**: attribute the entire value of the site in its highest and best use to the land. In this case the factory would be valued at zero. This approach was not favoured by the Board and at least one of the accounting firms.

Regardless of the approach taken, the accounting manuals encourage an entity to make an accounting policy election and apply it consistently.

7 The staff refers to the Board's decision in September 2008 as **Approach 4**. Approach 4 would result in Entity A recognising the following:

Factory value in current use	100,000
Land value in current use	30,000
Change of use option reflects option to convert land to alternative use	170,000 (300,000 – 30,000 – 100,000)

8 Another approach (**Approach 5**) would be to recognise the assets at their current use, and disclose the fair value of the assets reflecting the highest and best use based on the alternative use.

Analysis of potential approaches

9 Approaches 1 and 2 generate amounts that do not represent the fair values of the land and factory in this situation. This is because fair value reflects the highest and best use of an asset.

10 Approach 3 generates an amount that is consistent with highest and best use, but it means that Entity A does not recognise the factory—an asset it is still using—and the depreciation on the factory. The Board thought this would not provide the most helpful information to users.

11 Approach 4 results in the recognition of a ‘new’ asset. This approach essentially separates the land value in Approach 1 into two assets: the land value under its current use and a ‘change of use option’ reflecting the option to convert the land into an alternative use.

12 Although the Board’s decision pertained to a situation in which an entity currently uses the asset together with another asset in a use that differs from their highest and best use, this approach arguably could apply in any situation in which the highest and best use of an asset is not the current use, but an alternative use. That is, an entity would recognise the value assuming the current use, plus a ‘change of use option’ in the amount of the difference between the current use and the highest and best use.

13 Consider the following example:

Background
Entity Y owns vacant land in central London. The land is currently zoned for commercial use. The fair value of Entity Y’s vacant land is CU100,000. The value assuming the current use is CU20,000.

Entity Z owns land in central London adjacent to Entity Y’s land. Entity Z’s land is zoned for commercial use and has a small office building on it. Entity Z leases the office building to a third party. The cost to demolish the office building is minimal (it is made of aluminium siding).

Nearby land is being rezoned to residential use. The highest and best use of the land is as residential property. Therefore, the fair value of the land of Entity Y and Entity Z reflects the fact that the land could be rezoned to residential property and is available for residential development.

The fair value of Entity Z’s land and building is CU105,000 (net of the costs of demolishing the office building). The value of the land assuming the current use is CU20,000 and the value of the building assuming its current use is CU4,000.

Application of the change of use option
Because Entity Y owns vacant land, it would recognise the fair value of the land at CU100,000.

Under Approach 4, because Entity Z owns land with an office building, it would recognise the following:

Building value in current use	4,000
Land value in current use	20,000

Change of use option reflects option to convert land to alternative use	81,000 (105,000 – 4,000 – 20,000)

Does this provide comparable information?

14 Under Approach 4, depreciation would be based on the current use of the asset rather than on its highest and best use.[1] The change of use option presumably would not be depreciated or amortised, but would be tested for impairment annually until the asset is converted to its alternative use, or derecognised if the entity sells the asset without converting it.

15 However, this does not represent what a fair value measurement is meant to convey: an objective, unbiased measurement that removes the effect of entity-specific differences (advantages or disadvantages relative to the market), thereby enhancing comparability between entities. In effect, a fair value measurement proves a market 'benchmark' by which the entity's advantages or disadvantages relative to the market can be assessed. Recognising an asset at its current use rather than its highest and best use means that the entity is not recognising the asset at fair value, thereby not meeting the objective of a fair value measurement (the price at which an transaction would occur between market participants at the measurement date) and resulting in an entity-specific value.

16 Furthermore, Approach 4 can be extended to other areas for which there are potential measurement differences. Consider an entity that has access to two markets. Market A has a lower price than Market B for a particular asset. The entity sells the asset in Market A because Market A is closer and therefore easier to get to, even though the amount realised is lower. Should the entity recognise the asset using the price in Market A, plus another asset representing the option to sell the asset in Market B?

17 Finally, if a change of use option asset is tested for impairment annually (assuming the asset is not re-measured using the revaluation model), presumably any increase or decrease in value would be reflected in profit or loss. If the value of the land increases,

[1] How is this different from an entity that has a building that is 35 years old and is fully depreciated? The income generated from the building is recognised in profit or loss, but there is no depreciation. Matching is not an issue in this case, so why would it be an issue with highest and best use?

the value of the change of use option increases (assuming the current use value remains the same), resulting in a gain representing management's inefficiency relative to market participants. If the value of the land decreases, the value of the change of use option decreases (assuming the current use value remains the same), resulting in a loss representing management's relatively good decision not to convert the land to its alternative use.[2]

18 Approach 5 reflects the entity's existing operations and does not convey what fair value is meant to convey. Furthermore, disclosure is not a good substitute for recognition.

Staff recommendation

19 The staff recommends that the Board not address this issue in the fair value measurement project for the following reasons:

a this situation happens infrequently;

b some of the accounting firms have already developed guidance to address this situation;

c Approach 4 results in the recognition of a 'new' asset, for which subsequent accounting would need to be addressed. Asset recognition and subsequent accounting are outside the scope of the fair value measurement project;

d there could be unintended consequences in the measurement and recognition of a 'change of use option' under Approach 4 and entities might analogise to other similar situations, potentially recognising options on any flexibility in the business; and

e the measurement approach for a change of use option is currently unknown, potentially leading to complications and inconsistencies in application. For example, would entities need to use or develop sophisticated option pricing

[2] One could argue that management should not exercise the option before its expiration (if any) because it has time value.

models to measure the fair value of a change of use option, or would they be able to use an intrinsic value model?

20 However, if the Board wants to address this in the fair value measurement project, the staff recommends proceeding with Approach 1. Approach 1 results in a measurement that is based on the overall fair value, without splitting the land into two assets. Furthermore, it avoids the issues raised in paragraphs 19c, 19d and 19e above.

Questions for the Board

21 Do you agree with the staff recommendation not to address this issue in the fair value measurement project?

22 If not, which of the approaches would you like to propose in the exposure draft?