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**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: 18 September 2008, London

Project: Fair value measurement

Subject: Highest and best use (Agenda Paper 3A)

Introduction

- 1 The *Fair Value Measurements* discussion paper did not address highest and best use. However, respondents to the discussion paper raised questions about its application. Furthermore, the FASB's Valuation Resource Group (VRG) has raised this topic in its meetings. Therefore, the staff thinks the Board should deliberate this topic before publishing an exposure draft of an IFRS on fair value measurement.
- 2 This paper:
 - a reviews the highest and best use concept in FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157);
 - b addresses how highest and best use affects a fair value measurement;
 - c documents the highest and best use decision process; and
 - d addresses some common misconceptions about highest and best use.
- 3 This paper does **not** address the following:

- a defensive value;
- b the valuation premise (in-use and in-exchange);
- c restrictions on assets;
- d the reference (principal (or most advantageous)) market; or
- e whether the highest and best use concept can be applied to liabilities.

The staff will address these topics in a future meeting.

Highest and best in SFAS 157

- 4 Highest and best use reflects the assumption that the price a buyer will pay or that a seller will accept for an asset is based on the most profitable use of the asset.
- 5 SFAS 157 states that ‘a fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of the asset by market participants that would *maximise* the value of the asset or the group of assets in which the asset would be used’ (SFAS 157.12).
- 6 Example 2 in Appendix A of SFAS 157 notes that ‘the current use of [an asset] often is presumed to be its highest and best use’ (SFAS 157.A10).
- 7 When comparing the current use of an asset and the potential alternative uses, an entity must consider the demolition and other costs necessary to convert the asset to its alternative use. SFAS 157 does not specify what the ‘other costs’ might be. The highest and best use is the use that produces the higher of the value in the current use and the value (net of those conversion costs) in the alternative use(s).

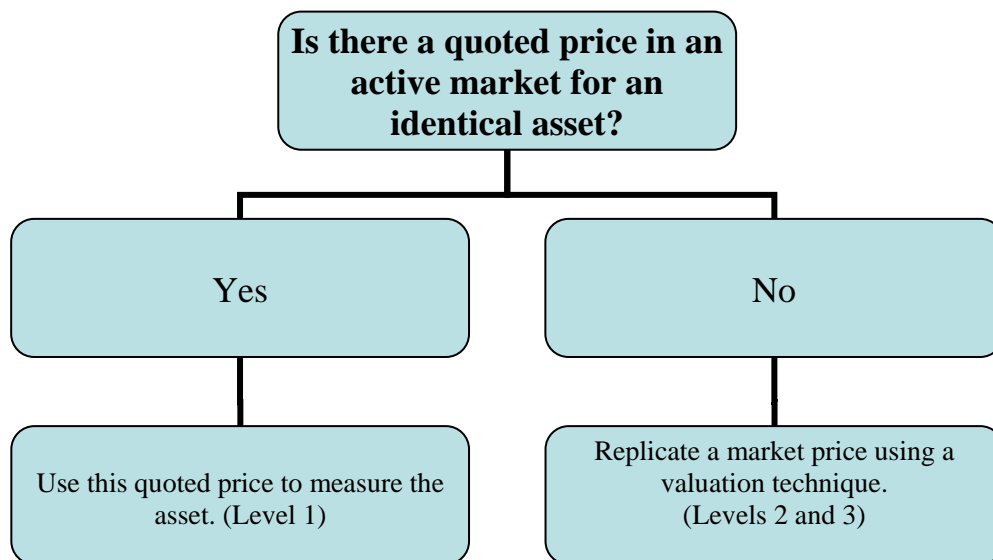
How highest and best use affects a fair value measurement

- 8 The definitions of fair value in IFRSs and in SFAS 157 are:

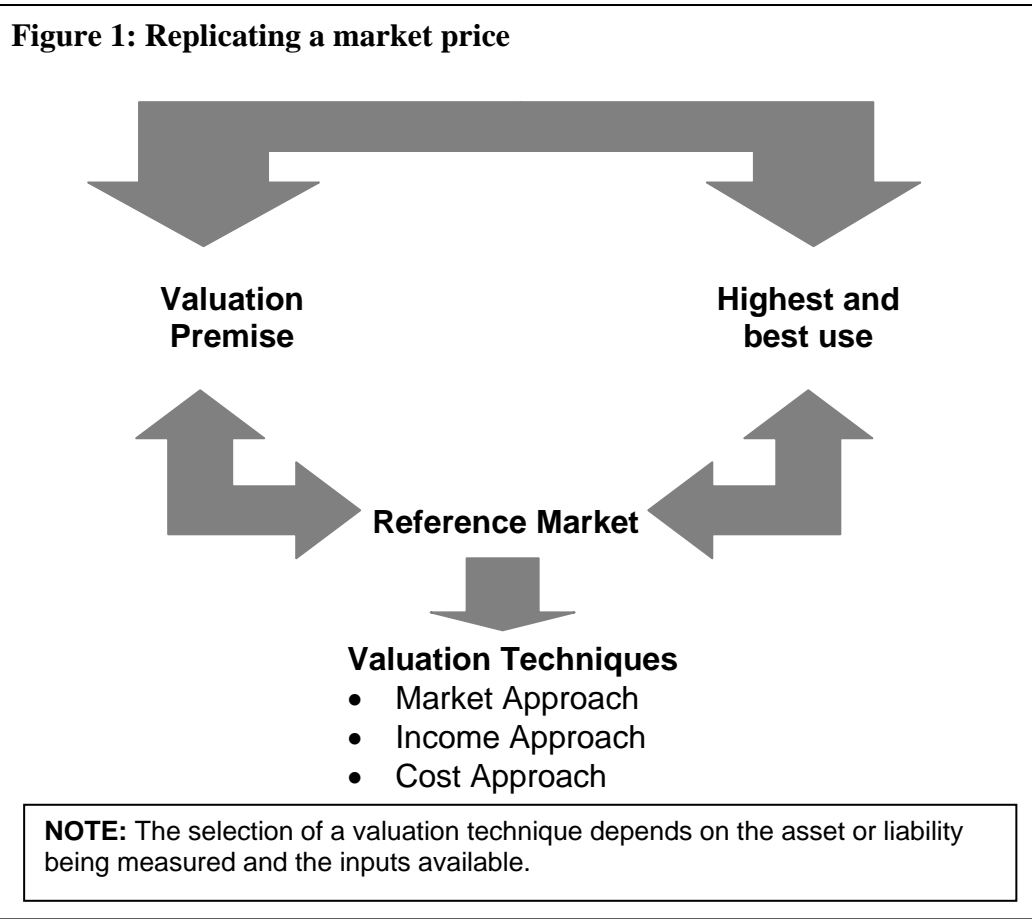
IFRSs: The amount for which an asset could be exchanged for, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

SFAS 157: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- 9 These definitions imply that fair value is an unbiased and neutral market price. By “unbiased and neutral” we mean not favourable or unfavourable for either the buyer or the seller. Both parties have agreed that the price for the asset is acceptable in such a transaction in the particular circumstances.
- 10 Fair value is easy to determine for assets that have quoted market prices in active markets (ie Level 1 of the fair value hierarchy). These prices represent the amount at which actual, arm’s length transactions could be expected to occur between market participants. However, there is not always a quoted market price (and markets are not always active). In such situations it is necessary to replicate this “unbiased and neutral” market price.



- 11 When there is a quoted price in an active market, the entity can assume that it reflects the market’s perception of the highest and best use of the asset. This is because a seller will seek to sell the asset to the buyer who will pay the best price for the asset, in other words the price that reflects the asset’s highest and best use. However, if there is no quoted price and/or the market is not active an entity will need to estimate the market’s perception of highest and best use.
- 12 Figure 1 shows the valuation concepts necessary to replicate a market price.

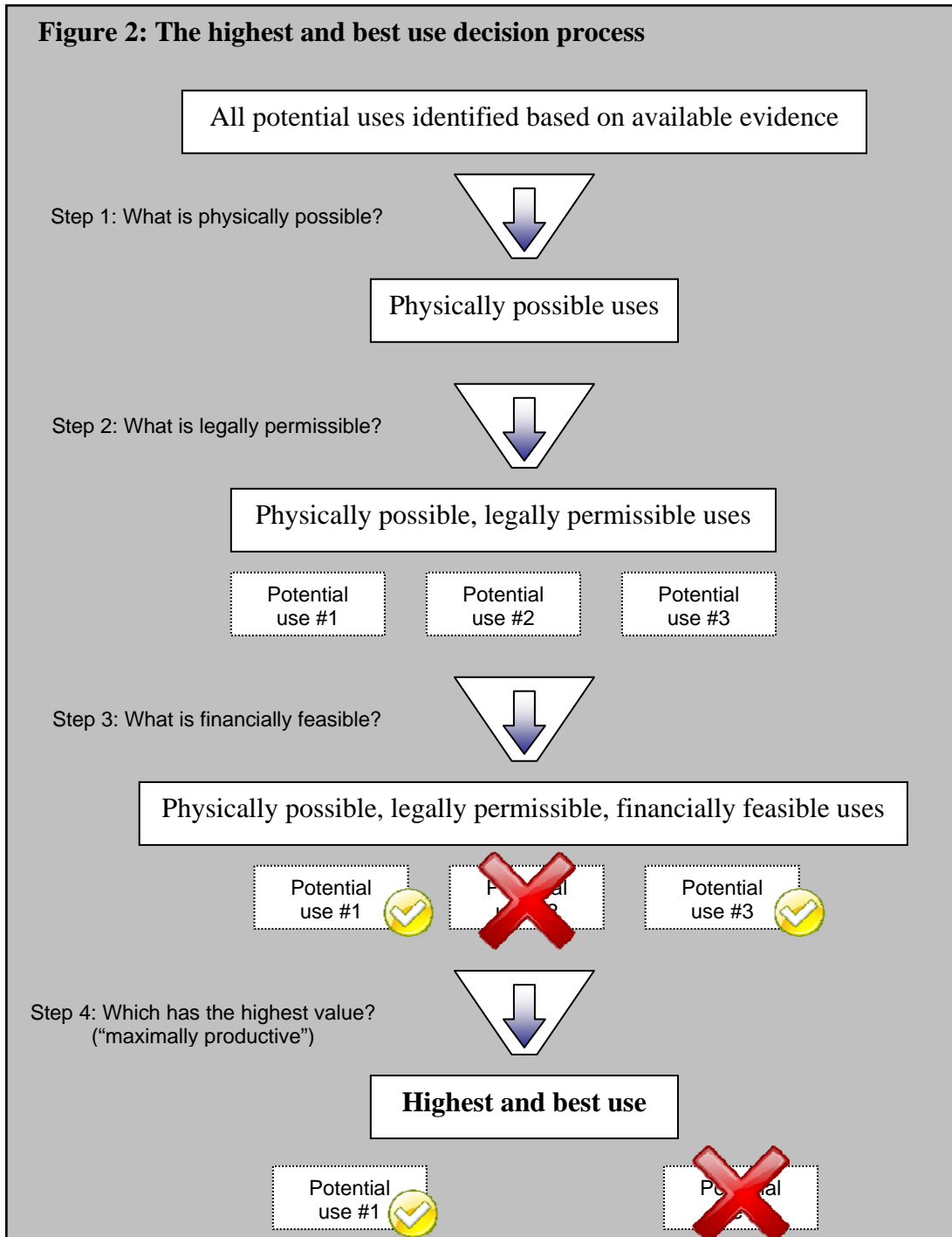


13 Determining the highest and best use, valuation premise and reference market for an asset is an iterative process. Later in the project the staff will provide the Board with examples illustrating this process. This paper focuses on highest and best use only.

The highest and best use decision process

14 SFAS 157 states that a fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is **physically possible, legally permissible, and financially feasible** at the measurement date. The highest and best use refers to the use of an asset by market participants that would maximise the value of the asset or the group of assets in which the asset would be used; it does not depend on the reporting entity’s intentions for using the asset.

- 15 Determining highest and best use involves a sequence of decisions. A potential use of an asset must first meet the criteria of being physically possible and legally permissible, and then it is tested for financial feasibility. The use of the asset with the highest value is the highest and best use. This process is shown in Figure 2.



- 16 Figure 2 assumes that the entity has first identified the reference market(s) to which it has access. We will discuss the reference market in a future meeting.

- 17 Figure 2 shows the sequence as ‘first determine what is physically possible, **then** what is legally permissible, **then** what is financially feasible...’ The first two might be interchangeable (ie an entity could identify potential uses that are legally permissible before considering whether they are physically possible). The third step must come after the first two because it is only once the entity knows what is both physically possible and legally permissible that it can determine which potential uses are financially feasible.
- 18 In most situations, it will be more efficient for an entity to first consider whether a potential use is physically possible so that there will be no need for it to consider legal permissibility for those uses that are not physically possible. There will be some situations in which the reverse is true. The staff does not think an IFRS on fair value measurement should be prescriptive with regard to the order of the first two steps.
- 19 SFAS 157 does not describe what physically possible, legally permissible or financially feasible mean. The staff thinks it would be helpful for readers if an exposure draft of an IFRS on fair value measurement explained each of these criteria and described how they should be applied. Each is described below.
- 20 The physically possible, legally permissible or financially feasible criteria historically have been specific to real estate. SFAS 157 extends this to all assets, including intangible and financial assets. The discussion below considers specifically whether these criteria are relevant for intangible and financial assets.

Physically possible

- 21 Every asset has physical characteristics (attributes). Some might have positive attributes that enhance their value. Others have negative attributes that decrease their value. For example, a property might have limited access, steep topography or unstable soil. It is necessary to weigh the positive and negative attributes when considering the property’s highest and best use.
- 22 For example, if the entity’s property is a 10,000 square foot site, it could not fit a 40,000 square foot single-storey warehouse. Even with negative characteristics, a use might be physically possible. For example, cities can be built on landfills.

- 23 Intangible and financial assets do not have physical substance. They are unique assets that often have only one use: that for which they have been created. For example, an intangible asset cannot be converted into something else without it becoming a different intangible asset. Similarly, a financial asset cannot be converted into another contract without it becoming a different financial asset. As a result, the entity's current 'use' of such assets will be their highest and best use. Therefore, the staff thinks this step will be irrelevant for intangible and financial assets.

Legally permissible

- 24 Legally permissible uses relate to whether the asset legally can be used differently from its current use. For example, property is defined by current zoning and other land use restrictions. A property might be currently zoned for residential use, but nearby properties are being rezoned and converted to commercial use. Must the highest and best use assume its current residential use? Or can the entity assume the property is rezoned to commercial use? Some interpret "legally permissible" to mean that an entity can only evaluate the property's highest and best use as a residentially zoned property. However, if there is **evidence** that rezoning would be approved (for example, when the approval seems likely because other nearby properties have been rezoned due to changes in city planning), it would be reasonable assume that the highest and best use of the property is commercial use (although the measurement would take into account the risk of the rezoning not being approved; see paragraph 32).
- 25 The entity would take a number of considerations into account in determining whether or not, for example rezoning, could be legally obtained. The probability of a zoning change could be based on one or more of the following:¹
- a the site is not physically suitable for the use currently allowed by zoning, but is physically suitable for the land development forecasted for the potential use;
 - b the potential use is compatible or can be designed to be compatible with adjacent land uses;
 - c the potential use of the site conforms to the city's comprehensive plan;

¹ Fanning, Stephen F., *Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use*.

- d a public good can be shown for the potential use of the site, which means that some level of economic demand should be considered along with other public interests;
 - e there is a history of approved zoning changes to similar properties in similar locations in other parts of town; or
 - f no nearby neighbourhood association is known to oppose similar zoning changes requests that would accommodate the forecast use for the subject.
- 26 It is worth noting that legally permissible pertains to the laws of a particular country or jurisdiction and that the different potential uses must be legal in that jurisdiction.
- 27 The legally permissible criterion is also relevant for intangible and financial assets. When applying the legally permissible criterion, an entity must consider whether other potential uses for its intangible or financial assets would be legally permitted in its jurisdiction.

Financially feasible

- 28 Once the potential uses are identified using the first two criteria (physical and legal), the entity can test those uses for financial feasibility. For example, using the approach in Figure 2, an entity might identify, based on evidence in surrounding areas, several physically possible uses for its 15,000 m² vacant land in central London:
- a as an office building;
 - b as a retail centre;
 - c as an apartment building;
 - d a park;
 - e a playground; or
 - f a cemetery.
- 29 The entity then tests these potential uses with the legal permissibility criterion. From this, it narrows the range of potential uses to the following (mainly because the land is

close to the River Thames and the city law restricts the last three on the list from being close to a body of water):

- a as an office building;
- b as a retail centre; or
- c as an apartment building.

30 The entity then tests these three potential uses for the financial feasibility criterion before determining which of the three uses is the highest and best use of the land. Financial feasibility means that the proposed use of a property must generate adequate income to justify the costs of construction (development costs) plus a profit for the developer. Generally, any use that produces a positive investment return is considered financially feasible.

31 The financial feasibility test for three potential uses of the vacant parcel of land (based on market data) results in the following:

<i>In currency units (CU)</i>	Office Use	Retail Use	Apartment Use
Potential net operating income	40 000	45 000	35 000
Market required rate of return	8%	8%	8%
Market value as improved ²	500 000	562 500	437 500
Costs to develop property (incl profit margin)	<u>(450 000)</u>	<u>(400 000)</u>	<u>(350 000)</u>
Residual land value = fair value	<u>50 000</u>	<u>162 500</u>	<u>87 500</u>

32 ‘Costs to develop property’ include the following direct and indirect costs:

- a development costs;
- b land acquisition costs;
- c the costs of obtaining necessary approvals and permits (including the uncertainty or risk that such approval will not be obtained);
- d land building costs;
- e architectural and engineering costs; and

² This is the present value of the potential net operating income over the life of the property. In this simple example, it is assumed that the operating income is constant over time and into perpetuity. In practice, this might not be the case.

f management costs.

These costs **do not** include the cost of disrupting the business or relocating the entity's staff. A market participant would not compensate the selling entity for those costs.

- 33 All three potential uses of the land are physically possible, legally permissible, and financially feasible. However, the **retail use** has the highest return and therefore is the **highest and best use** of the land.
- 34 The financially feasible criterion is also relevant for intangible and financial assets and the same thought process applies. However, for intangible and financial assets with a single potential use (its current use), this step will be unnecessary.³

Common misconceptions about highest and best use

- 35 Highest and best use, in a financial reporting context, does not:
- a indicate to users that the entity's existing asset is a different asset from the asset the entity actually holds; or
 - b require the entity to 'dream up' potential uses for an asset.

Turning the existing asset into a different asset

- 36 Highest and best use is a well-established valuation concept for real estate. Real estate appraisers, as a matter of practice, consider potential uses when valuing land. This is because land has any number of uses and any number of items can be built on it (eg it can be used for residential use or commercial use; it can have a building, parking garage or a park on it). Regardless of what is built on it, the land asset is always a land asset. But what about other assets? Can a factory be 'turned into' a high rise apartment building?
- 37 Many are concerned about using a highest and best use for an asset that is different from the entity's current or intended use. For example:

³ If the return on an asset with a single potential use is less than zero, this might be an indication that the asset is impaired or, for financial assets, that the item is a liability rather than an asset (eg a derivative).

“I am using the land as a parking garage, why must I value it as if I am using it to accommodate an office tower? I do not have an office tower, I have a parking garage!”

“I have a fish factory in Alaska, why must I value it as if it is a hotel?”

- 38 Consider a building and plot of land an entity is selling. Market participants are not concerned how the current owner uses, or has used, the building or land. A market participant buyer will consider only what it can do with that building and land, and how it could generate the highest potential return from them. Assume the entity uses that building for residential flats, but nearby properties are being converted to commercial use. The market-based notion in SFAS 157 applies here:
- a the entity (seller) would sell the land and building to the market participant who pays the best price. This is likely to be the market participant who would use the land and building at its highest and best use (eg as commercial use property);
 - b if a market participant buyer would use the land and building at its highest and best use, it would pay for the land and building and demolish the existing building;
 - c another buyer who intends to use the building as residential flats would not be able to match the price of the buyer who would convert the building to commercial use because it would not be able to obtain an appropriate return on investment—he would have paid so much that the income from the flats would be insufficient to provide a sufficient return on the purchase price.
 - d if a property has alternative uses, a purchaser might pay for the flexibility to switch to an alternative use if circumstances change. In some cases, the highest and best use might be to continue to use the asset in a way that preserves that flexibility.
- 39 Based on the above, it would be difficult to argue that the best indicator of the fair value of the land and building assumes its existing use, if evidence is available to indicate that market participants would pay for the ability to switch to another use.
- 40 This does not mean that entities must *use* the asset based on this identified highest and best use. The decision on how management employs this asset does not affect the value the market attaches to this property. There might be reasons for management to

use its assets in a way that is different from the market's perception of the highest and best use. Highest and best use is not an indicator of how management *should* be using (or is using) the asset, it is merely one step in estimating the price a market participant would pay for the asset on the measurement date.

Distinguishing between the highest and best use for land and the highest and best use for the building on the land

- 41 Consider, for example, land that is currently zoned for industrial use and it has a factory on it. Nearby parcels of land are being rezoned to residential use and developers have begun building high-rise condominiums in the area.
- 42 The land and factory were acquired for CU130,000, of which CU100,000 was attributable to the land and CU30,000 was attributable to the factory.
- 43 Assume that the highest and best use of the land (using the approach in Figure 2) is determined to be as 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. In other words, the highest and best use assumes that market participants are paying for the land, with the opportunity to build the condominiums; they would not pay for the existing factory.
- 44 The value of the land vacant and ready to build condominiums is CU305,000. **The costs to demolish the building are CU5,000.** Therefore, the fair value of the land is CU300,000. This indicates that the market's perception of the value of the land is based on the fact that the condominium can be built on it and is not based on the fact that it has a factory on it (except for the need to demolish the factory).
- 45 Because the fair value of the vacant land after demolition costs (ie assuming the factory is no longer on the land) is higher than the fair value of the land with the factory on it, the highest and best use of the land is 'as vacant', available to build the condominium. This means that the factory building is obsolete from a fair value measurement perspective (which implies an impairment for financial reporting purposes). This situation is **rare** in practice, but can occur in areas with rapid development.
- 46 In this example, the recognition of an impairment loss on the factory would seem counterintuitive if the entity intends to continue using the factory to generate net cash

flows. This is particularly the case if the impairment loss (included in profit or loss) is triggered by changes in the fair value of the land (recognised in other comprehensive income as a revaluation). It is beyond the scope of this paper to consider whether any changes should be made to the presentation of such items.

47 However, this obsolescence is the ‘economic reality’ because market participants would place no value on the factory. They would demolish the factory and build high-rise condominiums.

48 The above discussion assumes that it would not be cost-effective to relocate the factory, rather than demolish it. If relocation were cost-effective, market participants might attribute some value to the factory.

49 Recognising the obsolescence of the factory might be an issue for users of financial statements. The financial statement ratios might be confusing if the land is recognised at CU300,000, the factory at CU0, and the factory continues to generate income without any associated depreciation.

50 It is important to remember that this example is being used to illustrate the application of the highest and best use concept when the current use of an asset is different from the highest and best use of the asset. Although this situation is **rare** in practice, the exposure draft of an IFRS on fair value measurement could:

- a state that a fair value measurement should not reflect the highest and best use of an asset, but the entity’s current or intended use. However, this would not reflect a market-based value for the assets.
- b address this through the presentation of the fair value. Two possible approaches are as follows:
 - i the entity could split the CU300,000 land value between the land and the factory, for example CU30,000 for the factory and CU270,000 for the land. But this does not reflect the fact that the CU300,000 is the fair value of the land, and the land alone. The fair value of the land would not be CU300,000 if it had to keep the factory on it. It is likely to be far less (perhaps closer to CU100,000 depending on how long ago the land was acquired); or

- ii the entity could recognise a ‘change of use’ option as a separate asset. The change of use option would be measured as the difference between the fair value of the land as improved, less the fair value of the land in its current use and the fair value of the factory in its current use⁴: CU300,000 – CU100,000 – CU30,000 = CU170,000.
- c address this through the disclosure of the fair value, for example the entity could recognise CU300,000 as the fair value of the land and CU0 as the fair value of the factory. The entity then would disclose the value of the land and the factory (including depreciation) based on their current use. This both reflects the market-based value of the assets and allows users to perform their analyses based on the current use of the land and the factory. Because such a situation is rare, it is unlikely to affect most entities in most circumstances. However, it is important that users have this information. The incremental cost of performing the valuation using the current use and the highest and best use is unlikely to be significant given that the current use will be analysed in the highest and best use decision process. The staff thinks the benefits will outweigh the costs.

Looking for potential uses for an asset

- 51 Some wonder how many potential uses for an asset an entity must consider when analysing its highest and best use. They wonder whether an entity should search for potential uses even when they are not obvious.
- 52 SFAS 157’s market participant view is important here. A market participant would react only on available evidence, which in many cases is the same evidence available to the reporting entity.
- 53 The opportunity for an entity to do whatever it wants with land’s infinite possibilities extends to other assets. For example, suppose an entity bought a specialised shoe making machine three years ago. When it bought the machine, there was no evidence that market participants would use the machine for any other purpose and the cash flow projections used to support the transaction price at initial recognition assumed that the highest and best use of the asset was as a shoe making machine (there were no observable market prices and the entity used a discounted cash flow approach).

⁴ Assume the fair value of the land and factory in their current uses are CU100,000 and CU30,000 respectively.

- 54 Today, the entity sees in the newspaper that an inventor has discovered that shoe making machines can be converted to expensive jewellery making machines with minor adjustments and little cost of conversion. Now that such evidence is available, is the current use as a shoe making machine the best evidence of the value of the shoe making machine? Probably not. The amount the entity could realise from selling the shoe making machine today is likely to be based on the fact that the machine could be converted to another, more profitable use. The approach in Figure 2 would lead the entity to base the fair value of the machine on its highest and best use as a jewellery making machine (net of the costs to convert it to the alternative use).
- 55 This does not mean the entity now has, or should have, a jewellery making machine instead of a shoe making machine. Rather, the shoe making machine now has additional value because it can be converted to a more profitable use. Put differently, the entity now has an option to convert the use and that option enhances the value of the machine.⁵
- 56 Again, it would be **rare** for specialised equipment to have a highest and best use different from its current use. If other uses were possible this would be driven by known trends in the market and would only be applied in the measurement if evidence of such other uses presented itself.
- 57 An exposure draft of an IFRS on fair value measurement could state that, if there is no evidence available to suggest that the asset as a higher or better use than its current use, an entity does not need to perform an exhaustive search to find other potential uses on which to base the valuation.

Summary and staff recommendations

- 58 The staff recommends that an exposure draft of an IFRS on fair value measurement:
- a contains the principle in SFAS 157 that the highest and best use of an asset reflects its use by market participants that would maximise the value of the asset or the group of assets in which the asset would be used.

⁵ However, exercising the option would mean that the entity is no longer in the shoe making business but the jewellery making business. This is an investment/strategic decision that is outside the scope of this paper.

- b states that a fair value measurement considers the use of the asset that is physically possible, legally permissible and financially feasible at the measurement date, with an explanation of each criterion and a description of how they should be applied.
- c requires that an entity disclose the value of an asset (including the related depreciation) based on its current use if its highest and best use is different from its current use.
- d explicitly state that an entity does not need to perform an exhaustive search to find other potential uses on which to base the valuation if there is no evidence available to suggest that the asset has a higher or better use than its current use.

Questions for the Board

- 59 Does the Board agree that the fair value of an asset reflects its highest and best, that is its use by market participants that would maximise the value of the asset or the group of assets in which the asset would be used?
- 60 Does the Board agree that the highest and best use of an asset is that which is physically possible, legally permissible and financially feasible at the measurement date? If so, does the Board think the exposure draft should contain:
- a an explanation of each criterion?
 - b a description of how they should be applied?
- 61 Does the Board agree that an entity should disclose the value of an asset (including the related depreciation) based on its current use if its highest and best use is different from its current use?
- 62 Does the Board agree that the exposure draft should explicitly state that an entity does not need to perform an exhaustive search to find other potential uses on which to base the valuation if there is no evidence available to suggest that the asset as a higher or better use than its current use?