Project **Fair Value Measurement**

Topic **Incremental value**

Purpose of this paper

1. This paper addresses the accounting when the highest and best use of an asset differs from its current use by the reporting entity. In the IASB's exposure draft *Fair Value Measurement*, the difference between a current use value (not assuming highest and best use) and fair value (assuming highest and best use) is referred to as the 'incremental value'. The incremental value represents the value to the entity of the option to convert the asset to an alternative use.
2. This paper asks the boards whether to include such guidance in a converged fair value measurement standard.
3. Agenda Paper 2A (IASB)/3A (FASB) addresses the highest and best use concept generally.

Summary of differences between the IASB's exposure draft and Topic 820

4. The IASB's exposure draft provides guidance for measuring fair value when an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset. For example, an entity might operate a factory on a parcel of land even when the highest and best use of the land is to demolish the factory and build residential property on the land. FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) does not require disclosure about or address the presentation for this situation.

5. Paragraphs 20 and 21 of the IASB's exposure draft state:

> 20 In some cases, an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset. For example, an entity might operate a factory on a parcel of land even though the highest and best use of the land is to demolish the factory and build residential property. In such cases, the fair value of the asset group has the following components:
>
> (a) the value of the assets assuming their current use. This value differs from fair value when the current use of the assets is not their highest and best use. However, this value reflects all other factors market participants would consider when determining the price for the assets.
>
> (b) the amount by which the fair value of the assets differs from their value in their current use (ie the incremental value of the asset group).
>
> 21 An entity shall recognise the incremental value described in paragraph 20(b) together with the asset to which it relates. Using the example in paragraph 20, the incremental value relates to the entity's ability to convert the land from its current use as an industrial property to its highest and best use as a residential property. Accordingly, the fair value of the land comprises its value assuming its current use plus the incremental value described in paragraph 20(b). The amount attributed to the factory reflects its current use as noted in paragraph 20(a). An entity shall account for the assets in accordance with the IFRSs applicable to those assets.

6. The proposed requirement to separate the fair value of the asset group into components does **not** mean that an entity would recognise the incremental value

as a separate asset. An entity would recognise the incremental value and the current use value together as a single amount.

7. The IASB's rationale for the proposal is that it would not provide decision-useful information otherwise. This is because when an entity that uses two assets together (for example land with a building on it), highest and best use could result in one asset being measured at zero. Users would want to see depreciation on that asset so that they could assess the economic resources consumed in generating cash flows form its operation.

8. The appendix to this paper contains the illustrative example in the IASB's exposure draft.

Overview of comments received on the IASB's exposure draft

9. The invitation to comment for the IASB's exposure draft asked interested parties whether the proposed requirement to separate the fair value of the asset group into two components, as described in paragraph 5 above, is appropriate.

10. Some respondents support the proposal for the reasons given by the IASB. These respondents think that users will benefit most from disclosures that indicate both the current use and the highest and best use.

11. However, many respondents do not support the proposal for the following reasons:

    (a) this situation happens so rarely in practice it seems unnecessary to provide guidance for it

    (b) it is confusing because most asset groups have more than two assets and the assessment will be more complicated than indicated in the illustrative example in the exposure draft

    (c) it is inconsistent with fair value because none of the amounts recognised represent fair value, which could confuse users of financial statements

(d) if fair value does not provide meaningful information in the circumstances, the use of fair value as a measurement basis in that situation should be reconsidered

(e) it is inconsistent with the valuation premise. One aspect of the valuation premise is that all assets in an asset group must be measured on the same basis, ie either ‘in use’ or ‘in exchange’. The proposal would result in some of the assets within the asset group being measured ‘in use’ and others ‘in exchange’

(f) complying with the proposal will be costly because entities will need to measure two values: fair value and current use value

Staff analysis and recommendation

12. In addition to analysing the comment letters received on the IASB’s exposure draft, the staff has discussed this issue with valuation professionals. They further confirmed that this situation happens infrequently because:

(a) most entities behave rationally and seek to maximise profits by operating their assets in their highest and best use

(b) a proper assessment of highest and best use takes into account the following:

(i) all of the assets in the asset group, including intangible assets

(ii) the costs that would be incurred to convert the asset to an alternative use, including the risk and lost profits associated with converting the asset to an alternative use

13. Furthermore, this situation could arise today for assets being recognised at fair value in IFRSs and it has not been raised as a practice issue. It also has not been raised as a practice issue in the US by entities applying Topic 820.

14. The staff has the following concerns about the proposal:

(a) it is inconsistent with a fair value measurement objective. Neither of the two components is based on fair value assumptions (ie one component is based on the current use value of one of the assets and the other component is the difference between fair value of the entire asset group and the first component). Neither of these amounts reflects the price that would be obtained to sell an asset in an orderly transaction between market participants at the measurement date

(b) it might have unintended consequences given that:

(i) it has not been raised as a practice issue by entities applying IFRSs or US GAAP

(ii) many respondents to the exposure draft found the proposed guidance to be confusing

(c) the concern about depreciation is equally relevant for assets that are fully depreciated

15. The staff recommends that the boards:

(a) not require entities to separate the fair value of an asset group into two components as proposed when an entity uses an asset together with other assets in a way that differs from its highest and best use

(b) require entities to disclose information about when they use an asset in a way that differs from highest and best use (and that asset is recognised at fair value).

Question for the boards
Do the boards agree with the staff recommendations in paragraph 15? If not, what do you propose and why?

Appendix – Proposed example illustrating the application of ‘incremental value’ in the IASB’s exposure draft

Example 2—Land

IE5 An entity acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. As an industrial property (the current use), the indicated value of the land and factory is CU100,000 and CU60,000, respectively. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, the entity determines that the land currently used as a site for a factory could be developed as a site for residential use (for high-rise apartment buildings).

IE6 The highest and best use of the land would be determined by comparing (a) the value of the land as currently developed for industrial use (‘in use’) and (b) the value of the land as a vacant site for residential use, considering the costs of demolishing the factory and other costs necessary to convert the land to a vacant site (‘in exchange’). In this situation, the highest and best use of the land would be to develop high-rise apartment buildings (‘in exchange’). As a residential property, the indicated fair value of the vacant site is CU300,000 after considering the costs to demolish the factory and other costs of conversion to a vacant site.

IE7 Because the current use of the land differs from its highest and best use, the fair value of the asset group (land and factory) has two components: (a) the value of the assets assuming their current use as industrial property and (b) the amount by which the fair value of the assets differs from their value in their current use. The amount in (b) is determined by subtracting the current-use value of the land and factory (CU160,000) from the fair value of the vacant site (CU300,000).

IE8 The entity measures the land at CU240,000. This is the current-use value of the land (CU100,000) plus the incremental value of the land (CU140,000) that relates to the ability to convert the land from its current use to its highest and best use. The entity measures the factory at CU60,000. The entity accounts for the assets in accordance with the IFRSs applicable to those assets.