HM TREASURY

FRAB (116) 04
04 APRIL 2013

Financial Reporting Advisory Board Paper

IFRS 13 Fair Value – Application in Central Government

Issue:	In May 2011, the IASB issued IFRS 13 *Fair Value Measurement*. The standard emphasises the valuation of assets at market value, which is not in alignment with the existing approach for the valuation of some classes of assets and liabilities in the public sector (where valuations reflect future service potential as a proxy for fair value).
Impact on guidance:	No changes yet proposed.
IAS/IFRS adaptation?	No.
Impact on WGA?	Yes.
IPSAS compliant?	No. Reflects changes to fair value measurement as a result of IFRS 13. The IPSASB are exposing on the measurement of assets and liabilities in financial statements as part of the development of a Conceptual Framework for General Purpose Financial Reporting (GPFR) by Public Sector Entities.
Interpretation for the public sector context?	No.
Impact on budgetary regime?	No.
Alignment with National Accounts	Yes.
Impact on Estimates?	No.
Recommendation:	The Board is requested to provide advice on the full application of IFRS 13 *Fair Value Measurement* to Central Government financial reporting.
Timing:	Application for financial periods beginning on or after 1 January 2014.

DETAIL

Background

Why we revalue and asset valuation practice in central government

1. With the introduction of resource accounting, central government followed FRS 15 'Tangible Fixed Assets'. FRS 15 provided entities with an option to use Historical Cost Accounting (HCA) or to adopt a revaluation policy.

2. Central Government required financial statements to be prepared using the revaluation policy of Modified Historical Cost Accounting (MHCA). This was because:

- The introduction of resource accounting put tangible assets on the balance sheet for the first time. Not all entities had records of the historic costs of the assets that they owned. HCA balance sheets show asset values that are, in effect, based on historical costs that have differing age profiles depending on when assets are acquired. A similar effect applies to the depreciation associated with HCA valued assets;

- The impact of accumulated inflation over a period of years may have made nonsense of historical costs;

- Revaluation "provides useful information related to asset management plans and budgeting, and, given the long life of infrastructure, provides a better reflection of the cost of using it."; and

- With all costs being expressed at current price levels, revaluation allows valid comparisons to be made between bodies, within bodies, and between years.

3. Paragraph 53 (a) of FRS 15 required non-specialised properties to be valued at existing use value (EUV). The same paragraph required entities to declare instances where the open market value was materially different to EUV and the reasons for the difference between the two values.

4. Central Government applied IAS 16 'Property, Plant and Equipment' with effect from the 2009-10 financial year. IAS 16 also allows an asset to be measured after recognition using either the historic cost model or the revaluation model (with the asset value being its fair value at the date of revaluation). At that time, the IASB had also released an exposure draft for the proposed Fair Value Measurement standard.

5. Due to the perceived lack of clarity over IAS 16's treatment of certain asset classes and the impending release of a fair value standard that was expected to provide more guidance in these areas, IAS 16 was adapted in the FReM to retain the revaluation requirement to MHCA as well as the treatment of non-specialised property assets (i.e. they were required to continue to be valued at market value in existing use, as per 2013/14 FReM paragraph 6.2.5). This was because considerations at the time placed great emphasis on the cost/imposition of requiring up to three bases of valuation over a short space of time (existing use value under FRS 15 for 2008/09, an exit value basis under IAS 16 for 2009/10, and a potential third alternative basis under the pending IASB fair value standard – see paragraph 13 of the attachment at Appendix B).

6. There was also a question about the applicability of an exit price to the valuation of central government assets. This was particularly in regard to the relevance that market value would

have in a decision making process that was largely based on service potential and not disposal value/proceeds (see Appendix C for the IFRS concepts on the purpose of financial statements and their characteristics).

7. With regards to revaluation policies, both FRS 15 and IAS 16 take similar positions. Without insisting on annual revaluations for asset classes, there is a requirement in both standards that assets reflect current values at the balance sheet date. Specifically commenting on annual revaluations, paragraph 34 of IAS 16 states that 'frequent revaluations are unnecessary for an item of PPE with only insignificant changes in fair value. Instead it may be necessary to revalue the item only every three or five years.'

The development of a fair value standard

8. Some IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities or their own equity instruments. As IFRSs have been developed over many years, the requirements for measuring fair value and for disclosing information about fair value measurements have been dispersed and "did not articulate a clear measurement or disclosure objective."

9. IFRS 13 paragraph 9 now defines fair value as follows: "Fair value is 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."

Concepts introduced by IFRS 13

10. This definition equates fair value with an exit price.

11. Fair value is now defined from a market perspective, which requires consideration of a range of new factors (e.g. "highest and best use" by the market participants, as per IFRS 13 paragraph 27) and the disregard of a range of others (e.g. existing use as a primary driver for valuation).

12. The reference to an orderly transaction requires a valuer to suppose that the transaction is not forced (e.g. the seller is not undergoing liquidation and there is no element of financial distress affecting the sale).

13. In establishing a theoretical price for the item, the seller would take into account the fact that a buyer would pay according to the economic benefits expected to be gained in the use of the asset – that is, the asset would be valued as if it were employed in its "highest and best use", even if that is not its current use.

14. Highest and best use contributes to the maximisation of the value of an asset based on the different physically possible, legal and financially feasible uses that market participants could employ to generate economic benefits from the item undergoing valuation.

Technical components of IFRS 13

15. The data used during the valuation process, called inputs, have been placed into three possible categories:

- Level 1 inputs, or direct market inputs;
- Level 2 inputs, or indirect market inputs; and
- Level 3 inputs, or unobservable market inputs.

16. The standard requires the maximisation of level 1 inputs and the minimisation of level 3 inputs.

17. In addition, and separately regarded from inputs, are three valuation methodologies:

- The market method, based on market information;
- The income method, based on the present value of cash flows associated with the asset; and
- The cost method, generally read as the depreciated current replacement cost.

18. While there is some natural correlation between methodologies and inputs (i.e. Level 1 inputs with a market valuation methodology), each of the valuation methodologies are equally compliant under the standard and are not intended to correspond to the hierarchical ranking of inputs.

Interpretation and Application

19. In a general sense, IFRS 13 promotes a value that reflects a theoretical market price as much as possible and will attempt to simulate this amount where a ready price is not available.

20. The standard requires the maximisation of level 1 inputs, which are those directly observable from the market in which an asset would be sold – namely, a quoted price for an identical asset in an active market. By definition, if a Level 1 input is available then the market method is being used to value the asset.

21. Where level 1 inputs are not available, level 2 inputs are required to be used where available and appropriate. Level 2 inputs are market corroborated inputs other than those that classify as level 1 – for example, market indices for housing valuation. Level 2 inputs can feed into any of the three valuation methodologies available under IFRS 13.

22. Level 3 inputs are those that are not directly observable from the market. By definition, level 3 inputs cannot be used in a direct market valuation. However level 3 inputs may be used to adjust a market valuation.

23. A flowchart depicting the decision making process including selection of inputs and methodologies is available at Appendix A. It is up to each entity to justify any decisions they make to their auditors.

Adoption of IFRS 13 without adaptation or interpretation in central government

24. Valuation using market value in existing use is, conceptually at least, in direct contradiction of the IFRS 13 requirement that fair value should be market value of an asset in its highest and best use with regard to all market participants; i.e., while the existing use of an asset might be the highest and best use for the current owner of the asset, another market participant may be able to derive higher economic benefit employing the asset in a different way. It is conceivable that in some instances market value in existing use and fair value may be the same, but this will not be by design.

25. If a quoted price for an identical asset in an active market is available (for example, a valuation report with reference to the asset in question), then that price constitutes a Level 1 input using a market valuation methodology and will be the fair value for that asset. In subsequent years, if this price is adjusted for indexation to reflect ‘current year conditions’, it will constitute a Level 2 input.

26. Full adoption of IFRS 13 will result in most tangible assets being valued using a market valuation method with Level 2 inputs (see Appendix D(i)). Unless a direct assessment of an asset is undertaken, level 1 inputs will rarely (if ever) be available.

27. For non-specialised assets, the minimum fair value should be no lower than market value in existing use. This is by virtue of the restriction on distressed sale (see the 'concepts' section above) and the inclusion of the seller in the group of market participants (paragraph BC56) whose assumptions feed into the theoretical transaction price. A non-distressed seller will not dispose of the asset for an amount that is less than its market value in existing use.

28. As per IFRS 13 paragraph 93(i) "if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use."

29. This disclosure benefits commercial decision makers when an entity may not be utilising an asset to its highest economic benefit (possibly for competition reasons, i.e. withholding intellectual property until the most beneficial market entry point may yield long term benefits, but the asset is not generating cash flows until a future point in time and this would impact its valuation). This information can also benefit central government agencies whose fair value disclosures may belie how an entity uses an asset (specialised and non-specialised) to render public services and deliver departmental objectives.

30. In some cases, particularly for genuinely specialised assets, market value in existing use may not take into account the inherent characteristics of the asset (namely its current installation, configuration, ability to contribute to the economic benefit of the entity when used in conjunction with other assets).

31. Paragraph BC79 (in the basis of conclusion to IFRS 13) states that "when a market price does not capture the characteristics of the asset (e.g. if that price represents the use of the asset on a stand-alone basis, not installed or otherwise configured for use, rather than in combination with other assets, installed and configured for use), that price will not represent fair value."

32. In these situations, the standard requires the entity to disregard any market value that does not capture the nature of the asset and instead employ either the income method or depreciated replacement cost to arrive at an appropriate fair value.

CIPFA/LASAAC considerations of IFRS 13

33. Following the advice of FRAB at its December and February meetings, CIPFA/LASAAC considered its approach to the adoption of IFRS 13 Fair Value Measurement in the Code of Practice on Local Authority Accounting in the United Kingdom for property, plant and equipment assets at its meeting on 5 March 2013. It requested that the CIPFA Secretariat produce an issues paper which considers, on a conceptual basis, the approach to the measurement of local authority assets (as a part of the UK public sector). It wished this paper to set out the development of the current approach to the measurement of public sector assets in its historical context. It also requested that the Secretariat consider the potential impact of an IFRS 13 measurement on key examples of local authority assets.

34. CIPFA/LASAAC asked for this paper to be issued urgently to its members in order that the paper can be shared with FRAB. This will allow CIPFA/LASAAC Members to comment on the issues raised in the papers. The CIPFA/LASAAC Board noted that whilst it would be content for the paper and any comments of CIPFA/LASAAC's Members to be shared with FRAB to assist in the debate these would not be able to be considered as its formal position as they had not been considered at a meeting of the Board. As consideration of the conceptual issues will be wider

than the application of IFRS 13, this paper may help to inform the debate at stage 2 regarding the desirability or otherwise of adapting IFRS 13 for the public sector context.

Summary and recommendation

35. The IFRS 13 *Fair Value Measurement* valuation methodologies are based on exit values, which may not be the most conceptually appropriate basis for public sector assets that are specialised in nature or have no market. HMT recognises that for many classes of assets, given the methodologies in IFRS 13, the valuation would be the same. However, HMT believes that further work is required, especially with regards to the impact of IFRS 13 on the valuation of office accommodation and dwellings.

36. The decision to use 'market value in existing use' for in-use non-specialised property in the FReM when IAS 16 was introduced was based on the wish to minimise changes in accounting practice over a short period of time pending the release of an IASB fair value standard, rather than the merits of the existing methodology. HMT recognises that this should be revisited. The consultation on the move to the IFRS based Code specifically considered the interpretation of fair value on an existing use basis for assets that are not held for the purpose of generating cash flows.

37. As per CIPFA/LASAAC's considerations (paragraph 34 and 35 above), the CIPFA Secretariat is currently producing an issues paper following the request of CIPFA/LASAAC, which considers, on a conceptual basis, the approach to the measurement of local authority assets (as a part of the UK public sector). CIPFA/LASAAC asked for this paper to be issued urgently to its members in order that the paper can be shared with the FRAB.

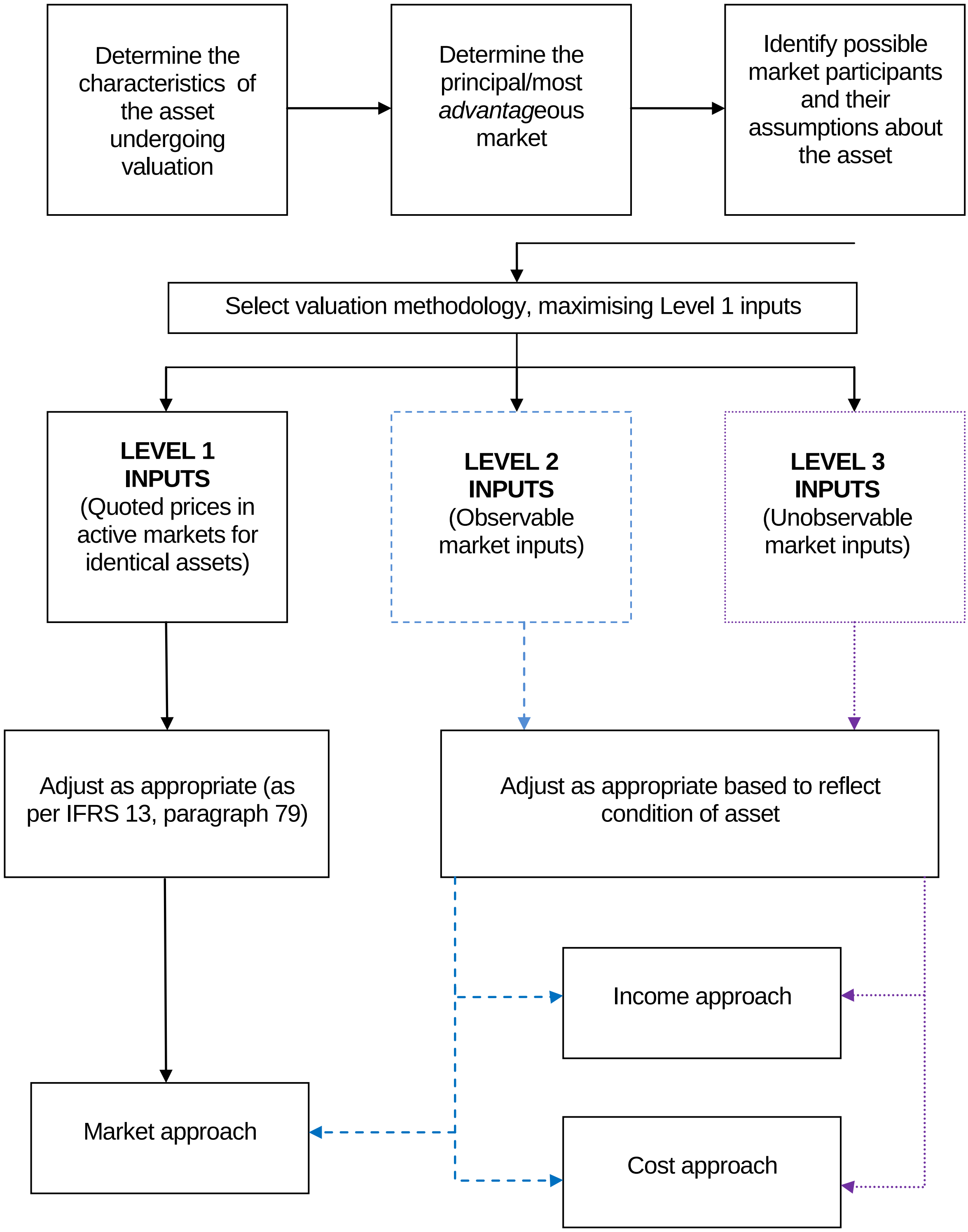
38. Application of IFRS 13 in full would result in new valuation profiles for certain classes of assets. HMT is proposing to issue a consultation paper considering the implications of the full application of the standard. Entities would be invited to comment on the impact this would have on their financial reporting, particularly for commercial and residential real estate assets. As the primary objective of this exercise would be to gauge the impact of full application of IFRS 13 on Central Government accounting, it would assist in identifying areas of asset valuation where full application of IFRS 13 creates contention.

39. The Board is requested to provide its advice on the application of IFRS 13 *Fair Value Measurement* to Central Government.

HM Treasury
4 April 2013

APPENDIX A

Valuation of an asset under IFRS 13 Fair Value



APPENDIX B

FRAB Paper (98) 04: "Re-measurement of in use non-specialised property under IAS 16 *Property, Plant and Equipment*"

FReM Chapter 6
Update Oct 2009.pdf

APPENDIX C

Extracts from the IFRS Conceptual Framework

Objective, usefulness and limitations of general purpose financial reporting (GPFR)

BC1.9: The requirements of the primary user group are a driver in the preparation of GPFR – the primary user group is defined as existing and potential investors, lenders and other creditors of a reporting entity.

BC1.9 goes on to say that regulators, and members of the public other than investors, lenders and other creditors may find information in GPFR useful but clearly states that those are not parties to whom general purpose financial reports are primarily directed.
It should be noted that these definitions are written from a private sector perspective and should be read for a public sector application. As taxpayers, the general public represents the existing investors defined by the framework as a group of primary financial report users.

Objective of the general purpose financial reporting

OB5: "Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed."

The impact of the Information needs of management of GPFR

OB9: "the management of a reporting entity is also interested in financial information about the entity. However, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally."

Information needs of governments

With regards to the information that users will need from general purpose financial statements: "The Board recognises, however, that governments, in particular, may specify different or additional requirements for their own purposes. These requirements should not, however, affect financial statements published for the benefit of other users unless they also meet the needs of those other users."

Enhancing qualitative characteristics of GPFR

Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction (of the economic phenomena underlying an event) is a faithful representation.

Appendix D(i) Generic - Assuming the valuation method required by EU-adjusted IFRS is described as ‘fair value’:

<table>
<tr><th></th><th colspan="2">Current valuation policies</th><th colspan="2">Under IFRS 13</th></tr>
<tr><th></th><th>Specialised</th><th>Non-specialised</th><th>Specialised**</th><th>Non-specialised***</th></tr>
<tr><td>Property</td><td>Depreciated replacement cost</td><td>Market value in existing use</td><td>Depreciated replacement cost</td><td>Market value*</td></tr>
<tr><td>Plant</td><td>Depreciated replacement cost</td><td>Depreciated replacement cost</td><td>Depreciated replacement cost</td><td>Market value*</td></tr>
<tr><td>Equipment</td><td>Depreciated replacement cost</td><td>Depreciated replacement cost</td><td>Depreciated replacement cost</td><td>Market value*</td></tr>
<tr><td>Residential Property</td><td>Depreciated replacement cost</td><td>Market value</td><td>Depreciated replacement cost</td><td>Market value*</td></tr>
<tr><td colspan="5">Other non-current assets</td></tr>
<tr><td>Assets under construction</td><td colspan="2">Valued at cost until completion</td><td colspan="2">Valued at cost until completion</td></tr>
<tr><td>Donated Assets</td><td colspan="2">Stated at fair value like any other purchased asset</td><td>Depreciated replacement cost</td><td>Market value</td></tr>
<tr><td rowspan="2">Heritage Assets</td><td>Operational</td><td>Market value where possible</td><td colspan="2" rowspan="2">Market value where possible, but more likely at depreciated replacement cost</td></tr>
<tr><td>Non-operational</td><td>Purchase price or market value where possible, or no value reported if cannot be obtained.</td></tr>
</table>

*Market value can be either a quoted price for an identical asset in an active market, or adjusted by Level 2/3 inputs where necessary.
** Depreciated replacement cost is the most likely result, but where possible adjusted market value could also be used.
***The income method is also a valid method for any of these asset classes, however as central government cash flows are not driven by profit and it can be difficult to isolate cash flow contributions to a particular asset (especially those always used in conjunction with other assets), this method is not expected to be in common use in the central government.

Appendix D (ii) Valuation policy by class with regards to top asset holder. Sourced from 2010/11 WGA data.

Asset class	Total NBV per WGA (£000's)	Highest value reporting entity	Value reported (£000's)	Valuation as per policy note	Likely valuation under IFRS 13
Infrastructure	162,919,554	Department for Transport	102,143,424 62.70%	Depreciated replacement cost	Depreciated replacement
Buildings	72,673,851	Foundation Trusts	14,085,700 19.38%	Generally, market value in existing use	Market value (adjusted where appropriate for condition of asset).
Single use military equipment	35,726,460	Ministry of Defence	35,726,460 100.00%	Depreciated replacement cost	Depreciated replacement cost
Payments on account and AUC	26,869,252	Ministry of Defence	16,777,928 62.44%	Valued at cost and subject to indexation.	Valued at cost and subject to indexation.
Land	24,342,853	Ministry of Defence	7,463,737 30.66%	Non-specialist properties are valued at fair (i.e. market) value. For in-use non specialist properties, valued at market value for existing use. Specialist property for which there is no external market is valued at depreciated replacement cost.	Market value (adjusted where appropriate for condition of asset). Specialist property for which there is no external market may continue to be valued at depreciated replacement cost.
Transport equipment	9,089,665	Ministry of Defence	8,471,997 93.20%	In general, depreciated replacement cost. A small amount valued at market value in existing use (standard vehicles).	In general, depreciated replacement cost. A small amount valued at market value.

Asset class	Total NBV per WGA (£000's)	Highest value reporting entity	Value reported (£000's)	Valuation as per policy note	Likely valuation under IFRS 13
Plant and machinery	8,174,588	Ministry of Defence	1,854,067 22.68%	Market value	Market value (adjusted where appropriate for condition of asset).
Dwellings	7,273,438	Ministry of Defence	5,593,387 76.90%	The majority is valued at depreciated replacement cost. Market value for existing use is more appropriate for a small number of houses in a single location.	Remote location may provide basis for continued depreciated replacement cost. For other properties, most likely market value.
IT, hardware, software and equipment	5,478,412	Ministry of Defence	2,726,627 49.77%	Historical cost.	Historical cost.
Furniture and fittings, and other assets	3,607,493	Department of Health	966,917 26.80%	Modified historical cost.	Historical cost.

Appendix D (iii) Total per asset class per WGA sector*

Net book value (£'000's)	Academies	Central Government	Foundation Trusts	Local Government	NDPB	NHS Trusts	Public Corporations	Grand Total
Buildings	2,654,682	36,825,423	14,085	133,809,979		12,570,454	7,131,985	**207,078,223**
Dwellings		5,859,499	206	75,388,943	495,163	206,667	3,452,407	**85,609,079**
Furniture and Fittings, and other assets	84,797	2,052,319	107	5,221,640	1,254,585	107,992	433,366	**9,262,499**
Infrastructure		134,315,991		80,263,670	29,830		39,483,116	**254,092,607**
IT, hardware, software, equipment		4,372,626	355	137	186,796	426,290	84,315	**5,562,727**
Land		16,306,219	3,091	17,597,021	1,010,147	3,4,158	1,367,585	**42,376,130**
Payments on account & Assets under construction		20,761,249	767	14,698,353	2,780,466	557,121	2,067,339	**41,631,828**
Plant and Machinery		3,781,372	1,354	8,199,356	1,8,470	1,436,209	1,761,644	**17,541,851**
Single Use Military Equipment		35,726,460		-			-	**35,726,460**
Transport Equipment		8,652,665	44	1,837,909	111,932	129,859	380,303	**11,156,668**
Grand Total	**2,739,479**	**268,653,823**	**20,012**	**337,153,871**	**6,877,389**	**18,438,750**	**56,162,060**	**710,038,072**

***Sourced from 2010/11 WGA data.**