Financial Reporting Advisory Board Paper

IFRS 13 *Fair Value Measurement* – Application in Central Government and steps toward formal consultation

Issue:	In May 2011, the IASB issued IFRS 13 *Fair Value Measurement* ("IFRS 13" or "the standard"). The standard emphasises the valuation of assets at market value, which is not in alignment with the existing approach for the valuation of many classes of assets and liabilities in the public sector.
Impact on guidance:	No changes yet proposed.
IAS/IFRS adaptation?	No.
Impact on WGA?	Yes.
IPSAS compliant?	No. Prior to the release of IFRS 13 and the changes to the definition of fair value, the IPSAS definition of fair value complied with IFRS definitions. However, the IPSASB have issued an Exposure Draft 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 which proposes an entry value perspective to address service potential.
Interpretation for the public sector context?	No.
Impact on budgetary regime?	No.
Alignment with National Accounts	No.
Impact on Estimates?	No.
Recommendation:	The Board is requested to endorse the current position taken by the Working Group (comprised of members from HM Treasury, CIPFA and additional experts) to progress the work on identifying the appropriate application of IFRS 13 to public sector financial reporting.
Timing:	Application for financial periods beginning on or after 1 January 2014.

DETAIL

Concepts introduced by IFRS 13

1. 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." This definition equates fair value with an exit price and is defined from a market perspective, which requires consideration for the concept of the "highest and best use" principle (IFRS 13 paragraph 27) and that the measurement is to be derived from the assumptions of market participants (IFRS 13 paragraphs 22 to 23).

2. 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. Highest and best use contributes to the maximisation of the value of an asset based on the different physically possible, legal permissible and financially feasible uses that market participants could employ to generate economic benefits from the item undergoing valuation (IFRS 13, paragraph 28).

3. FRAB paper (116)04 provides comprehensive information on the direct application of IFRS 13 as read. The paper noted that 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.

4. Further to the discussion contained in the FRAB (116)04 paper, IFRS 13 paragraph 16 states that "a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:

- in the principal market for the asset or liability; or
- in the absence of the principal market, in the most advantageous market for the asset or liability."

5. As the standard anticipates that valuations should reflect market participants' assumptions, it does not consider an entity's intent to sell as a factor at the measurement date. However, for an orderly transaction to occur under the standard IFRS 13 paragraph 19 provides that "the entity must have access to the principal (or most advantageous) market at the measurement date".

Application of IFRS 13 to the public sector

6. The Working Group that considered the standard is of the view that fair value as defined by IFRS 13 generally supports the objectives and principles of financial reporting as laid out by the IFRS Conceptual Framework (paragraph OB2 – useful information for decision making) and the FReM (paragraph 2.2.1 – useful information about stewardship and accountability). However, it should be recognised that IFRSs are designed to apply to the statements and reporting of profit-oriented entities (see "Preface to IFRSs", paragraph 7) and as such decision making is accepted to refer to economically driven decisions for commercial and profit related purposes. Economic information alone is not sufficient for all decision making purposes, particularly in the public sector when considerations of service potential are often important.

7. While further work is required with regards to application of the standard to public sector liabilities and equity, as well as the disclosure requirements of IFRS 13, the Working Group does not consider there to be conceptual difficulties in these areas. It is envisaged that additional guidance will be issued for the application of the standard, developed and assessed by the Working Group. Feedback from this process will be provided to the FRAB.

8. The Working Group considers that there is a case that the standard can be applied to public sector entities. However, application of the standard to property, plant and equipment assets in the public sector will need to consider the constraints on highest and best use included in paragraph 28 of the standard, i.e. that the principle of highest and best use takes into account the use of the asset that is physically possible, legally permissible and financially feasible. These constraints have a particular importance in the application of highest and best use to public sector entities and could limit fair value measurement to current use by public sector entities in a number of cases.

9. The most relevant constraint under IFRS 13 to the public sector is whether a market participant consideration of alternative higher and best use asset is 'legally permissible'. Certain types of assets (for example, but not limited to, social housing, hospitals and schools) must undergo extensive procedural hurdles prior to any possible sale.

10. The constraints on sale may in IFRS 13 terms constitute either:

- lack of access to a market for the entity; or
- a characteristic of the asset that a market participant would take into consideration that would affect the theoretical sale price of the asset.

11. These constraints are more extensive than, for example, office accommodation requiring planning permission prior to development as residential properties. These types of disposals often require lengthy statutory public consultations, fulfilment of regulatory obligations and ministerial approval or consent. These processes can take a number of financial years and, at the measurement date it is unlikely that it can be determined whether there is a legal basis for market participants to consider alternative/highest and best use of the asset in question in a given reporting period.

12. Other constraints may also apply to public sector assets. The public sector may have to provide the service in a particular way (including for example geographical or other service limitations), or there may be restrictions on sale (for example, limiting the potential purchasers) intended to ensure the assets continue to deliver public services. Because these constraints restrict the disposal options for the public sector, the public sector is unable to access the returns available to the private sector via an alternative use. As a result, they could limit fair value to current use as opposed to highest and best use.

13. Therefore, application of the standard will need to give consideration to the following effects on the fair value measurement of public sector assets:

- examples where fair value measurement of the assets directly under IFRS 13 would replicate existing practices;
- examples where fair value measurement of the assets would remain unchanged due to the constraints faced by public sector entities;
- examples where fair value measurement of the assets would produce results which do not reflect the constraints faced by public sector entities; and
- examples where fair value measurement of the assets would change because the constraints (economic decisions) faced by public sector entities are very similar to private sector entities.

14. These points are addressed in order below. A summary of the impact of the standard on fair value measurements is shown in Appendix A. In order to ensure consistency in the public sector and in individual asset classes it will be important that measurement of fair value under constraints is applied consistently for each class of asset in the relevant Manuals; and some form of additional guidance/interpretation mat be required in the FReM.

Examples where fair value measurement of the assets would replicate existing practices

15. For assets that have unique characteristics that cannot be captured by direct market information or adjusted market information (i.e. level 1 or 2 inputs as per IFRS 13 paragraphs 76 to 85) ie where no market exists, 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. This reflects the existing practice whereby many specialised assets are currently valued using depreciated replacement cost in the public sector; an income method, the other option mentioned in IFRS 13 is not prevalent. This is because many public sector assets (eg highways infrastructure assets) generate no cash flows on which an income method could be based.

Examples where fair value measurement of the assets would remain unchanged due to the constraints to be faced by public sector entities

16. The Working Group is of the view that there are some assets where restrictions on disposal mean that a market for these assets does not exist, or that sales processes are so complex and lengthy that market participants could not consider alternative use. The Working Group is consulting with experts in the disposal of assets to determine the characteristics of these constraints and whether or not these can be captured by the measurement requirements of the standard. If these constraints are the legal constraints described in paragraph 11 then market participants would not be able to assess at the reporting date that alternative/higher and best use was achievable. Fair value would be limited to current use and the measurement of these assets would not be subject to change. If the constraints arise from restrictions on disposal that limit the market for the assets (so that an orderly market does not exist), then such assets would either have to be valued using a cost/income method due to lack of market information for the asset in its highest and best use, or the asset would have to valued using estimated market information with the constraints taken into consideration. In the latter example, as any transfer of these assets at the measurement date would require the asset to continue to be used in their existing capacity, the most appropriate valuation methodology would be market value in existing use.

Examples where fair value measurement of the assets would produce results which do not reflect the constraints faced by public sector entities

17. The Working Group looked at the wider constraints faced by public sector entities in the provision of services and considered whether measurement from a private sector / financial capacity perspective in these circumstances provided relevant information to the users of the financial statements. These wider constraints might mean, for example, that the resources that might be available under an assessment of financial capacity cannot be practically and realistically accessed by the public sector entity due to its operational constraints. Under the standard, the value of a property asset (that includes a building) in premium areas will generally reflect a higher fair value with the building demolished and the site available for development – this is an issue subject to ongoing discussion in the private sector as well as the public sector. Where a private sector entity and the users of its financial reports often base decisions on the economic imperative inherent in maximising use of property, this does not reflect the public sector constraint of having limited or no choice but to continue to provide services via property assets in a particular location. Therefore where a private sector entity would be able to make an economic decision to sell a property to realise its fair value and operate from a less expensive property in a different location without diminishing its service capability, a public sector body would have to purchase a similar or identical asset in the same area to fulfil its service mandate.

18. Following the principles outlined in paragraph 17, and focusing on measures of operational capacity and the cost of providing the services to the public, there are other constraints that the measurement requirements of the standard would not fully capture. The IFRS conceptual

framework also states that "general purpose financial reports are not designed to show the value of a reporting entity" but to provide information to assist the primary financial statement users to "estimate the value of the reporting entity" (paragraph OB 7). For assets that are held in a very specific geographic location for the delivery of public services, the initial Working Group analysis is that fair value measurement does not appropriately contribute to an understanding of the value of a public sector reporting entity as the entity does not have the discretion to take advantage of market dynamics to acquire assets in a different location to render the service.

19. For the two examples above, highest and best use under IFRS 13 does not always appropriately reflect the value of the reporting entity and there will be consideration of an adaptation to IFRS 13 to require public sector bodies to value geographically restricted assets used in the direct provision of public services on the basis of market value in existing use.

Examples where fair value measurement of the assets would change because the constraints (economic decisions) faced by public sector entities are very similar to private sector entities

20. The Working Group were of the view that application of IFRS 13 in full would result in re-measurement on the basis of highest and best use for certain classes of assets, the clear example being office accommodation used purely for administrative purposes. In the majority of cases, there are no or very few constraints on access to a market, the public sector takes similar decisions to the private sector for the use of assets and these are not specialised assets. Users of the financial statements are likely to take the same or similar decisions relating to these assets as users of private sector entities. Where this is the case, it is no longer considered appropriate for such an asset to be measured at market value in existing use and, where an appropriate market exists, the relevant valuation technique under the standard should apply. For the users of the financial statements the disclosure requirements in paragraph 93 (i) of the standard will apply "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." This information can benefit the users of public sector financial statements whose fair value disclosures may not reflect how it uses an asset to render public services and deliver service or departmental objectives. In future development of the application of the standard the FReM and the Manuals may need to consider aggregation of these disclosures to ensure that the financial statements are not overburdened with excessive detail.

Summary and recommendation

21. The Treasury is proposing to issue a joint consultative paper with the Relevant Authorities considering the implications of the application of the standard as described above across the public sector, especially as regards the consideration of constraints on the sale of an asset. Entities would be invited to comment on the impact this would have on their financial reporting, particularly for commercial and residential property assets. Should further research conclude that the sale of geographically constrained service-delivery assets does not support adjustments to the valuation process under the standard, an adaptation will be drafted for FRAB consideration. Alternatively, a FReM interpretation may be required in order to ensure consistent application by both preparer and auditor.

22. The Board is requested to provide its advice on the application of IFRS 13 *Fair Value Measurement* to the public sector and the intended approach to a summer consultation process. It is also requested to approve the further development of the consultation paper through further meetings of the small Working Group and electronic communication with the Board.

HM Treasury & CIPFA
24 May 2013

APPENDIX A

Asset class	Current treatment*	Probable treatment under IFRS 13*
Property, plant and equipment		
Infrastructure Assets	Depreciated replacement cost	Depreciated replacement cost
Buildings	Non-specialised in use properties: market value for existing use.	Remote location of certain properties may provide basis for depreciated replacement cost, but this is unlikely to apply to the whole class. For hospitals and schools, there is a case for market value in existing use (or an adaptation may be appropriate). For other properties, most likely market value
Dwellings	Non-specialised in use properties: market value for existing use.	Remote location of certain properties may provide basis for depreciated replacement cost, but this is unlikely to apply to the whole class. For social housing, there is a case for market value in existing use (or an adaptation may be appropriate). For other properties, most likely market value.
Land	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.
Single use military equipment	Depreciated replacement cost	Depreciated replacement cost
Plant and machinery	Market value. The FReM provides the use of historical cost as a proxy for non-material transactions.	Market value (adjusted where appropriate for condition of asset). The FReM provision for non-material transaction would continue to apply.
Transport equipment	In general, depreciated replacement cost. A small volume valued at market value in existing use (standard vehicles). The FReM provides the use of historical cost as a proxy for non-material transactions.	In general, depreciated replacement cost. A small amount valued at market value. The FReM provision for non-material transaction would continue to apply.

* In general, specialised assets are measured using depreciated replacement cost.