HM TREASURY

FRAB (119) 02
13 December 2013

Financial Reporting Advisory Board Paper

IFRS 13 Fair Value Measurement

Issue:	Proposals for the application of IFRS 13 Fair Value Measurement have been considered by the Board on a number of occasions. At FRAB 118 the Board advised HM Treasury and CIPFA to look again at the current approaches to valuation in the FReM and the Code. This paper provides the Board with an overview of the current approach to the valuation of property, plant and equipment in the FReM and the Code, what the objective of the valuation basis for is, and a suggested approach that will be taken forward to consultation that will allow the introduction of IFRS 13.
Impact on guidance:	Yes. FReM, Code and other Manuals would require amendment. Additional guidance on valuation would also need to be produced.
IAS/IFRS adaptation?	The proposed approach would require adaptations of IAS 16 (and it would be expected IAS 38) for the public sector context.
Impact on WGA?	Yes
IPSAS compliant?	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?	The proposed approach would require interpretations of IAS 16 (and it would be expected IAS 38) for the public sector context.
Impact on budgetary regime?	Changes in asset values would impact on depreciation charges.
Alignment with National Accounts	Current market prices are generally used for stocks of assets, but allowance is made for the use of alternative valuation methods where an active market does not exist.
Impact on Estimates?	Changes in asset values would impact on depreciation charges.
Recommendation:	HM Treasury and CIPFA ask the Board to note the current approach taken to accounting for property, plant and equipment in the FReM and the Code in order to reflect the desired measurement objectives and

	valuation basis of these assets. The Board is also asked to comment on the proposals for measurment objectives and valaution basis following the introduction of IFRS 13, and the proposed timings of that introduction.
Timing:	There is a potential for the introduction of IFRS 13 in the FReM for 2014-15. However, it does not appear possible for a further consultation process on the proposed way forward to be completed in time for the changes to be adopted in 2014/15 Code.

DETAIL

Background

1. Proposals for the application of IFRS 13 Fair Value Measurement have been considered by the Board on a number of occasions since it was promulgated by the IASB and adopted by the European Union. To date HM Treasury and CIPFA have not convinced the Board of the merits of the approaches that have been proposed. There has also been some divergence between HM Treasury and CIPFA as to the correct approach to take. This has regrettably resulted in the standard not yet being adopted in the Financial Reporting Manual or the Code.

2. The difficulties faced by the relevant authorities in determining the appropriate application of the standard and the debates held at the Board reflect to an extent the problems inherent in applying a standard that is aimed at the needs of the investor community in the private sector with no direct link to the wider objectives of public sector financial reporting. HM Treasury and CIPFA have both looked to ensure that the essential accountability and decision-making functions of public sector accounts have been met by their proposals for IFRS 13 adoption. Where they have differed recently is that HM Treasury has felt it possible to achieve what it has felt to be the correct valuation basis for public sector property, plant, and equipment by applying IFRS 13 in full and focussing on the restrictions within the standard. CIPFA on the other hand has felt it necessary to continue to include an adaptation to the standard that would restrict the application of fair value as defined by IFRS 13 when there is evidence that an entity is constrained by service needs to provide the asset in a particular location or the asset's market is restricted by geographical limitations. Although there were dissenting views (significantly from audit bodies and professional firms) the consultation responses demonstrated substantial support for the proposals for the adaptation, particularly from accounts preparers.

3. At FRAB 118 the Board advised HM Treasury and CIPFA to look again at the current approaches to valuation in the FReM and the Code. IFRS 13 fair value measurement applies when another standard requires that an asset or liability be measured at fair value. The Board suggested that if fair value wasn't actually the conceptual valuation basis that HM Treasury and CIPFA were seeking to apply when valuing property, plant and equipment in particular, then the way forward could be found by building on current adaptations in the Manuals, in particular IAS 16 This paper therefore provides the Board with an overview of the current approach to the valuation of property, plant and equipment in the FReM and the Code, what the objective of the

valuation basis for public sector property, plant and equipment is, and a suggested approach that will be taken forward to consultation.

Current approach to property, plant and equipment in the FReM and the Code

4. Both the FReM and the Code currently adapt and interpret IAS 16 in order to restrict options for reporting entities and to specifiy the valuation basis for certain types of asset.

5. The FReM withdraws entirely the option to measure at historical cost (except for small value or short life assets where historical cost is deemed an acceptable proxy for fair value) while the Code currently permits or requires infrastructure, community assets and assets under construction to be held at historical costs. Apart from these assets, however, both the FReM and Code require all other classes of asset to be held at fair value.

6. In both the FReM and the Code, however, additional interpretations and adaptations restrict how fair value is applied to asset classes for property, plant and equipment. Although the wording is slightly different betwen the FReM and the Code both require fair value for non-specialised land and buildings to be interpeted as the amount that would be paid for the asset in its exisiting use. For non-cash generating assets the value in use being the present value of the assets's remaining service potential, which can be assumed to at least equal the cost of replacing that service potential.[1] Specialised assets are frequently measured at depreciated replacement cost following the requirements in the Manuals.

7. These adaptations, therefore, remove (i) the option to hold most assets at historical cost and (ii) effectively require the valuation of all other assets on the basis of either existing use value (non-specialised) or depreciated replacement cost (specialised).[2]

Why do the FReM and Code amend and interpret IAS 16 in this manner?

8. In the private sector it is relatively uncommon for property, plant and equipment to be held at fair value, with historical cost being the preferred approach by mosts entities for financial reporting. In the public sector, restrictions on the use of historical costs and a preference for current valuations are based on a number of factors.

9. Firstly, on a practical level upon conversion to accrual accounting the absence of data on the historical cost of assets meant that a current value approach was necessary as without it there could be no justification for the values of assets on the balance sheet. Secondly, ESA 95 requires tangible fixed assets to be measured at current values rather than historical cost, so a current valuation approach was necessary in order to ensure alignment between resource accounts and National Accounts. Thirdly, holding assets at current rather than historical values was deemed to provide the right asset management incentives for those charged with the stewardship of assets. Historical cost

[1] The Code requires that if there is no market-based evidence of fair value because of the specialist nature of the asset and the asset is rarely sold, authorities may need to estimate fair value using a DRC approach.
[2] There are examples of an income approach being used in a limited number of cases, such as the use by some local authorities of a discounted cash flow model for measuring housing assets.

measurements would not provide the right incentives to those charged with the stewardship of assets to maintain the service potential of those assets, and the capital charging regime that used to be widespread throughout the public sector was also dependent on current valuations to ensure that entities were incentivised to utilise assets in an efficient and effective manner by charging them on asset holidings. And finally, there were also intergenerational equity considerations, with a desire to ensure that resources being consumed by users of services were clear to key users of the financial statements such as taxpayers.

Measurement objectives and the valuation basis for property, plant and equipment in the public sector

10. The need to ensure alignment with National Accounts, to provide the correct incentives to those charged with the stewardship of assets, and to ensure intergenerational equity considerations are addressed remain key factors that require the use of a "current" valuation approach.

11. The primary function of government and other public sector entities is to provide goods and services that protect rights and enhance or maintain the well-being and capabilities of citizens and other eligible residents. Governments and other public sector entities are accountable to those that provide them with resources and to those that depend on them to use those resources to deliver goods and services both during the reporting period and over the longer term. This provides a wider user group for the information within financial statements than is seen within the IASB conceptual framework, where the focus is very much on the investor community.

12. To that end the measurement of tangible fixed assets in the UK public sector has sought to value the service potential or operational capacity of assets used to deliver goods and services. It is service potential, rather than the opportunity cost of holding assets in terms of the cash flows that could be generated through sale that has been deemed to be the primary driver of financial reporting. Whilst "exit price" is undoubtedly useful background information to users of financial statements, it is not the basis on which financial reporting has been based and is not how those charged with the stewardship of public assets have been incentivised to manage them.

13. HM Treasury's approach to the adoption of IFRS 13 that was discussed at FRAB 118 was on the basis that the income or cost models available to entities under the standard could effectively allow for a valuation based on service potential to be captured. In many ways, however, this was a theoretical construct that was being used to derive a service potential valuation basis for the majority of assets either because a market does not exist or it cannot be readily accessed by the reporting entity. It did not have service potential as the fundamental measurement objective that a valuation methodology could be applied to. The approach also it must be noted led to further complications and issues for consideration, such as the appropriateness of charging services with the costs of using the asset in its highest and best use and not in accordance with how those charged with stewardship are actually required to use the asset, and the difficulty of applying highest and best use to a portfolio of assets that may by necessity be geographically constrained.

14. Having worked further on this issue and mindful of the discussion recently held at CIPFA/LASACC where an approach to the adoption of IFRS 13 based on a service potential measurement objective was discussed, HM Treasury and CIPFA now propose that the measurement objective determining the valuation of assets used to provide services directly to the public be explicitly recognised as being to determine the valuation of the service potential of those assets.

Proposals for measurement objectives and valuation basis

15. HM Treasury and CIPFA propose that the existing requirement under IAS 16 to restrict the use of historical cost measurement be maintained. This provides alignment with National Accounts and also ensures that those responsible for the stewardship of those assets are provided with the correct asset management incentives.

16. HM Treasury and CIPFA also propose to now explicitly note that the measurement objective for public sector assets that are used to provide services directly to the public is to value their service potential and not their fair value. For in-use public sector assets that are used to provide services directly to the public, this measurement objective requires a valuation basis of market value for existing use, defined by RICS as ‘market value on the assumption that property is sold as part of the continuing enterprise in occupation’. Where the asset is non-cash generating its value in use will be the present value of the asset’s remaining service potential, which can be assumed to be at least equal to the cost of replacing that service potential. For specialised assets, the measurement objective is likely to require a valuation methodology of depreciated replacement cost, although this would be subject to discussions between the valuer and the entity when determining the most appropriate methodology for obtaining a market value in existing use.

17. For public sector assets that are not used to provide services directly to the public, and which are not subject to any service or other constraints that would restrict the ability of the reporting entity to sell the asset, the measurement objective is proposed to be to measure the fair value of the asset in accordance with IFRS 13, i.e. the price that would be received to sell the asset in an orderly transaction at the measurement date taking into account its “highest and best use” even if that is not its current use.

18. The nature of service or other constraints faced by public sector entities has been highlighted previously at the FRAB when examining the adoption of IFRS 13 These go beyond what is ‘legally permissible’ as noted under the standard and instead require entities to provide services with assets in a particular way (including for example geographical or other service limitations), or place restrictions on sale (for example limiting the potential purchasers) with the intention of ensuring that the assets continue to be used for a specific purpose related to the delivery of services rather than the potential highest and best use. Examples here include operational schools or housing. These constraints are more extensive than office accommodation requiring planning permission for development as residential properties – they often require lengthy public consultations, fulfillment of regulatory obligations and possible Secretary of State approval. Where such constraints do

exist then HM Treasury and CIPFA are of the view that this precludes measurement under IFRS 13 and instead these assets are to be accounted for so as to reflect a measurement objective that values their service potential and not fair value. This would require a valuation basis of value in existing use.

19. It is expected, therefore, that the only property, plant and equipment that public sector reporting entities would hold at IFRS 13 fair value measurement would be those where the entity was able to act without any service or other constraint as if it were a commercial entity. This would be expected to include office accommodation used purely to provide back-office support functions. It would also be expected to include cash-generating assets where the reporting entity is acting on a commercial basis and is not restricted in the manner in which it delivers services related to these assets.

Disclosure of highest and best use values

20. When holding initial discussions on this approach, CIPFA/LASAAC noted that while tentatively in agreement with the proposition that the measurement objective of accounting for service potential should be the primary driver for financial reporting, information on the opportunity cost of holding assets in terms of the cash flows that could be generated through sale would still be very useful information for users where these would be materially different from value in use measurements.

21. HM Treasury and CIPFA in principle support this view, believing it would provide users with additional information that could be used to hold those charged with the stewardship of assets and the delivery of services to account. It gives the users of the accounts an understanding of the potential financial benefits that could be realised if alternative policies for the delivery of services (including stopping the delivery of those services) were adopted and an asset no longer constrained in its use.

22. HM Treasury and CIPFA are, however, mindful of the additional costs and burdens that may arise from requiring entities to request two valuations using different valuation methodologies on an asset, and will discuss the practicality of this approach with valuers while asset valuation guidance is being developed before making any final proposals that it should or should not be a requriement.

What will this mean for valuation methodologies?

23. It is expected that under these proposals, the majority of asset classes will maintain their existing valuation methodologies as these are based on the objective of measuring service potential. The main change is expected to be in relation to land and buildings which are not used to directly provide services to the public and where there are no additional constraints which would restrict the ability of the reporting entity to sell the asset as if it were a commercial entity. In these situations the entity would apply the appropriate valuation methodology in accordance with IFRS 13 Fair Value Measurement.

Timing of introduction of IFRS 13 in the FReM, Code and other manuals

24. HM Treasury is providing the 2014-15 FReM for approval at this meeting, and the proposals in this paper have not been incorporated into the document. While it would

require a change to previous practice, the 2014-15 FReM could in theory be amended following a short consultation between meetings with a final version presented to the Board out of meeting before 1 April 2014. This would allow for the introduction of IFRS 13 for the 2014-15 financial year. This would have implications for other Manuals, which are reliant upon the FReM being presented in final format by December 2013. A further consultation process on the proposed way forward would not be able to be completed in time for the changes to be adopted in 2014/15 Code.[3] As previously noted to the Board it would also cause difficulties within the NHS where budgets and the charging regime for 2014-15 have been set on exisiting asset valaution methodologies.

25. Given the implications for Whole of Government Accounts of having inconsistent accounting policies, regrettably it would appear necessary to delay the introduction of IFRS 13 into the Manuals until the 2015-16 financial year.

Recommendation

26. HM Treasury and CIPFA ask the Board to note the current approach taken to accounting for property, plant and equipment in the FReM and the Code in order to reflect the desired measurement objectives and valuation basis of these assets. The Board is also asked to comment on the proposals for measurment objectives and valaution basis following the introduction of IFRS 13, and the proposed timings of that introduction.

HM Treasury and CIPFA

13 December 2013

[3] It is likely that there will be resource implications for local authorities for those property, plant and equipment assets required to be measured at fair value, where current use is not also highest and best use. This will impact on most authorities but will be particularly burdensome for authorities that do not have in-house valuation teams. As noted in FRAB (119) 09 the audit community were not supportive of the use of a "directors' valuation" proposed in the CIPFA/LASAAC consultation paper which would have reduced the cost of the introduction of these new reporting requirements. CIPFA/LASAAC are concerned about the prospect of any delay. However, CIPFA/LASAAC; (i) is aware that the timescales for the production of the Code leave a short time available for redrafting, even without an additional consultation, and (ii) has concerns where the adoption of the new standard may lead to a significant cost burden (ie for the remeasurements) for local authorities that might outweigh the benefits of such a change.