



# DRAFT Financial Reporting Advisory Board Paper

## IFRS 13 Fair Value Measurement

<b>Issue:</b>	At FRAB 120 HM Treasury and CIPFA recommend a new principles-based approach for determining the use of IFRS 13 across the public sector. This paper provides the Board with an opportunity to comment on the Exposure Draft which will be consulted on this summer and provides an update on plans for implementation and review.
<b>Impact on guidance:</b>	Yes, the FReM, Code and other Manuals will require amendment.
<b>IAS/IFRS adaptation?</b>	Yes, adapts IAS 16 and IAS 38. No adaptations are proposed to IFRS 13.
<b>Impact on WGA?</b>	Yes
<b>IPSAS compliant?</b>	The draft IPSAS Conceptual Framework allows a range of measurement bases dependent on what is most appropriate for holding the entity to account and for decision making purposes. The proposal outlined in this paper is consistent with IPSAS.
<b>Interpretation for the public sector context?</b>	Yes, interprets IAS 16 and IAS 38 for the public sector context.
<b>Impact on budgetary regime?</b>	Changes in asset values will impact on depreciation charges.
<b>Alignment with National Accounts</b>	Proposals retain alignment with national accounts. Current market prices are used for assets in the national accounts, but alternative valuation methods are allowed where an active market does not exist.
<b>Impact on Estimates?</b>	Changes in asset values will impact on depreciation charges.
<b>Recommendation:</b>	HM Treasury and CIPFA ask the Board to provide comments on the Exposure Draft and to agree plans for a due process consultation and follow-up review.
<b>Timing:</b>	Adoption is planned for 2015-16 to allow time for due process consultation with users and preparers this summer.

## DETAIL

### Background

1. The Treasury published Exposure Draft 13(01) on IFRS 13 in July 2013 which proposed that IFRS 13 should be adapted such that it did not apply to assets which were subject to restrictions on geographic location. After considering the responses to the exposure draft, the Treasury put forward a recommendation that IFRS 13 should be adopted in full with no adaptation, but with enhanced guidance in the FReM to explain the restrictions that are likely to apply in the public sector.
2. Following the consultation and further discussions at the FRAB, the Treasury and CIPFA concluded that exit values are not appropriate for most public sector assets, because assets are specifically held for their service potential.
3. Since December 2013, the Treasury and CIPFA have been exploring options to adapt IAS 16 and IAS 38 such that fair value is only used when it is appropriate.<sup>1</sup> This has involved going back to first principles to look at the following measurement objectives for public sector assets and broader objectives of financial reporting:
  - i. To provide incentives to support **good asset management**;
  - ii. To support **intergenerational fairness** by providing transparency over resources consumed; and
  - iii. To **align with the requirements in National Accounts** to measure assets at current values.
  - iv. To provide financial information that is **useful to those who provide resources**; and
  - v. To provide information that is useful to a wide range of users to permit them to assess the **stewardship and accountability** of management for the resources entrusted to them.
4. The Treasury and CIPFA presented a final proposal at the April 2014 meeting which focuses on whether an entity is holding an asset primarily for its service potential as an operational asset, or for financial returns either as an investment property or through being held for sale<sup>2</sup>.

### Exposure Draft

5. The changes to the FReM arising from the implementation of IFRS 13 will be consulted on this summer. The proposed Exposure Draft is included in the Annex. The Exposure Draft has been reviewed by a working group of representatives from each relevant authority in line with the Memorandum of Understanding between relevant authorities. The proposal in the Exposure Draft is unchanged from that presented at the April 2014 meeting. In summary, it proposes:

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<sup>1</sup> IAS 38 will continue to apply without adaptation in the Code of Practice on Local Authority Accounting in the United Kingdom ("the Code"). The FReM currently adapts IAS 38 to require intangible assets to be valued at fair value. Therefore amendments are proposed to the FReM but not to the Code to align the treatment of revalued intangible assets with revalued property, plant and equipment.

<sup>2</sup> The comments on CIPFA/LASAAC's proposals are based on its initial views at CIPFA/LASAAC's 4 June 2014 meeting; final approval of the text of the Exposure Draft of the Code has yet to take place.

- The valuation basis used depends first on whether an asset is held for its service potential or not and secondly on whether an asset held for its service potential (or held most recently for its service potential) is in use or surplus.
  - Assets which are held for their service potential and are in use will be valued in accordance with the existing adaptations of IAS 16 to determine a current value of their service potential based on their existing use. For non-specialised assets such as office blocks the valuation methodology for determining their market value in existing use will be Existing Use Value. For specialised assets, the methodology used will be depreciated replacement cost on a modern equivalent asset basis.
  - The valuation of assets which are held for their service potential and are surplus will depend on whether there are restrictions on the asset's use or disposal. Restrictions here are taken to include public sector specific requirements such as the legal duty to consult on the disposal of an asset. If there are restrictions which would prevent the entity from freely disposing of the asset at the statement of financial position date by accessing the market, then the asset will be valued at current value in existing use in line with the existing adaptations to IAS 16. If there are no restrictions and the entity could access the market then the asset will be held at fair value under IFRS 13.
  - The Treasury's rationale for valuing surplus assets which are subject to restrictions at current value in existing use based on their previous use under IAS 16 and not fair value under IFRS 13 is that this is likely to result in a higher valuation for specialised assets. The benefit of the higher valuation is that it retains the financial management incentive to dispose of surplus assets.
  - All assets which are not held for their service potential are deemed to be being held for financial objectives and will be valued in accordance with IFRS 5 or IAS 40 depending on whether the asset is or is not being held for sale. References to fair value within IFRS 5 and IAS 40 will not be adapted and IFRS 13 will be applied in full. The existing FReM interpretation which withdraws the option of the cost model within IAS 40 will continue.
6. The proposal for dealing with surplus assets subject to restrictions in the FReM is slightly different to CIPFA/LASAAC's current proposal for the Code which is to apply IFRS 13 without adaptation to all surplus assets. CIPFA/LASAAC anticipates that application guidance might be needed on the necessity of considering restrictions when measuring an asset. The two approaches are not expected to result in material differences, if any at all.
7. The following practical difficulties are drawn out and answered within the Exposure Draft:
- There may be ambiguity when an asset is temporarily not in use as to whether it is surplus. In these cases, the Treasury's view is that if there is a clear plan to bring the asset back into future use as an operational asset then the current value in existing use should be maintained. Otherwise, the asset should be assessed as being surplus and valued under IFRS 13.<sup>3</sup>
  - There will be multi-use buildings which are partly used for their service potential and partly held for financial return. Where this is the case, the existing guidance on multi-purpose properties in IAS 40 is relevant. If part of a building is not being used for operational reasons, there are no restrictions, and that part of the building can be separately sold or leased, then if material that part should be recognised as an

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<sup>3</sup> Local authorities are already required to take appropriate decisions in classifying surplus assets and CIPFA/LASAAC does not propose any changes to the Code in this respect.

investment property under IAS 40 and held at fair value under IFRS 13. This will not require any amendments to existing standards.

8. Finally, HM Treasury has consulted with working group members on proposals for disclosure requirements within the Exposure Draft. HM Treasury proposes that the FReM should not include an additional disclosure requirement for fair value to be disclosed for assets held at current value in existing use. This is because we are not clear that it will improve decision making and because the disclosure would be out of line with IAS 16 which does not require fair value to be disclosed when assets are held at depreciated cost. No objections were raised by working group members. The Northern Ireland representative highlighted that additional disclosures are not necessary so long as the basis of valuation continues to be disclosed and would not be in line with the spirit of simplifying accounts.
9. CIPFA/LASAAC is currently proposing the inclusion of the disclosure objective of IFRS 13 (i.e. for users to understand the valuation techniques and inputs used to develop the valuations and the impact of the changes of these techniques on the Comprehensive Income and Expenditure Statement) within its disclosures for property, plant and equipment. CIPFA/LASAAC considered but decided against including requirements for disclosing fair value measurements, where this information was available and materially different from current values (in existing use).

### Impact of FReM changes

10. The typical valuation basis that will arise is set out below:

	Valuation basis	
	Existing FReM	2015-16 FReM
<b>Assets held for their service potential</b>		
→ In use	Market value in existing use	Market value in existing use
→ Surplus		
→ Restrictions on sale	Market value in existing use	Market value in existing use <sup>4</sup>
→ No restrictions on sale	Market value in existing use	Highest and best use
<b>Assets not held for their service potential</b>		
→ Investment property	Highest and best use	Highest and best use
→ Held for sale	Market value in existing use or highest and best use	Market value in existing use or highest and best use

11. There will be no change in the methodologies used to produce valuations under each basis as the methodology is determined by the RICS red book and not the FReM. The valuation methodology for determining market value in existing use will either be existing use value (for

<sup>4</sup> The current proposals for changes to the Code anticipate that all surplus assets will be measured based on their highest and best use. The restrictions will be factored in to valuations produced by the valuer.

non-specialised assets) or depreciated replacement cost (for specialised assets). 'Existing use value' is defined by the RICS red book as:

*The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had acted knowledgeably, prudently and without compulsion, assuming that the buyer is granted vacant possession of all parts of the asset required by the business, and disregarding potential alternative uses and any other characteristics of the asset that would cause its market value to differ from that needed to replace the remaining service potential at least cost.*

12. By comparison, 'highest and best use' will consider all factors which impact on an asset's market value.
13. The changes set out in the Exposure Draft will affect surplus assets which are not subject to restrictions on sale. This will have a knock-on effect if these assets are subsequently assessed as meeting the held for sale criteria under IFRS 5. It will also be important that reporting entities accurately identify surplus assets in order to apply the correct accounting treatment.
14. The likely impact on each sector is summarised below:

#### *NHS*

15. The NHS has a higher proportion of specialised assets for which the valuation methodology used to arrive at a market value in existing use is depreciated replacement cost. Applying the depreciated replacement cost methodology can give a higher valuation than one produced under IFRS 13.
16. An existing issue in the NHS is that specialised assets can have a relatively high carrying value based on depreciated replacement cost and this can result in a large impairment when the asset is classified as held for sale. Under the FReM changes, the impairment could apply earlier as soon as the asset is surplus and the restrictions lifted. The criteria for being classified as held for sale may not be met at this stage. For example, a Foundation Trust may be planning a staggered withdrawal from a site and will only initiate a disposal once the whole site is free.
17. Therefore impairment charges on surplus assets that will be disposed of eventually may be brought forward and depreciation charges between the time that an asset is made surplus and classified as held for sale will be lower (subject to restrictions being lifted).

#### *Remainder of central government*

18. Most surplus assets within the rest of central government comprise of land and office accommodation which are not subject to significant restrictions. The valuation of these surplus assets will increase to reflect the highest and best use. If they subsequently meet the criteria of assets held for sale then again the valuation will be higher than it is currently because IFRS 5 applies the lower of the carrying amount immediately prior to classification as held for sale and fair value less costs to sell. Under the FReM changes, the carrying amount immediately prior to classification will reflect its fair value, rather than its (lower) current value in existing use.

19. The higher valuations that the FReM changes will produce will incentivise disposal and support the rationalisation objective of the Government's Estate Strategy.<sup>5</sup>
20. In theory, academy school sites could become surplus if an academy closed but this will be rare given the expansion of the programme and it is more likely that the site would be re-used for another school. Academies follow the Charities SoRP and will be unaffected by FReM reporting changes. The value of academy assets consolidated into the Department for Education's accounts will not be materially affected.

#### *Local government*

21. The Code currently requires that surplus assets are identified and measured in the same way as operational property, plant and equipment based on their use before becoming surplus. CIPFA/LASAAC's proposal for the 2015/16 Code is that surplus assets are measured at fair value as by definition these assets are not currently providing service potential to the authority but are available for a number of alternative uses which could include realisation of fair value by disposal. An authority would need to ensure that the measurement of the assets reflect any restrictions on the asset in accordance with the requirements of IFRS 13. Therefore, in practice there are likely to be few, if any, differences between valuations that would be produced through applying the FReM and through applying the Code

#### **Review**

22. At the April 2014 FRAB meeting, HM Treasury and CIPFA committed to reviewing the approach to valuing non-current assets in the future, in particular to reflect IPSAS and EPSAS developments.
23. The IPSASB conceptual framework is expected to be completed by the end of 2014 and will be discussed at the following FRAB meeting (expected March 2015). HM Treasury and CIPFA will provide the FRAB with an assessment of the consistency between IPSAS and the FReM/Code in respect of prioritising an in-use value over an exit value. This will act as a check that the final proposal for implementing IFRS 13 and adapting IAS 16 and IAS 38 is appropriate for the public sector context.
24. EPSAS developments will similarly be monitored and reported to the FRAB. If EPSAS develops a conceptual framework separate to the IPSAS conceptual framework then this will necessarily be to a longer timetable and a review date cannot be planned at this point.
25. In addition to reviewing the conceptual basis behind asset valuations, the Board also suggested that the information needs of users in respect of asset valuations and disclosures are reviewed as part of the simplifying project. HM Treasury will coordinate its consultations this summer such that the form and content of the annual report and accounts (as covered by the consultation on the simplifying project) can be considered alongside the basis of preparation (as covered by the IFRS 13 Exposure Draft and an additional consultation on the 2015-16 FReM). The consultation documents will be circulated to members for review and comment before the consultations start.

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[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/209484/Government\\_s\\_Estate\\_Strategy\\_-\\_June\\_2013\\_v1.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209484/Government_s_Estate_Strategy_-_June_2013_v1.pdf)

## **Recommendation**

26. HM Treasury and CIPFA ask the Board to provide comments on the Exposure Draft included in the Annex and to agree plans set out above for a due process consultation and follow-up review.

**HM Treasury, CIPFA**

**19 June 2014**