HM TREASURY

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CIPFA The Chartered Institute of Public Finance & Accountancy

Financial Reporting Advisory Board Paper

IFRS 13 Fair Value Measurement

Issue:	At FRAB 119 the Board recommended that HM Treasury and CIPFA carry out further work on their proposals for distinguishing assets which should be subject to valuation using IFRS 13 and those that should not. This paper refines the approach proposed at that meeting to recommend a new principles-based approach for determining the use of IFRS 13 across the public sector.
Impact on guidance:	Yes, the FReM, Code and other Manuals would require amendment.
IAS/IFRS adaptation?	Yes. Adaptations are proposed to IAS 16 and IAS 38. No adaptations are proposed to IFRS 13.
Impact on WGA?	Yes
IPSAS compliant?	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 proposals outlined in this paper are consistent with IPSAS.
Interpretation for the public sector context?	The proposed approach would require interpretations of IAS 16 and, if the approach is agreed, by analogy to IAS 38, for the public sector context.
Impact on budgetary regime?	Changes in asset values would impact on depreciation charges.
Alignment with National Accounts	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.
Impact on Estimates?	Changes in asset values would impact on depreciation charges.
Recommendation:	HM Treasury and CIPFA ask the Board to comment on the proposed approach to accounting for property, plant and equipment in the FReM and the Code following the introduction of IFRS 13, and the proposed next steps to support introduction in 2015-16.
Timing:	Adoption is proposed 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 adaption, but with enhanced guidance in the FReM to explain the restrictions that are likely to apply in the public sector.

2. The key issue identified by some FRAB members at the October 2013 meeting was that if the public sector is applying IFRS 13, then it is also necessary to subscribe to the principle of exit values which IFRS 13 is based on. The Treasury and CIPFA agree that exit values are not appropriate for most public sector assets, because they are specifically held for their service potential.

3. IFRS 13 could be used to produce valuations for assets held for their service potential, but, if fair value is not appropriate, then FRAB members suggested that the way forward could be to adapt other standards, in particular IAS 16, so that fair value is only used when it is appropriate. The key question is therefore 'when should fair value valuations be applied', rather than how IFRS 13 could be applied in all situations.

4. At the last FRAB meeting in December 2013 the Board were provided with a joint CIPFA/HMT paper which provided:

   - An overview of the current approach to the valuation of property, plant and equipment (PPE) in the FReM and the Code;
   - A summary of the objectives of the valuation basis for PPE; and
   - A suggested approach that could be taken forward to consultation to allow the introduction of IFRS 13 in 2015-16.

5. The paper proposed that the measurement objective for public sector assets that are used to provide services directly to the public should be to value their service potential and not their fair value. Conversely, the paper proposed that the measurement objective for public sector assets that are not used to provide services directly to the public, and which are not subject to restrictions which prevent the reporting entity from selling them, should be fair value in accordance with IFRS 13.

6. This approach has a number of practical difficulties which were identified by some FRAB members at the December 2013 meeting. In particular, there were questions about determining the boundary of assets providing services directly to the public, the unit of account and dealing with mixed-use assets, and handling changes in use.

7. This paper refines the approach put forward at the FRAB meeting in December 2013 to address practical difficulties, whilst still ensuring that the objectives of the valuation basis for PPE are met. The following sections set out the valuation objectives in more detail before considering how they can be best met. Two options are set out, including HM Treasury and CIPFA's final proposal that IAS 16 is adapted such that IFRS 13 applies to assets which are not held for their service potential and to surplus assets which can be disposed of.

Valuation objectives

8. The public sector has three primary objectives in valuing assets. These are:

   i. To provide incentives to support good asset management (in the past this also included an asset charging regime and this is still in place for the NHS);

   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.

9. To these we can add the broader objectives of financial reporting which are:

   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.[1]

10. The FReM and the Code currently adapt IAS 16 to remove the option to hold most assets at historical cost and to effectively require the valuation of all other assets on the basis of either existing use value (for non-specialised assets) or depreciated replacement cost (for specialised assets). These adaptations were made in order to support the objectives above and, in implementing IFRS 13, the Treasury and CIPFA are seeking to ensure that performance against these objectives is not reduced, and is enhanced where possible.

11. All of the options being considered by the Treasury and CIPFA maintain the use of current values and therefore valuation objectives (ii) and (iii) will continue to be met. This paper assesses the two options being considered against the remaining objectives, which are expanded on below, and based on whether they can be implemented in a clear and transparent way.

Incentives to support good asset management

12. The measurement of PPE in the UK public sector since the introduction of accrual accounting has sought to value the service potential or operational capacity of assets used to deliver goods and services. Service potential is of primary interest when managing public sector assets because the purpose of acquiring and holding assets within the public sector is to enable the delivery of services. This is therefore the basis on which those charged with the stewardship of assets and the management of these scarce resources are held to account.

13. Although management of service potential has been the primary driver of financial reporting, that doesn't mean that other aspects of good asset management are not relevant. For example, there will be cases where value for money could be improved by using assets differently, by disposing of surplus assets or by using an asset with a lower specification. It would be useful to have financial information to support these considerations. Local decision makers may choose to carry out property reviews to target their resources at those assets which are most likely to be available for sale.

14. It's worth noting in this context that the public sector has other sources of information in addition to financial statements and other controls and incentives to support good asset

[1] 2014-15 Financial Reporting Manual, paragraph 2.2.1

management. Therefore the options for financial reporting need to considered as part of a package of measures to support good asset management.

15. For example, the Government Property Unit (GPU) was created in 2010 and works across the public sector to deliver savings and to reduce the number of properties in the public sector estate, focusing on the central civil estate (i.e. office buildings). The GPU oversee national property controls, which do not allow lease renewals, sales or acquisitions on new properties without the Minister for the Cabinet Officer's approval. They work with departments to rationalise the central government estate and they have begun pilots with the Local Government Association to develop programmes of disposals in local authority areas. The GPU makes use of private sector benchmarking information for office costs and explicitly identifies that many departments may be able to operate just as effectively from a cheaper peripheral location as from the city centre. Since 2010, annual running costs of the central civil estate have reduced by £454 million.[2]

16. The budgeting system within central government also incentivises good asset management. Departments are allowed to re-invest the book value of assets disposed of and can use profits on disposal either to benefit their resource budget (up to a limit set by the Treasury for departments or unlimited for NHS bodies) or for capital investment. At Spending Round 2013 the Government announced that it would dispose of £5 billion of land and property between 2015 and 2020 and departments have signed up to individual targets which will be factored into their future settlements.

17. Local authorities have similar financial incentives for good asset management as it provides opportunities for efficiency gains, capital receipts and income streams. Measures have been taken to remove statutory restrictions on local authorities where they acted as disincentives for optimal decision making on capital programmes. For example, controls on the use of non-housing capital receipts have been abolished and the prudential system has been introduced.

Provision of information that is useful to those who provide resources

18. In the public sector, resources are provided by Parliament and, in the case of local authorities, also by local taxpayers. These resources are provided to allow organisations to deliver public services. Therefore, in order to be useful financial information needs to communicate the cost of delivering public services and information about the asset base used to deliver those services. Decisions on whether to provide resources for capital expenditure will be based on what is needed to support service delivery, taking into consideration opportunities for re-deploying or disposing of existing assets.

Provision of information for assessing the stewardship and accountability of management

19. Public sector organisations are accountable to Parliament, the general public, and other stakeholders. Organisations need to provide information to demonstrate that they are using public resources wisely. For assets, this will include information about whether the organisation is maintaining the required capacity to support service delivery, minimising losses and making the best use of assets.

[2] Source: Government's Estate Strategy, published June 2013

Restrictions versus constraints

20. Throughout this paper, references to 'restrictions' are taken to include statutory requirements for public consultations, fulfilment of regulatory obligations and Secretary of State approval. HM Treasury and CIPFA are clear that restrictions always need to be taken into consideration when valuing an asset. This happens at present and is also a requirement of IFRS 13.

21. The FRAB has previously discussed other constraints faced by public sector entities, which, although not based legislation, limit options for sale. These constraints include the need to provide a service within a specified area (e.g. schools), and political and public opposition to a sale.

22. The Treasury and CIPFA are concerned that if constraints are allowed to be considered in the choice of the valuation methodology, or the valuation produced, that this could add subjectivity to asset valuations. There is a risk that this subjectivity could be exploited and that it could result in significant difficulties for auditors.

Valuation options

23. In principle, the Treasury and CIPFA agree with the use of fair value when it is the appropriate measurement objective to support robust financial reporting. Treasury and CIFPA are conscious, however, that there are significant restrictions and constraints on accessing markets for many public sector entities and assets, and, in the case of restrictions, these need to be reflected in asset valuations.

24. At the October 2013 FRAB meeting, the Treasury suggested that IFRS 13 could be applied to all assets. This option was subsequently discounted on the basis that if IFRS 13 is being used to fair value assets then it is necessary to subscribe to exit values as the measurement objective which is a significant departure from previous public sector accounting practice. Further details on the rationale for not pursuing this option are provided in Appendix A.

25. At the December 2013 meeting, the Treasury and CIPFA proposed that assets that are used to deliver services directly to the public could be valued based on their service potential and other assets would measured at fair value in accordance with IFRS 13. However, as a number of Board members identified, there are significant practical difficulties with determining an appropriate boundary. The Treasury and CIPFA have concluded that such a boundary cannot be defined without introducing an unacceptable level of subjective judgement about whether an asset, or a component of an asset, is delivering services directly to the public.

26. Since the December 2013 meeting, the Treasury and CIPFA have considered what would be an appropriate, principles-based, boundary for categories of PPE that should be measured at current value, defined through adaptations to IAS 16, and those categories that should be measured at fair value in accordance with IFRS 13 without adaptation. This is set out as a final recommendation below and has been assessed based on the valuation and financial reporting objectives previously noted and practical considerations for implementation.

27. An alternative approach has also been considered which approaches the problem from the perspective of what valuation outcome is desirable for categories of asset (in particular "generic" office buildings) and setting requirements within IAS 16 to achieve this. This option is not recommended on the basis that it mimics exit values within IFRS 13, even though the option of applying IFRS 13 without adaptation has been dismissed on the basis that exit

values are not the measurement objective on which valuation methodologies should be based for assets held for their service potential within the public sector.

Option 1 – Adapt IAS 16, apply IFRS 5/IAS 40 to assets which are not held for their service potential and IFRS 13 for surplus assets on which there are no restrictions on sale (recommended)

28. HM Treasury and CIPFA's final proposal is to focus 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.

29. Assets are therefore first classified based on whether they are held for their service potential or not. Assets which are held for their service potential are then assessed as being in use or surplus.

30. 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.

31. Assets which are held for their service potential will be assessed as being either 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. For non-specialised assets such as office blocks this will be market value in existing use. For specialised assets, this will be depreciated replacement cost on a modern equivalent asset basis.

32. 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 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.

33. The rationale for valuing surplus assets which are subject to restrictions at current value 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. Given the restrictions in place on surplus assets an IFRS 13 valuation reflecting those restrictions could result in a very low value. The benefit of this higher valuation is that it retains the financial management incentive to dispose of surplus assets.

34. This approach provides a useful distinction between assets which will continue to be held for their service potential and those which are being held for financial gain or are surplus and can be disposed of. Exit values are appropriate for this second group of assets which allows Treasury and CIPFA to commit to the principles of IFRS 13, IFRS 5 and IAS 40 and apply the standards in full when valuing this group. In particular, entities have access to the market for these assets and can therefore use market information for decision making. This approach does not force market valuations where an entity cannot freely access the market or when decisions about the utilisation or disposal of the asset would be primarily based on information about its service potential.

35. There are some practical difficulties to this approach but these are significantly less pervasive than with the proposal that was put to the Board at the December 2013 meeting. For example, assets may move between valuation categories when they are temporarily surplus. Where an asset has a history of moving between operational and non-operational use, or has only recently been made non-operational and the future status is uncertain, then clearly a strong argument for maintaining current value would exist.

36. Another consideration is multi-use buildings. While it is not expected that there will be a large number of examples of multi-use buildings which are partly used for their service potential (either to deliver front or back office services) and partly held for financial return it is clear that they do exist, for example where part of a building is used to earn rental income. Where they do exist, the 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 it should be recognised as an investment property under IAS 40 and held at fair value under IFRS 13.

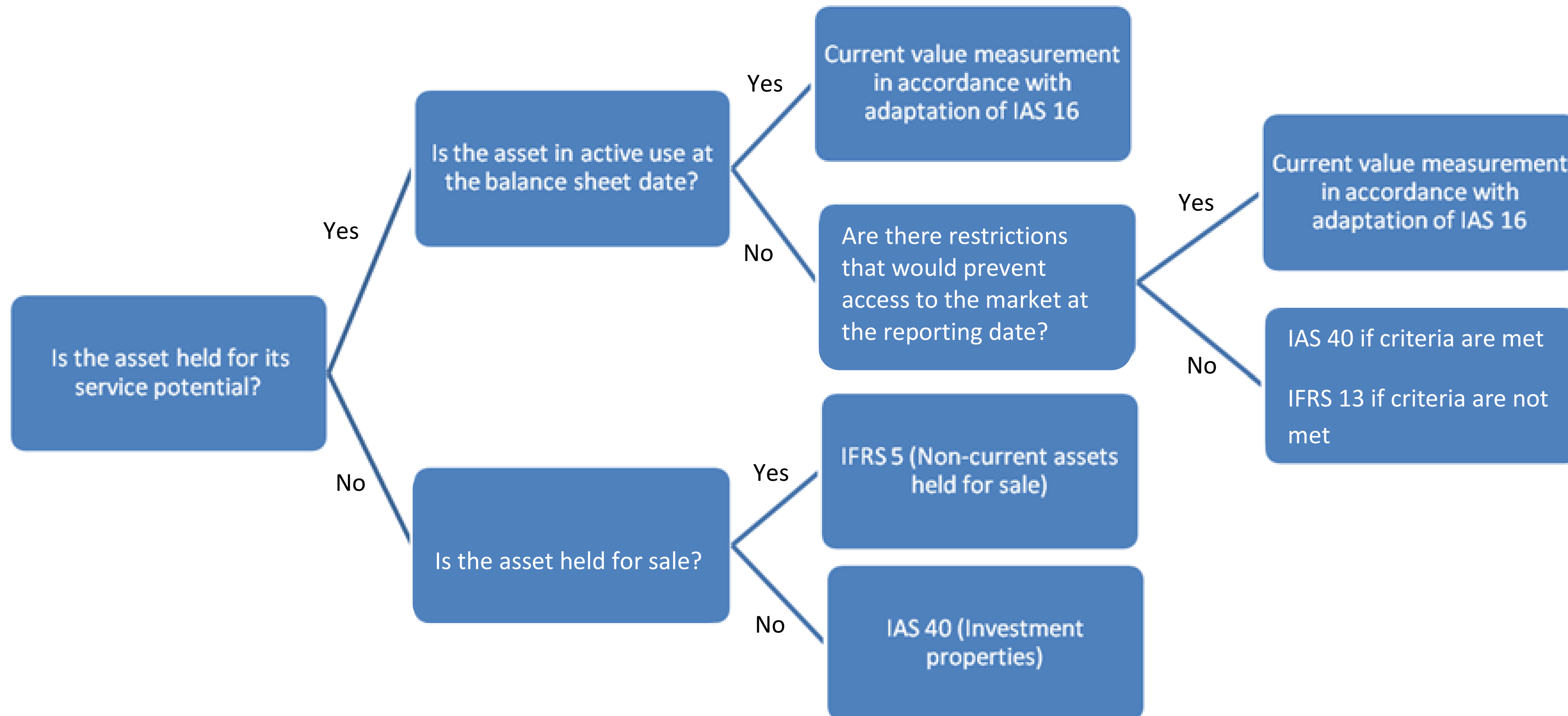
37. One perceived disadvantage of this approach that is recognised is that the values of non-specialised assets based on their current market value in existing use will sometimes be lower than an IFRS 13 "highest and best use" valuation. This may mean that incentives around the use or disposal of office buildings in prime locations may not be as strong as they would otherwise be. This is a necessary compromise in order to achieve a robust principles-based approach and to avoid subjective judgements about which valuation methodology should be applied. In practice, however, the current value in existing use may not be materially different to an IFRS 13 valuation and, even if significantly lower, would still signal to users of financial statements that the location is valuable. As noted open market valuations are also available to those who are making strategic decisions on the most efficient and effective use of the government's property portfolio.

38. On balance, this final proposed approach meets the accountability and decision making objectives of financial reporting by providing the right incentives for good asset management, particularly when supplemented by the other asset management controls and incentives which exist in the public sector.

39. A similar treatment would also be used for intangible assets. The existing interpretation in the FReM to IAS 38 removes the cost option and requires entities to adopt a revaluation model. The Code allows intangible assets for which there is no active market to be carried at cost less any accumulated amortisation and impairment loss, with those for which there is an active market being held at fair value. HM Treasury and CIPFA propose that IAS 38 is adapted to require intangible assets to be held at current value at the reporting date rather than fair value in their respective manuals. For the FReM this will either be market value or, where no active market exists, entities should revalue the asset to the lower of depreciated replacement cost and value in use where the asset is income generating. Where there is no market value in existing use, the asset should be valued using depreciated replacement cost. For the Code this will be market value where there is an active market or cost less accumulated amortisation and impairment where no market exists. If an intangible asset is held for sale then it will be accounted for under IFRS 5.

40. The decision tree for this option is set out on the following page.

Option 1 – Decision tree



Option 2 – Adapt IAS 16 to mirror valuations under IFRS 13, but without applying IFRS 13 directly (not recommended)

41. The perceived disadvantage of option 1 is that the values of non-specialised assets based on their current value in existing use will sometimes be lower than an IFRS 13 valuation. This second option is not recommended by the Treasury and CIPFA but has been developed to demonstrate how the disadvantage of option 1 could be overcome.

42. Under this option, IAS 16 would be adapted to set the valuation methodology for property, plant and equipment. This methodology asks three questions:

    - Are there any constraints or restrictions on the disposal of the asset?
    - Do these constraints or restrictions concern unique characteristics or legal restrictions?
    - Is there clear evidence that constrained by service needs to provide asset in a particular location or asset's market restricted by geographical limitations?

43. This methodology effectively mirrors IFRS 13 but with the additional consideration of constraints. All assets would therefore be valued based using the principles of IFRS 13 as imported into IAS 16 and taking into consideration any constraints on the asset. The outcome would be expected to be broadly similar to option 1, but with non-specialised assets such as offices valued based on their highest and best use if they are not subject to restrictions. This is illustrated on the following page.

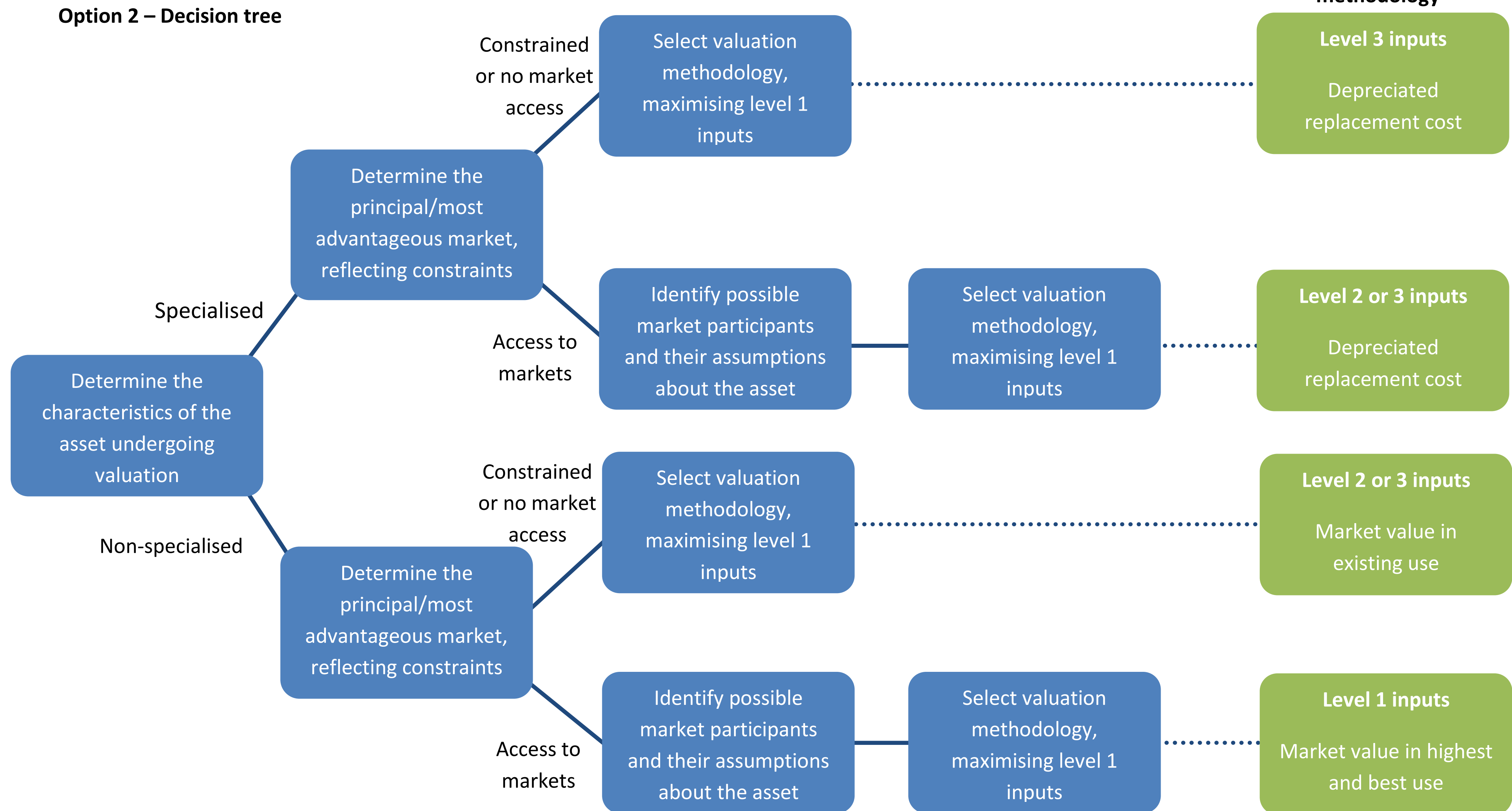
44. Although this valuation methodology may produce what may initially appear to be a preferable outcome for the valuation of non-specialised assets to support good asset management, the Treasury and CIPFA are unable to recommend it. The use of IFRS 13 without adaptation was discounted as an option on the basis that the public sector does not, on the whole, subscribe to exit values as assets are maintained in order to deliver services. Mirroring IFRS 13 within IAS 16 in this way and adding a consideration of constraints would result in the public sector applying a rules-based system without agreeing the exit value principle which those rules are based on.

45. The Treasury and CIPFA have sought to deliver a principles-based solution in option 1 that is based on the objective of holding an asset for its service potential, a long-standing principle of financial reporting in the public sector. There is no alternative principle behind option 2 if the principle of exit values continues to be discounted.

46. We are uncomfortable with setting valuation rules within IAS 16 which, without the exit value principle underpinning them, appear to be arbitrarily set to deliver a particular valuation outcome. In particular, this may lead to inconsistencies over time if the valuation rules have to be revisited or expanded. Therefore it will be necessary to retain this principle in order to guarantee that the methodology will continue to be internally consistent and rational.

47. Overall, this option is not fundamentally different to the option considered at the October 2013 FRAB meeting. Since then, the Treasury and CIPFA have gone back to first-principles, considering why fair values were first introduced in the public sector, and what the valuation and financial reporting objectives are. We consider that the valuations that this methodology would produce would support the achievement of valuation and financial objectives. However, the principle of exit values is in conflict with the primary reason that we introduced fair values into the public sector, which was to reflect service potential.

Option 2 – Decision tree



Comparison with the private sector

48. The typical valuation methodology that will arise from each of the two options that we have considered is set out below:

	Current valuation	Option 1	Option 2
Specialised assets	Remaining service potential, typically DRC	Remaining service potential, typically DRC	Mirrors IFRS 13 valuation, will typically give DRC
Non-specialised assets	Fair value in existing use	Dependent on whether assets are operational, see below	Mirrors IFRS 13 valuation, will reflect any restrictions and constraints
➔ Operational assets			
➔ Restrictions on the asset		Market value in existing use	Market value in existing use
➔ No restrictions on the asset		Market value in existing use	Highest and best use
➔ Non-operational assets			
➔ Restrictions on the asset		Market value in existing use	Market value in previous use
➔ No restrictions on the asset		Highest and best use	Highest and best use

49. The degree to which market information will continue to be used in valuing public sector assets compares well to the private sector where assets can be carried at cost less accumulated depreciation and impairment. The majority of UK firms elect to use historical cost accounting with impairment testing for property, plant and equipment after IFRS adoption.[3] Therefore, in recommending option 1, we expect that the public sector reporting will continue to demonstrate good practice and transparency in its valuation of assets.

Comparison with IPSASB

50. IPSASB issued their third exposure draft on the Conceptual Framework for general purpose financial reporting by public sector entities in November 2012. This exposure draft covers the measurement of assets and liabilities. For asset valuations, the exposure draft proposes that measurement bases may use either entry of exit values and concludes that the following measurement bases may be used:

    - Historical cost
    - Market value

[3] *Does Fair value Accounting for Non-Financial Assets Pass the Market Test?* (Christensen and Nikolaev, University of Chicago, November 2012) reported that in a sample of 934 UK companies subject to mandatory IFRS, only 5% of companies used fair value for at least one class within property, plant and equipment and no companies used fair value for any class of intangible assets.

- Replacement cost
- Net selling price
- Value in use

51. Following a review of consultation responses, IPSASB have agreed on the following measurement objective: *'To select those measurement bases that most fairly reflect the financial capacity, operational capacity and cost of services of the entity in a manner that is useful in holding the entity to account, and for decision-making purposes'*.

52. The Treasury and CIPFA are satisfied that the option proposed meets IPSASB's criteria for selecting appropriate measurement bases.

Next steps

53. The Treasury and CIPFA intend to run a due process consultation over the summer to seek the views of users and preparers with the intention of incorporating IFRS 13 into the 2015-16 versions of the FReM and the Code. An illustrative Exposure Draft is included in Appendix B. The purpose of this illustrative Exposure Draft is to set out how the proposed changes could be incorporated into the FReM. The Exposure Draft will be reviewed by the FRAB Working Group before it is issued.

54. The Treasury and CIPFA will also work with the other relevant authorities to assess the likely impact of the proposed changes on valuations across central government, local government and health. An update will be provided at the next FRAB meeting.

Recommendation

55. The Treasury and CIPFA ask the Board to comment on the final recommended approach to accounting for property, plant and equipment in the FReM and the Code following the introduction of IFRS 13 on which exposure drafts will be developed, and the proposed next steps to support introduction in 2015-16.

HM Treasury and CIPFA

3 April 2014