IFRS13 – LATEST CHANGES IN THE WORLD OF LOCAL AUTHORITY ASSET VALUATION, PART ONE

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Chris and Susan from CIPFA provide some valuable detailed guidance for valuation practitioners for local authority accounting purposes.

Some significant changes are taking place to the way that local authority property assets are to be measured and valued from 1 April 2015, thanks to the adoption of International Financial Reporting Standard 13 (IFRS13 within the CIPFA Code of Practice on Local Authority Accounting (the Code). This two-part article sets out for local authority valuation practitioners, some of the key changes that they need to be aware of and which will impact upon this year's asset valuation programme.

There has been a fairly long lead-in to the changes. Discussions around how and the extent to which IFRS13 should be adopted and implemented have been rumbling on for a while. The full extent of the implementation proposals was contained in the exposure draft for the 2015/2016 CIPFA Code when it was published for consultation in the summer of 2014.

The first thing to say about the adoption of IFRS13 within the Code is that it is prospective. So this means that there is not going to be a requirement to make any retrospective changes or restatements.

While IFRS 13 introduces changes to accounting standards that create changes to valuation approach, it is not intended to establish any valuation standards or affect valuation practices outside of financial reporting. For local authority asset valuers, the publication of valuation standards remains the role of the RICS. Some redrafting of the RICS Red Book has accordingly been taking place in parallel with the drafting of the CIPFA Code in order to reflect the changes we are going to discuss in this article.

In essence IFRS13:

- Defines fair value
- Sets out in a single IFRS a framework for measuring fair value, and
- Requires disclosures about fair value.

One thing practitioners need to bear in mind is that IFRS13 is an international accounting standard and so is phrased in terms that make it capable of application globally and of course capable of application within a wide range of organisation types. So some of the language within the standard itself can be confusing and to some seem rather impenetrable.

IFRS13 became effective globally from 1 January 2013 and one of the reasons it has taken until this year for the standard to be adopted by the CIPFA Code is that there has been a need to

consider the implications of adoption on local authority accounts and balance sheets.

One of the principal issues to be considered was the definition of fair value under IFRS13, which is essentially the highest and best use. In other words "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."

If this basis had been fully adopted by the CIPFA Code then it would effectively result in all property assets being valued to highest and best use irrespective of the use to which the asset is put. In valuer language this would result in all property assets being valued in most cases at market value – including all operational property assets that have in the past been valued on an existing use basis.

CIPFA/LASAAC, the body that determines local authority accounting standards, resolved after much debate that for assets used by local authorities in the delivery of public services, it would not be appropriate for these to be measured and valued in that way, and that the 'existing use' approach still had relevance.

Therefore, while the CIPFA Code fully adopts IFRS13, it does so only for certain classes of property asset, namely Investment Property; Non-Current Assets Held for Sale; and Surplus Assets. The first 2 of these asset classes should already be valued at Market Value and so in theory the valuation approach should not be changing. However, we know from discussions we regularly have with local authority valuers that the proper intention of market value may not have been fully embraced by everyone, in which case the adoption of IFRS13 provides an opportunity to revisit current valuation approaches in this area to ensure compliance with the CIPFA Code and the RICS Red Book. We will explore this further later on in this article.

For all other classes of property assets, while there is a change in terminology within the CIPFA Code, the valuation approach will remain entirely unchanged. So the terminology for the valuation of the majority of Property, Plant & Equipment (PP&E) assets that local authority valuers will be familiar with, such as Existing Use Value, Existing Use Value – Social Housing, and Depreciated Replacement Cost (DRC) are all still there – albeit that they now fall under a new 'umbrella' term adopted in the new CIPFA Code of "current value" and DRC is now adopted as an accounting 'basis of value' and is not simply a valuation approach.

So what does all this mean for the valuation approach?

It means that the biggest single change in the valuation approach of local authority property assets will be in respect of Surplus Assets. Up until 31 March 2015 the valuation basis for these assets was fair value (existing use) and under the 2014/2015 CIPFA Code this required such assets to be assumed to be still in the same use as they were when last occupied, for the purpose of the asset valuation, irrespective of what, when or how long ago that was.

From 1 April 2015 the valuation of Surplus Assets is brought in line with Assets Held for Sale and will need to be valued to the IFRS13 definition of fair value, i.e. highest and best use.

This will impact upon your valuation programme for 2015/2016 as this is a change in accounting standard, meaning that all your Surplus Assets will need to be revalued this year to ensure that they comply with the standard at the balance sheet date of 31 March 2016.

What does the new IFRS13 definition of fair value mean?

It is important to understand the workings of fair value under IFRS13 as of course this is a new basis of valuation for Surplus Assets. But as hinted at previously, it is possible that your approach to the valuation of both Investment Property and Assets Held for Sale might need to be reviewed to see if you are complying with the IFRS13 requirements.

A key aspect of fair value under IFRS13 is the concept of 'highest and best use'. This concept means that it is the duty of the valuer to consider value for the asset that may not necessarily be reflected in the actual current configuration or use.

As to whether a higher value exists for alternative configuration or uses will be dictated by how the valuer believes 'the market' would view the asset. It is the same whether the asset is an Investment Property, an Asset Held for Sale or a Surplus Asset.

The local authority valuer should already be considering alternative configuration and use in adopting the RICS Red Book definition of market value for Investment Property and Assets Held for Sale, but we are aware that this is not being universally applied.

To illustrate the point, if an authority owns say a rank of retail units in a town centre, the most common valuation approach is likely to be one that involves a term and reversion valuation on each retail unit, where each unit is identified in the asset register as a distinct and separate asset. However, it might be the case that the value of the assets in combination with each other would attract a higher value in the market. If the valuer believes this to be the case then the assets should be valued in combination, provided this alternative use is realistic.

The term and reversion valuation approach is robust enough as far as it goes, but of course it is based on the existing uses, rents passing and reversionary values of the rents passing. In many cases this approach may well generate the highest and best use, and hence meet the requirements of the IFRS13 fair value definition. However, it cannot be assumed that this will automatically be the case in every instance.

Let's say that the retail units in our example have a large enough footprint where 'the market' might consider redevelopment of the site through say demolition of the existing retail units and the construction of a replacement

asset such as an indoor shopping centre. If this were the case then the valuer will be obliged to consider this alternative and determine which use would most closely meet the IFRS13 definition of highest and best use, after taking account of demolition, tenant compensation etc.

Naturally the valuer should not necessarily restrict his or her consideration to the same type of use. If the highest and best use for our retail units would be residential development or leisure development then these should be considered and the highest and best use selected for the asset valuation. But in considering the various alternative options IFRS13 requires that such uses must be:

- physically possible
- legally permissible, and
- financially feasible.

Physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset e.g. location or size

Legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when valuing the asset e.g. zoning regulations, title restrictions

Financially feasible takes into account whether a use of the asset that is physically and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

One other important aspect of IFRS13 is the position regarding 'the market' and it introduces the twin concepts of what are called the "Principal Market" and the "Most Advantageous Market".

The Principal Market is defined as "The market with the greatest volume and level of activity for the asset or liability."

The Most Advantageous Market is defined as "The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs."

In practice, in terms of property assets, our view, which we accept might not necessarily be shared by all, is that the Principal Market and the Most Advantageous Market may be one and the same thing, but this may not always be the case. However, IFRS13 does say that in absence of evidence to the contrary, the market the authority would normally enter into a transaction to sell the asset is presumed to be the principal market.

In considering alternative higher and best uses for the asset being valued, IFRS13 therefore means that the valuer must not be restricted by the existing configuration or use of the asset and needs to consider alternatives that might generate highest and best use.

This does of course raise the thorny issue of valuer competence under PS2 of the RICS Red Book. Where a valuer in undertaking an asset valuation identifies the potential of a higher and best use for the asset in a different configuration or use, then of course the valuer would need to satisfy his or herself that they have the necessary competence to make the decision of whether to continue to undertake the valuation or pass responsibility for the valuation to someone else – a colleague or an external valuer - that has more appropriate skills, knowledge and experience of that asset or use.

Not that much seems to have changed – so what is all the fuss about?

Well the answer to that will be clearer in the 2015 Summer Terrier, when we move on to the 2nd part of this 2-part article and get into the areas of accounting disclosures, valuation hierarchy and valuation inputs.

Branches News

RICHARD ALLEN, HEART OF ENGLAND BRANCH

To 'promote and support the corporate role of branch members, as both strategic asset and general public sector property managers, to achieve the highest standards of performance; through the provision of professional development and the sharing of best practice through networking, holding regular meetings and exchanging views'.

This was the mission statement adopted by the branch at its first meeting of the year, hosted by Kettering Borough Council and held in their council offices on 5 March. The mission statement forms part of an Action Plan to promote the benefits of ACES and to increase attendance at branch meetings and national conferences. The plan sets out the benefits of ACES membership, branch aims and roles for members. The action plan had been taken to ACES Council in January where it was endorsed. At Council's request, now that it has been formally adopted, it will be shared with all other branches.

There were 19 attendees at the meeting