

# report

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The purpose of this report is to seek the views of CIPFA/LASAAC members on the approach to the adoption of certain new and amended standards (issued in May by the IASB) in the Code of Practice on Local Authority Accounting in the United Kingdom (the Code).

## 1 Introduction

1.1 In May this year four new standards were issued with significant amendments to two related, current standards. The standards issued include:

- IFRS 10 *Consolidated Financial Statements*;
- IFRS 11 *Joint Arrangements*;
- IFRS 12 *Disclosure of Interests in Other Entities*;
- IAS 27 *Separate Financial Statements* (as amended in 2011);
- IAS 28 *Investments in Associates and Joint Ventures* (as amended in 2011); and
- IFRS 13 *Fair Value Measurement*

The amendments and the new standards have an effective date of 1 January 2013. Earlier adoption is permitted. However, if an entity adopts IFRSs 10-12 and IAS 27 and 28 (as amended) early it must adopt all of the five group accounting standards. The application date would otherwise require the standards to be adopted in the 2013/14 Code.

IFRS 10 replaces the consolidated financial statements provisions in IAS 27. IFRS 11 supersedes IAS 31 interests in Joint Ventures. IFRS 12 replaces the disclosure requirements of IAS 27, IAS 28 and IAS 31 except for the disclosure requirements in IAS 27 for the preparation of separate financial statements. IAS 28 (as amended in 2011) now additionally includes the requirements for the application of the equity method for an entity's interest in joint ventures.

1.2 This report will provide an overview of the new standards and examine application issues in relation to IFRS 10-12, IAS 27 and 28 (the Group Accounting Standards) and IFRS 13 in relation to their application for public sector circumstances.

## 2 Group Accounting Standards

2.1 As indicated above the Group Accounting Standards were issued as a suite of standards.

2.2 IFRS 10 defines the principle of control and establishes control as the basis for determining which entities are consolidated in the consolidated financial statements. It states that an investor is deemed to control an investee when it is exposed or has rights to variable returns through its power over an investee. An investor controls an investee if it has all of the following:

- Power over the investee, (ie existing rights that give an investor the current ability to direct the relevant activities of an investee that significantly affect the investee's returns).
- Exposure or rights to variable returns (from involvement with an investee where these returns will vary as a result of the investee's performance).
- The ability to use the power over the investee to affect the amount of the investor's returns.

2.3 IFRS 11 requires a party to a joint arrangement to determine the type of joint arrangement in which it is involved by assessing its rights and obligations arising from the arrangement rather than its legal form (as per the current standards). The IFRS defines joint control and classifies joint arrangements into two types; joint operations and joint ventures. The IFRS requires a joint operator to recognise and measure assets and liabilities (and related revenues and expenses) in relation to its interest in the arrangement. It requires that joint venturers recognise an investment using the equity method in accordance with IAS 28 (unless exempted by the standard).

2.4 IFRS 12 presents a single disclosure standard for reporting entities with interests in other entities. The new standard specifies a disclosure objective ie an entity is required to disclose information that will allow users of the financial statements to evaluate the nature and risks associated with its interests in other entities and the effects of those interests on the reporting entity's financial position, financial performance and cash flows. It requires that entities disclose information that enables the users of the financial statements to understand:

- the significant judgements and assumptions made in determining the nature and of its interest in another entity.
- the interest that non-controlling interests have in the group's activities
- the nature and risks associated with its interests in other entities.

2.5 It should be noted that the principle of control applied in IFRS 10 is relied upon in all the new or amended standards. The Basis for Conclusions (BC) in IFRSs 10 - 12 set out that the IASB decided to align the effective dates for the IFRSs and with IAS 27 and IAS 28. The BCs state:

“When making this decision, the Board noted that the five IFRSs all deal with the assessment of, and related accounting and disclosure requirements about, a reporting entity’s special relationships with other entities (ie when the reporting entity has control or joint control of, or significant influence over, another entity). As a result, the Board concluded that applying IFRS 10 without also applying the other four IFRSs could cause unwarranted confusion.”

#### *Application Issues*

- 2.6 It is clear that the assessment of control in IFRS 10 places heavy reliance on the power of the investor to influence an investee’s returns. The standard is also written from the perspective of investor and investee relationship, though the standard clarifies that control is regardless of the nature of the involvement with the entity. Furthermore, the concept of returns is largely described in terms that relate to profit-making entities. The examples of returns in the application notes of the standard include:
- dividends and other distributions of economic benefits;
  - remuneration for servicing an investee’s assets; and
  - returns that are not available to other interest holders; for example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale and/cost savings.
- 2.7 Such a reliance on the investor and investee relationship and the concept of returns as set out above is likely to cause significant application difficulties for local authorities whose interest in their subsidiaries is often not to benefit from a financial return but to benefit from the service potential generated by activities of the subsidiary or to allow others to benefit from the activities. Furthermore, the power a local authority may be able to exercise over another body may not derive from an ownership relationship but the rights may be established by some other legal or contractual form. It is recognised that some local authorities will receive financial returns from the entities they control. However, for many authorities the concept of the investor/investee relationship and reliance on returns (neither of these concepts are included in the definition Appendix in the Standard) will therefore require significant interpretation for local authority circumstances on adoption of this standard in the Code.
- 2.8 CIPFA/LASAAC might want to consider delaying the adoption of IFRS 10 until IPSAS has interpreted the standard to ensure that there is appropriate interpretation for the public sector. However, delaying adoption of IFRS 10 is likely to mean that adoption of all five of the group accounting standards should be delayed following the IASB comments set out above and when taking into account that the definition of control is central to these standards. It is useful to note that the part of the rationale for the changes to the standards was in response to a request from G20 leaders, the Financial Stability Board and others to review the accounting and disclosure requirements for off balance sheet vehicles. In the current economic climate it might be difficult to justify any prolonged delay to the adoption of these standards. IPSASB has confirmed the project brief for consolidations (Update of IPSAS 6, along with IPSAS 7 and IPSAS 8). It is anticipated that Exposure Drafts will be issued in 2012, with new IPSASs being issued in 2013.

- 2.9 Another option open to CIPFA/LASAAC might be to provide a detailed interpretation of what the investor/investee relationship and returns are likely to mean for local authorities and the public sector. This definition would be based on IFRS 10 but could also include the interpretation which describes the investor/investee relationship in similar terminology to the IPSASB Exposure Draft of the *Conceptual Framework for General Purpose Financial Reporting for Public Sector Entities* (Conceptual Framework ED) (the consultation period closed on the ED on 15 June 2011) which refers to a public sector body having the authority and capacity to direct the other entity. It should be noted that the reporting entity definition proposed in Phase 1 of the IPSASB's Conceptual Framework project does not use the term control.
- 2.10 A further item to consider in the use of the concept of investor and investee is that this relationship when considered by IPSAS 7 *Investments in Associates* sets out that it only relates to investments in the formal equity structure (or its equivalent) of an investee. It is by no means clear that the IPSAS conceptual framework would expect this to apply to all control relationships. However, if ownership were to apply to all local authority interests in other entities this would exclude some entities from local authority boundaries including charitable trusts. The consolidation of local authority charitable trusts is considered in more detail on a separate report on the CIPFA/LASAAC agenda.
- 2.11 The concept of returns could be given interpretation additional to the examples included in the standard so as to cover other economic benefits and service potential derived from the ability to direct that other entity to achieve its service delivery objectives. Such an interpretation would also need to be based on IPSAS 6 *Consolidated and Separate Financial Statements*. This option might also require interpretation of the other group accounting standards but this is unlikely to be significantly more than is normally required for new standards. There may, however, need to be more detailed application guidance for users. It is notable that the standards include detailed application notes.
- 2.12 A further option could also be considered for further development. Where interests in other entities are intended to generate profits to provide an income stream for the authority, IFRS 10 may be followed (and adopted in the Code); where the interests are intended to deliver services or to meet non-cash generating objectives the Code could adopt IPSAS requirements in the Conceptual Framework ED.
- 2.13 It should be highlighted that such an approach to the adoption of the standard will need to be taken forward in parallel with the approach in the FReM on the new standards. CIPFA Secretariat will therefore liaise with Treasury officials on their intended approach and report to the Board at its next meeting.
- 2.14 It is also important to point out that the interpretation described above, should this approach be required by the Board, will require a significant development period for appropriate consultation to ensure that the interpretation effectively defines local government circumstances and does not widen the scope of the standard's provisions. Therefore the timetable for development of this project in the Code will need to commence earlier than the normal timetable for Code development. CIPFA/LASAAC's initial views are sought on the approach to the adoption of the group accounting new and amended standards.

### 3 IFRS 13 Fair Value Measurement.

- 3.1 The new standard IFRS 13:

- provides a definition of fair value;
  - presents in a single IFRS a framework for measuring fair value; and
  - requires disclosures about fair value measurements.
- 3.2 The standard applies to all IFRSs that require or permit fair value measurements or disclosures about fair value measurement except in specified circumstances. As noted above it has an application date of 1 January 2013, earlier application is permitted. The standard requires prospective application. The IFRS explains how to measure fair value for financial reporting purposes. It does not require any additional fair value measurements than those already required by IFRSs.
- 3.3 IFRS 13 defines fair value as:
- “... 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.”  
(IFRS 13, paragraph 9)
- ie measurement at an exit price.
- 3.4 The definition of fair value highlights that it is a market based assessment. It is not an entity specific measurement as a result an entity's intention to hold an asset and its use is not relevant to the standard when measuring fair value. Instead when measuring fair value an entity uses assumptions that market participants would use when measuring an asset or a liability including the assumptions used about risk.
- 3.5 Other useful points to note about the IFRS include that for non-financial assets the standard requires that entity's measurement is at the highest and best use of an asset. In addition the standard also includes a fair value hierarchy that categorises into three levels the inputs to valuation techniques used to measure fair value:
- Level 1 inputs – quoted prices in unadjusted markets
  - Level 2 inputs – other than quoted prices that are observable for the asset or liability either directly or indirectly
  - Level 3 inputs – unobservable inputs for the asset or liability.
- 3.6 Previous reports to CIPFA/LASAAC have indicated that a definition of fair value based on a market based assessment of an exit price is not likely to provide a true and fair view of the economic benefit and service potential of the non-financial assets and liabilities held by local authorities. The Secretariat has undertaken an initial analysis of the standard's suitability to measure the assets and liabilities held by local authority at Appendix A to this report. This analysis uses as its starting point the table in the Code at paragraph 2.1.2.26. This is a high-level overview to highlight the issues arising on adoption of the standard. A more detailed analysis will be required on adoption in the Code. The Appendix highlights that property, plant and equipment; heritage assets and assets or liabilities where a measurement of service potential might be required are likely to require a different measurement of fair value than that provided by the standard.

- 3.7 It will therefore be important to consider the application of the standard in detail. It is likely that some significant interpretation of the standard will be required for local government/public sector circumstances. The Secretariat is aware that this issue has been raised at meetings of the Government's Financial Reporting Advisory Board. Again, it is likely to be necessary to co-ordinate the development of the Code on this issue with that of the FReM.
- 3.8 CIPFA/LASAAC's initial views are sought on the approach to the adoption of the new standard in the Code.

## Recommendation

CIPFA/LASAAC is asked to:

consider the report and give its initial views on its desired approach to the adoption of the new and amended standards in the Code.

**Summary Table Analysing the Appropriateness of the Adoption of FRS 13 in Relation to Local Authority Assets and Liabilities**

Circumstance	Fair Value as Currently Interpreted in the Code	Appropriateness of the Adoption of the IFRS 13
Revenue recognition; this is the general definition that applies unless a more specific definition applies	Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction.	Not entirely clear. It is likely that the new standard would be able to be applied. However, there are likely to be circumstances where it would not be appropriate ie where the revenue recognition requires a measurement of service potential.
Property, plant and equipment	Fair value (for land and buildings) is to be interpreted as the amount that would be paid for the asset in its existing use. This requirement is met by providing a valuation on the basis of existing use value (EUV) in accordance with UKPS 1.3 of the RICS Valuation Standards. The fair value of council dwellings shall be measured using existing use value–social housing (EUV–SH). The fair value of surplus assets should be based on the existing use value of the asset, applying the same assumptions relating to the level of usage, etc as those in the most recent revaluation as an operational asset.	In the majority of cases existing use value remains an appropriate measure of economic benefits and service potential for property, plant and equipment. It should be noted that the IPSASB Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements follows the deprival value approach.
Leases	Fair value will follow the appropriate class of property, plant and equipment, or intangible assets.	As above with the exception of intangible assets (see consideration of intangible assets below).
PFI and PPP arrangements	On initial recognition, fair value is the cost to purchase the asset. Subsequently, fair value will follow the appropriate class of property, plant and equipment, or intangible assets.	As above with the exception of intangible assets (see consideration of intangible assets below).

Circumstance	Fair Value as Currently Interpreted in the Code	Appropriateness of the Adoption of the IFRS 13
Investment property	Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction. For this section of the Code, fair value is to be interpreted as the amount that would be paid for the asset in its highest and best use, ie market value. The fair value of investment property held under a lease is the lease interest.	As the benefits being received by the authority are based on capital appreciation or financial returns then it would be appropriate to use IFRS 13 to measure investment properties.
Intangible assets	IAS 38 allows an intangible asset to be carried at a revalued amount only where its fair value can be determined by reference to an active market. Where there is no active market, assets are carried at cost less any accumulated amortisation and any accumulated impairment loss.	Intangible assets carried at a revalued amount should be measured in accordance with IFRS 13. Where there is no active market, assets will continue to be carried at cost less any accumulated amortisation and any accumulated impairment loss.
Non-current assets held for sale	Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction. For this section of the Code, fair value is to be interpreted as the amount that would be paid for the asset in its highest and best use, ie market value. Fair value for social housing being disposed of under Right-to-Buy (RTB) legislation is the discounted RTB value.	The new fair value standard would provide an appropriate measurement for non-current assets held for sale. There may need to be further interpretation for RTB properties.
Heritage Assets	Heritage assets are carried at valuation rather than fair value, reflecting the fact that exchanges of heritage assets are uncommon. Valuations may be made by any method that is appropriate and relevant. There is no requirement for valuations to be carried out or verified by	The measurement requirements of the Code's adoption of FRS 30 are likely to be needed for heritage assets.

Circumstance	Fair Value as Currently Interpreted in the Code	Appropriateness of the Adoption of the IFRS 13
Inventories	<p>external valuers, nor is there any prescribed minimum period between valuations. In some cases it may not be practicable to establish a valuation for a heritage asset, in which case the asset is carried at historical cost if this information is available. Authorities may elect to use this basis for community assets.</p> <p>Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction.</p>	<p>It is likely that most inventories will be able to be measured in accordance with IFRS 13. There will be exceptions ie:</p> <ul style="list-style-type: none"> <li>• where inventories are held for distribution at no charge or a nominal charge</li> <li>• where authorities hold inventories of goods or services whose future economic benefits or service potential are not directly related to their ability to generate net cash flows.</li> </ul>
Debtors	<p>Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction.</p>	<p>It is likely that most debtors will be able to be measured in accordance with IFRS 13. There may be exceptions ie those debtors which include a measure of service potential.</p>
Financial instruments	<p>Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. Usually the best evidence of the fair value is the transaction price (ie the consideration) and unless the transaction was not at arm's-length this should be the value used. However, if the</p>	<p>IFRS 13 is an appropriate measurement for financial instruments.</p>

Circumstance	Fair Value as Currently Interpreted in the Code	Appropriateness of the Adoption of the IFRS 13
	<p>transaction is not based on market terms, a valuation technique shall be used to determine the appropriate fair value for initial recognition of the instrument.</p>	
Creditors	<p>Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction.</p>	<p>It is likely that most creditors will be able to be measured in accordance with IFRS 13. There may be exceptions ie those creditors that include a measure of service potential.</p>