HM Treasury

Financial Reporting Advisory Board Paper

Thematic Review – valuation for non-investment assets

Issue:	HM Treasury are conducting a thematic review of non-investment asset valuation for financial reporting purposes. The purpose of the review is to consider the costs and benefits of the current regime and explore possible alternatives, including the accounting policy choice of whether to hold assets at valuation.
Impact on guidance:	N/A at this stage.
IAS/IFRS adaptation?	No adaptations or interpretations proposed at this stage.
Impact on WGA?	None.
IPSAS compliant?	N/A
Interpretation for the public-sector context?	No adaptations or interpretations proposed at this stage.
Impact on budgetary regime and Estimates?	N/A
Alignment with National Accounts	Changes will not directly impact on National Accounts though ONS data sources are considered as part of the review.
Recommendation:	**That the Board note the progress on the review and provide comment on the preliminary findings, the potential alternatives to consider and next stages of the review.**
Timing:	The Board will receive a further update on the review at the November meeting

DETAIL

Background

1. HM Treasury has committed to undertake a thematic review of property valuation for financial reporting. This is part of a wider Government Financial Reporting Review commitment to carry out regular thematic reviews focusing on different issues in government financial reporting. To date, HM Treasury have completed three thematic reviews covering Parliamentary accountability and reporting against the Estimate, a strategic review of the financial reporting response to COVID-19 and a post implementation review of IFRS 9 and IFRS 15.

2. Moreover, this thematic review contributes to HM Treasury's commitment to supporting the Department of Levelling Up, Housing and Communities (DLUHC) as they take steps to address the underlying issues in local authority reporting and audit in their package of measures

announced in December 2021.

3. The core scope of this review is focused on non-current assets in the WGA boundary that are not held at fair value. Certain classes of non-investment assets within IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets, subsequent to initial recognition, are held at current valuation. There have been challenges raised in relation to meeting the burden of audit requirements for such valuations. These challenges have anecdotally been conveyed as a contributory factor in the delays in financial reporting in local government. The purpose of the thematic review is to build the evidence base around the costs and challenges, and to identify and evaluate the benefits and uses of the financial information produced. This, combined with an assessment of possible alternatives, will help determine the case for any change.

4. The current regime sees the FReM, the Code of Practice on Local Authority Accounting and the GAM adapt IFRS by removing the option of measuring non-investment assets at historical cost and rather than applying IFRS 13 Fair Value, sets out the basis for current valuation (either depreciated replacement cost or market value in existing use).

Preliminary findings and conclusions

5. The full extent of anticipated benefits/uses for the current regime have not been realised in practice. Aspects inherent to the regime and wider fiscal and financial management frameworks mean the scope for wider fiscal or financial management use of the data may be limited.

6. Key challenges experienced by preparers of the financial statements include time and expenses incurred by engaging with external parties to provide valuation services and efforts involved in the audit process. However, stakeholder discussion suggests the perceived cost burden differs across sectors (central government and local government). Larger departments in central government noted that they have a well-established valuation process and are managing challenges relatively smoothly without disrupting the financial reporting process. Given the reporting regime has remained stable for many years, the perceived increases in burden appear to have been driven primarily by evolution in the audit regime and practice, and the perception of burden is more acute in the local government sector. This may have been a contributory factor in the delays to the publication of audited accounts.

7. Preparers of the financial statements, specifically within local government, experience varying degrees of challenge when applying the current regime. There is a mixture of views and experiences on whether current valuation provides useful information, whether that be operationally or to external users of the financial information, but in general the evidence of use is limited. There are also sector differences, with for example a comparatively more positive assessment of usage in defence.

8. We have conducted initial stakeholder interviews to gain an insight into the benefits and costs of the current regimes, as well as alternative options. The stakeholders included preparers (central government, local government and other authorities), valuers (RICS), auditors (NAO and lead public sector audit and valuation specialist teams at Deloitte), users (ONS, OBR, Balance Sheet Management Team (HMT), the Government Property Agency) of the financial information and other interested parties (CIPFA, PSAA). At this stage, the evaluation is qualitative rather than quantitative. Parliament is considered the principal user of departmental annual reports and accounts, and the Treasury is drawing on its knowledge of previous engagements and discussions with Parliamentary users at this stage of the review. More specific engagement will be undertaken with this key user(s) on this issue as the review's findings and recommendations become firmer.

9. The benefits/uses and costs of the current regime have been identified and given preliminary evaluation in a draft interim report prepared by Deloitte. In broad terms the different stakeholder groups identified similar benefits and costs of the current regime; however, the severity of observations differed depending on the stakeholder and so the evaluation of benefits and costs has been presented by each stakeholder group. It should be noted that these assessments were not based on statistical samples of the stakeholder groups and should be considered preliminary.

10. The perception of cost and burden in the current regime was recognised, to some degree, by essentially all stakeholder groups. Consistent themes included the time consuming and costly nature of the valuation exercise (especially for local government), the challenges in preparing and obtaining verifiable audit evidence, the often high estimation uncertainty and perception of a potential lack of consistency in the current regime.

Next steps

11. During the initial stakeholder interviews alternative regimes that could be adopted instead of the current one were discussed. Some prospective alternatives were generated by Deloitte and further ideas sought and tested with stakeholders engaged during this phase of the work. In broad terms, the main issue raised with the current valuation regime was the perception of a disproportionate degree of audit related work and this finding has shaped consideration of possible reporting alternatives.

12. The following alternative options were identified and discussed (a breakdown of some advantages and disadvantages of each option is provided in the draft interim report):
    - Historical/Deemed cost model in accordance with IFRS
    - Revaluation model for all non-investment assets in accordance with IFRS (including IFRS 13)
    - Differential regime: Historical/deemed cost model for certain categories of assets (e.g. specialised) and revaluation model for others (e.g. non-specialised assets)
    - Periodic reset of historic/deemed: reset carrying values to current value every 5 years (but no annual requirement to hold at valuation)

13. No alternatives are without drawbacks and alternative options will be explored and evaluated further over the next phase of the review. Initial reflections informed by stakeholder engagement suggest option 2 above is least favourable in addressing current concerns as it is likely to be as costly as the current regime and significant audit related efforts would be required to evaluate the reasonableness of the fair values of assets.

14. From discussions with stakeholders, there may be scope for further consideration of the best way to segment any differential approach under option 3. One way would be the existing segmentation between specialised and non-specialised assets. Other possible areas for segmentation that could be explored include special consideration around Military Assets or Network Assets.

15. HM Treasury will commission data from Departments and local government to develop a more systematic understanding of costs related to the current regime. This will inform further steps for the thematic review, as a fuller understanding of the scale of cost will be valuable in evaluating the case for change.

16. This is the first phase of the thematic review. Further detailed work is to be undertaken over the coming months. Our goal remains to complete the review by late Autumn and to present more finalised conclusions at the November Board meeting. Stakeholders have been clear on the importance of consulting on any significant changes to the regime, so the implications are well understood. As expected, this makes the likelihood of proposing changes for 22/23 implementation very low.

Recommendation
That the Board note the progress on the review and provide comment on the preliminary findings, the potential alternatives to consider and next stages of the review.

HM Treasury

30th June 2022