HM Treasury

Financial Reporting Advisory Board Paper

Thematic Review – valuation of non-investment assets

Issue:	HM Treasury's thematic review of non-investment asset valuation for financial reporting purposes (the Review) is concluding. This paper sets out proposed changes to the regime.
Impact on guidance:	New guidance will be issued for transition to the new regime.
IAS/IFRS adaptation?	Yes – the proposals will change the IAS 16 & 38 adaptations.
Impact on WGA?	Yes – the proposals will change the measurement base of some IAS 16 and 38 assets in WGA.
IPSAS compliant?	Yes – the proposals are considered to be substantially complaint with IPSAS. They align with the IPSAS 17 (Property, Plant and Equipment) requirement to apply either the cost model or revaluation model as an accounting policy by class of PPE.
Interpretation for the public-sector context?	Yes – the proposals with prescribe a differential valuation regime, based on the asset type.
Impact on budgetary regime and Estimates?	Yes – but the changes will remain consistent with accounting treatment
Alignment with National Accounts	No – but WGA asset values and depreciation are not used as a National accounts data source.
Recommendation:	**That the Board comment on the proposed changes and the results of the thematic review, and support issuance of an Exposure Draft to consult on the changes.**
Timing:	HM Treasury intends to issue an Exposure Draft as soon as possible, with a view to providing feedback at the March Board meeting. Subject to consultation the intention would be to implement changes in 2024-25. The changes would be incorporated into the 2024-25 FReM approved by the Board in November 2023.

DETAIL

Background

1. HM Treasury has conducted a thematic review of non-investment property valuation for financial reporting; scoped at IAS 16 and IAS 38 property within the boundary of Whole of Government Accounts. 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. 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.

2. At the June 2022 FRAB meeting the Treasury set out the preliminary findings of the review. The Review is now concluding and the final report from our advisors, Deloitte, has been made available to the Board. Since the June 2022 meeting a detailed survey has been undertaken across central and local government, to identify and evaluate costs and benefits, and prospective alternatives analysed and tested with stakeholders.

3. This paper sets out some of the headline conclusions from the Review, including that there is a strong case for change. The paper in particular sets out HM Treasury's specific proposals for change, balancing the needs of users and producers of the financial information, value for money considerations and the importance of timely financial reporting.

4. This paper in addition sets out the forward timelines for consultation and implementation of the proposed changes. Alongside this paper is an Exposure Draft for the changes proposed at Whole of Government Accounts level. These provide a vehicle to consult on the proposals, including with users, and identify the need for any additional guidance to aid implementation. This consultation process does not substitute for due process by other relevant authorities, but rather seeks to expedite the identification of issues for consideration.

Findings and conclusions

5. The Review found that elements of the regime are costly relative to their benefits, and the outlook is the costs will continue to rise significantly. The Review found the estimated financial cost of the current regime is in the region of £50m per year (i.e. external valuations, preparer and auditor costs). More than half of that cost is from external valuations, and around 15% are auditing costs. The cost burden was felt most acutely in English local authorities. Relative to the value of assets in scope, network assets (at least highways and the rail network) appear less costly.

6. The Review did not estimate the changing costs of the regime over time, but there was a widespread view that the use of external valuations has been growing over time, and the principal driver is changes in the audit regime, as the financial reporting regime in this area has remained static for many years. Contextually, Public Sector Audit Appointments has indicated, on reporting the outcome of their recent procurement exercise, that they expect audit fees for 2023-24 to be in the order of 150% higher than the 2022-23 position.

7. More broadly the Review found a strong consensus that the current regime was considered burdensome, and the Review found that the work associated with reporting audited asset valuation was a contributory factor in the timeliness of reporting. There is also a broad recognition that timeliness is an important characteristic of high quality financial reporting.

8. The Review considered the views of users, preparers and auditors and found that the uses of the financial information provided by the current regime have been limited. Survey respondents were asked to consider uses of the information by both themselves or those outside their organisation (to the best of their knowledge). Internal uses appear stronger in the NHS sector, but discussions with stakeholders suggest this is predominantly a second

order effect arising from their use in the regimes that underpin some financial flows within the DHSC Group. For example, Public Dividend Capital dividends flows are based on net asset values, and therefore PDC dividend payers need to consider the net asset implications of their decisions.

9. The professional valuation community indicated there could be unrealised asset management benefits from the valuations undertaken, while in practice preparers noted a distinction in processes between asset management and financial reporting, even where they may draw upon the same data inputs. To some degree, it is unsurprising that the information in general purpose financial reports do meet the specific decision making needs of internal users.

10. When consulted on the preliminary findings of the Review, the User Preparer Advisory Group emphasised the importance of the views of users, and consideration of conceptual principles like intergenerational fairness (discussed in more detail below).

11. It is palpably clear Parliament (more specifically the Committee of Public Accounts (PAC)) is concerned about the timeliness of financial reporting, across both the local and central government sector and at the Whole of Government Accounts (WGA) level. The Treasury's engagement with the Committee through WGA hearings indicates they value faithful representation in reporting. It is less clear where current valuations under the current regime deliver a particular premium in terms of the relevance of financial information (to the decisions of users), especially where those valuations do not provide predictive value or confirmatory value in terms of future cash flows.

12. The Review found that valuation of specialised assets (by definition rarely sold in the market) is more prone to being assumption driven, and the contestability of assumptions affects the audit process. Similarly, it is less clear, to a non-specialist user, how understandable some of the measures of replacement of service potential are. For example, valuations reflect the cost of building a modern equivalent asset (where the evolution of modern standards, or judgements of modern equivalence could be a key driver of value), rather than a value that is reflective of what the actual asset cost, or what the actual asset could be sold for (i.e. two intuitive propositions of what a non-specialist user might take an asset figure in a balance sheet to represent). Public consultation on the specific proposals is a mechanism to identify further user views and any final proposals for change that are supported by Ministers, will be put to the PAC.

13. Intergenerational fairness is an important principle. However, there are limits on the extent to which general purpose financial reports can serve as the principal data source for such evaluations. In addition, within the financial statements there is arguably some differentiation in insight provided by asset types (cash generating versus non-cash generating assets) and an overarching significance for liabilities (to be met by future generations). The scope of information to be considered (both financial and non-financial) in assessing international generation fairness is far wider than the narrow scope of IFRS based financial statements, and one where broader, often statistical approaches, are required to provide informed insight.

Proposed changes to the Regime

14. Notwithstanding the findings in respect of the current regime, no alternatives come without drawbacks. HM Treasury has concluded that a balanced approach is required, which

includes recognising the potential uses of financial information and the challenges currently faced where alternative measurement bases are being used (in particular with respect to infrastructure assets in local government). The case for change points most strongly toward a differential approach (one of the four options set out to the Board in June), recognising that the costs and value (to users) of holding assets at valuation can vary by asset class. There was general support for the sub-categories that already exist in the FReM (e.g. the specialised/non-specialised, networked assets etc), and specific consideration was given to further categorisation e.g. military assets, as mentioned in the June paper to the Board.

15. Assets which are specialised (to meet a public sector use) often require a greater degree of judgement in the assumptions applied to determine a stylised estimated cost of a modern equivalent asset. These judgements can have material impacts on the valuation, and the inherent uncertainty in such judgements can drive costs (both time and resources) to achieve a valuation measure that meets audit requirements within the current context of standards and regulation.

16. HM Treasury have come to the following primary conclusions in light of the Review:

    a. Networked assets should remain at depreciated replacement cost – reflecting the strength of support for the current regime by preparers (currently applying this), the relative low cost of the regime, the economically material nature of the assets, and the tangible challenges currently being experienced with an historic cost alternative. In practice, a fair value measurement base would likely lead to the same result.
    b. Specialised assets should no longer be revalued – i.e. the regime should transition to deemed cost, with future expenditures recognised at depreciated historic cost. The cost/benefit trade off in this class is weakest, and the relevance and reliability of the measurement most doubtful.

17. A more tentative conclusion from the Review is a reconsideration of the application of market value in existing use (Existing Use Value), which is only applied in the UK public sector. There was some support from stakeholders to transition to fair value, particularly in respect of non-specialised assets (e.g. offices), where there may be benefit from using a more widely used measurement base, where the assets are not specialised to public service delivery, and where accountability may be better served by recognising the opportunity cost of holding the asset (irrespective of whether it would be sold).

18. In light of this reconsideration, the measurement bases of the remaining asset categories would be as follows:
    a. Non-specialised assets to be held at Fair Value.
    b. Social Housing could be retained at Existing Use Value (rather than moving to fair value), but this is a decision for CIPFA/LASAAC.
    c. Intangibles (IAS 38 assets) and ‘other IAS 16 assets’ (i.e. the residual) no longer revalued and new expenditure reported at depreciated historic cost
    d. Military assets (essentially a category of specialised assets) should similarly no longer be revalued and new expenditure reported at depreciated historic cost
    e. Operational Heritage assets remain unchanged.
    f. Surplus assets remain unchanged (typically fair value)[1]

19. The proposed changes and the accompanying rationale are summarised in Annex A.

[1] Held for Sale non-current assets measured under IFRS 5 as applied under the FReM

Next Steps

20. The Treasury would like to move forward with public consultation on the proposed changes through issuing an Exposure Draft. This will support further discussion by the Board on the changes in March, the development of application guidance and FReM amendments, and accord with a timeline to introduce the changes into the 2024-25 FReM, which will be put to the Board in November 2023. A prompt consultation will also support the timeliness of other relevant authorities in applying their own due processes.

21. The Treasury will be developing a publishable version of the Review, which it expects to publish in early 2023. Before finalisation of the proposals in the FReM, the Treasury will seek the support of Ministers, with a view to setting out the proposals to Parliament.

HM Treasury

15th November 2022

Annex A

Asset category	Current measurement	Proposed Measurement	Rationale
Networked Assets	Depreciated replacement cost (with the exception of English Local Authorities who depart from the FReM and value at historical cost)	Depreciated replacement cost	Distinguishing characteristics of networked assets in the public sector – such as, long useful lives, complexity of componentisation, frequency of alterations and restrictions on use) – indicate the DRC valuation basis is the most appropriate method to measure the service potential of the asset.
Specialised Assets (land and buildings)	Depreciated replacement cost	Historical deemed cost	Valuation of specialised assets is based on a hypothetical modern equivalent asset, and it involves highly subjective assumptions. Due to complexity of such valuations and a lack of market-based evidence, applicated of historical deemed cost will enhance the reliability of financial information. The proposed measurement basis may also support moving towards removing the WGA qualification for non-coterminous year ends in respect of the Academies sector.

Non-specialised Assets (land and buildings)	Market value in existing use	Fair value	The new measurement basis will provide more useful information and may help support asset management decisions. It will provide transparency and accountability of the opportunity cost of holding public sector assets which could be sold in the market.
Military Equipment	Depreciated replacement cost	Historical deemed cost	Military equipment typically has shorter lives compared to networked assets or buildings due to fast technological developments. As such, the new measurement basis has relatively low risk for significant divergence between carrying value and fair value and so there is limited perceived benefit for estimating fair value.
Operational Heritage Assets	Market value in existing use or fair value but, where it is not practicable to obtain a fair value, the heritage assets may be reported at historical cost	No change – market value in existing use or fair value but, where it is not practicable to obtain a fair value, the heritage assets may be reported at historical cost	Entities holding the majority of heritage assets have elected the revaluation model under SORP for charities, and so any changes create the risk of dual accounting regimes.
Residual IAS 16 Assets	Market value in existing use or historical cost for low value or assets with short useful lives.	Historical deemed cost	Other assets tend to have shorter lives compared to networked assets or buildings. The new measurement basis has relatively low risk

			for significant divergence between carrying value and fair value and so there is limited perceived benefit for estimating fair value.
IAS 38 Intangible Assets	Market value in existing use or historical cost for low value or assets with short useful lives.	Historical deemed cost	There is a lack of observable market inputs for valuation purposes. The new measurement basis has relatively low risk for significant divergence between carrying value and fair value and so there is limited perceived benefit for estimating fair value.