

2024-03-05 Draft Guidance for Valuers – Proposed Changes to FReM

Background

HM Treasury has published an Exposure Draft (ED) to consult on changes that will affect Financial Reporting Manual (FReM) adaptations and interpretations of International Accounting Standard 16 Property Plant and Equipment (IAS 16) and adaptations of International Accounting Standard 38 Intangibles (IAS 38), in respect of the measurement of assets. These changes flow from HM Treasury's Thematic Review of non-investment asset valuations for financial reporting and a previous Consultation Paper published on this area.

Purpose of this Guidance

The purpose of this guidance is to outline a recommended process for valuers where the proposed FReM updates result in changes to current valuation methodology or approach. Any proposed changes regarding intangible assets are not within the scope of this guidance.

Valuer Significant Changes Proposed:

1. HM Treasury's proposed update to Chapter 10 of the FReM to introduce the concept of assets held for their operational capacity, remove the specialised / non-specialised asset split from the FReM, and add additional guidance from IPSAS 45 on how to identify as an asset held for its operational capacity.
2. The current requirement to consider alternative locations when valuing an asset using DRC should be removed from the FReM.
3. HM Treasury are proposing to reduce the number of processes entities can use when revaluing their assets to three, being:
 - a. A quinquennial revaluation supplemented by annual indexation in intervening years.
 - b. A rolling programme of revaluations over a 5-year cycle, with annual indexation applied to assets during the four intervening years.
 - c. For non-property assets only, to utilise appropriate indices.

Proposed effective date of financial year 2025-26 for the changes.

4. HM Treasury's proposed update to the existing adaptation of IAS 16 covering measurement bases to introduce the concept of assets held for their operational capacity and remove the specialised/ non-specialised asset split from the FReM.

Recommended Guidance to Valuers.

1. HM Treasury's proposed update to Chapter 10 of the FReM to introduce the concept of assets held for their operational capacity, remove the specialised/ non-specialised asset split from the FReM, and add additional guidance.

This is a change only regarding how an entity should classify its property assets from a FReM Chapter 10 asset classification requirement perspective.

HM Treasury in its Exposure Draft (ED) at Para 5.5 proposes that “assets which are held for their operational capacity service potential (i.e. operational assets held with the primary objective to deliver either front line services or back-office functions) should be measured at their current value in existing use”.

The valuation “Basis” remains at “Current Value in Existing Use”. From a valuation perspective there is no change to the valuation method to be adopted in arriving at the EUV, this will still follow existing RICS Red Book definition at UKVPGA 6.

Where in the valuer’s opinion a property asset is so specialised that a market does not exist to draw a satisfactory body of transactional evidence in order to establish a Current Value in Existing Use, then the valuer will adopt Depreciated Replacement Cost methodology as previously and as set out in RICS Depreciated Replacement Cost Method of Valuation for Financial Reporting 2018.

Equally, where sufficient market evidence is available a comparable based EUV valuation will be carried out having regard to RICS Professional Standard “Existing Use Value (EUV) Valuations for UK Public Sector Financial Statements” published in July 2023.

HM Treasury states in the Exposure Draft at para 5.8 that assets which are not held for their operational capacity service potential should be valued in accordance with IFRS 5 or IAS 40 depending on whether the asset is actively held for sale.

Where such assets are surplus and do not fall within the scope of IFRS 5 or IAS 40, they should be valued at fair value applying IFRS 13.

For the valuer this will require the provision of a Fair Value. Fair Value is defined in IFRS 13 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’.

2. The requirement to consider alternative locations when valuing an asset using DRC should be removed from the FReM.

The valuer will follow the guidance set out in RICS Guidance note: “Depreciated Replacement Cost Method of Valuation for Financial Reporting” published in 2018.

The valuer will first need to establish whether the previous valuation which is the subject of a revaluation in 25/26 onwards, included an alternative MEA (Modern Equivalent Asset) site assumption.

If there was an alternative site assumed, the valuer will need to check with the entity whether a hypothetical “MEA Model” was adopted which included an assumed hypothetical combined building or buildings on that assumed hypothetical site.

If that has not been the case then the valuer will revalue the operational land in the vicinity of the actual site, adopting an MEA site area as discussed and agreed with the entity. The option remains for the entity, in discussion with its valuer, to assume where appropriate, a smaller MEA site than the actual.

For valuation of the land, as previously, the valuer will assume the locational characteristics and planning regime of the actual site and its vicinity.

The “Hypothetical MEA Model” under MEA means the MEA hypothetical range of buildings which could be the same range and distribution as on the existing site but with MEA reduced GIAs or could be a reduced number of hypothetical combined buildings by function.

Importantly, if, however, the entity’s current valuation “MEA Model” assumes a hypothetical combined building or set of buildings hypothetically situated on an alternative site, then a full reworking of the “MEA Model” will be required.

This will require the disaggregation of the MEA hypothetical “combined” building(s) and agreeing with the entity a new hypothetical “MEA Model” which assumes the remaining service potential provided by the actual buildings on each actual site is re-provided within a hypothetical model which assumes MEA reprovision on the actual site only.

This will require a full reworking of the calculations to provide equated remaining lives appropriate to the newly assumed hypothetical block or blocks on the actual site only.

These equated remaining lives will be derived only from those specialised DRC valued assets which are located on the actual site itself. This contrasts with the previous position which meant it was possible to assume that in the hypothesis a building’s service potential could be reprovided at an alternative site. This proposal, however, excludes that possibility.

3. HM Treasury are proposing to reduce the number of processes entities can use when revaluing their assets to three, being:

- a. A quinquennial revaluation supplemented by annual indexation in intervening years.*
- b. A rolling programme of revaluations over a 5-year cycle, with annual indexation applied to assets during the four intervening years.*
- c. For non-property assets only, appropriate indices.*

Proposed effective date of financial year 2025-26 for the changes.

Whilst a significant valuation programme change for many entities, from a valuer’s perspective these proposed changes have no direct impact on valuation processes.

Instructions to provide valuation advice will be limited to those entities requiring a. or b. above.

Under this proposal the intervening years will be dealt with in-house by the entities adopting indexation.

The indices to be adopted or the manner of their application has not been specified though reference has been made to the BCIS All-in TPI (Tender Price Index) as one potential option.

4. Indexation (e.g. list of indicators that could be used including for land and buildings and how/when regional variations should be taken into account)

Presently we are not aware of any existing General Property Valuation index in the United Kingdom.

However, the following are published national indices:

- BCIS all in TPI is an index of inflation or deflation of building construction costs only. It is provided as a national index by the RICS' Building Cost Information Service. but with regional location factors to enable locational adjustment.
- ONS currently also produce it's UK House Price Index by region.
- ONS also publish it's "Experimental Index of Private Housing Rental Prices" by region.
- In terms of general inflation in the economy ONS provide CPI, as a general measure of inflation in the economy, it is not property value related.

The VOA may be commissioned to provide a General Property Valuation index in due course, the feasibility of this is being considered at present.

5. IAS 36 Impairment (e.g. indicators of impairment)

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External sources of information

(a) there are observable indications that the asset's value has declined during the period significantly more than would be expected as a result of the passage of time or normal use.

- Observable Indications including dilapidated state, significant disrepair, structural defects.
- Physical changes to the vicinity could impact on property values, for example building of a new by pass.
- Economic changes within the vicinity for example the closure of a major employer.

(b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

- This will be mainly for the entity to identify, but a general market decline such as that seen in the aftermath of the financial crisis in 2008/9 could be relevant.
- Significant changes to funding or service delivery requirement from Government.
- Technological advances.

(c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

- Have there been significant changes to Interest Rates or Market Yields?
- Could affect non-specialised asset values but not specialised assets valued to DRC.

(D) the carrying amount of the net assets of the entity is more than its market capitalisation.

- A matter for the entity to assess. However, it is worth noting that asset valuations for financial reporting purposes are made assuming the assets are held for their operational capacity and so valued to EUV (Existing Use Value) and so the asset valuation may well differ from market capitalisation or market value.

Internal sources of information

(e) Evidence is available of obsolescence or physical damage of an asset.

- The entity may identify if an asset has become obsolete in terms of suitability for the entity's service delivery needs. The entity's estates team will identify physical damage.

(f) Significant changes with an adverse effect on the entity have taken place during the period or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

(g) Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

- Not within the scope of this guidance.

(h) An entity may identify other indications that an asset may be impaired, and these would also require the entity to determine the asset's recoverable amount or, in the case of goodwill, perform an impairment test in accordance with paragraphs 80–99.

(i) Evidence from internal reporting that indicates that an asset may be impaired

- Not within the scope of this guidance.

(j) Capital projects (e.g. how CAPEX should be treated, including when on an existed building/to extend the life of an asset when they fall between valuations, should it trigger full revaluation etc.)

- To be discussed with HMT. In the absence of annual revaluations capex would not be reflected until year 5. However, newly built assets would presumably require to be valued at the operational date.

6. Transition (e.g. entities are able to retain alternative site valuation until the end of their cycle of valuations providing there is sufficient disclosure)

- The valuer will need to assist the entity with re casting the MEA Model only at year 5 when the entity must revalue but without alternative site. Meanwhile the entity will simply index forward its current valuation including with an alternative site assumption for the 4 years preceding the first full revaluation under the new regime.

7. Choice of revaluation process (e.g. guidance to avoid default to indexation only, should there be a hierarchy of choice)

- Should the entity choose Option A, then all property assets would simply be indexed forward by the entity each year by the change shown in the selected index. Revaluation would not take place until year 5.
- Alternatively, should the entity select Option B, a rolling programme, a percentage- for example 20% or 30%, would be identified on a rolling programme basis for full inspection and revaluation, with the remaining 70 to 80% being indexed.

8. Networked assets (e.g. whether each network asset should continue to be treated as a single asset, how the revaluation reserve should be treated)

- Suggest HMT provide the wording for this section?

9. HM Treasury propose an effective date of financial year 2025-26 for the changes.

- This has no direct impact on the valuer's processes other than it is understood that revaluation instructions will not be required for prior year in the transitional period.

10. RoU and Peppercorn leases (e.g. guidance on the initial and subsequent treatment of peppercorn leases)

- Para 3.27 of the Exposure Draft, there are no changes proposed to the valuation of Right of Use Assets.

8. Worked Example with CAPEX:

There is no change to the DRC methodology, and so at each quinquennial valuation Capex which has occurred during the previous 4 years as well as that occurring in year 5 will be reflected in the usual way.

For example, if all the windows in an operational building have been replaced, so at the quinquennial valuation the remaining life for that building component will be amended by the valuer to reflect its modernity (say 60 years). If the valuer is adopting the "Top Down" Holistic approach they will adjust the GRC by an appropriate percentage adjustment.

Where using the Elemental Approach the valuer will adopt a full remaining life and the current year for that building element.

If, however, a newly built asset is erected during the 4-year interval it will fall to be valued at the date it becomes operational, for example a new Emergency Department in a NHS Hospital, the asset will be valued as at the date of opening. It will thereafter be indexed forward alongside the remainder of the estate.

The DRC valuation will be based on cost per m2 provided by specialist-chartered building surveyors or BCIS.

In subsequent years it will be indexed forward annually in line with the remainder of that estate.

9. Worked example EUV for a mixed-use building.

We would recommend all valuers should first read the latest RICS Professional Standard EUV Existing Use Valuations for UK Public Sector valuations, published July 2023.

Where the building is non-specialised the valuer will adopt a rent per m² appropriate for the identified uses within the building, and also adopt market yields appropriate to that use for example office use, or storage.

Where capable of separate occupation, in discussion with the entity, the different functions may fall to be separately valued.

For a specialised building, where the majority of the building is used for an identified function, for example Outpatients Department in a hospital scenario, the valuer will first adopt building replacement costs to reflect that majority use. Specialist Chartered Building Surveyor would then be consulted for appropriate adjustments to building costs to reflect those other uses or functions.

10. Worked Example Optimised Alternative Site.

Example of a Hospital Trust comprising specialist buildings valued to DRC, where two actual sites are each situated within an expensive private executive housing area and each being 3 HA in size. The MEA optimised hypothetical site is currently assumed to be situated hypothetically on an alternative low value site adjacent to social housing, and to be of just 4 HA in size.

The MEA valuation is currently 4 HA @ £350,000 / HA = £1,400,000

Under the proposed regime the actual sites will need to be valued in their actual vicinity – ie an executive housing area. This will be 3HA @ £1,000,000 ha = £3,000,000 for each site, producing a total valuation of £6,000,000 for the two actual sites.

Regarding the specialised buildings, currently the optimised MEA Model assumes one optimised hypothetical building on the single alternative site, of just 80,000 m²

However, the actual sites each have actual buildings which total a GIA of 50,000 m² each, i.e. a total of 100,000 m². The optimised MEA GIA for each is £40,000 m²

Further to the proposed changes to the process, the hypothetical model will have to be re-calculated so that the new hypothetical optimised single building on each site is based on a MEA GIA of 40,000 m².

The weighted average remaining lives for inputting to the DRC valuation, for each actual site's hypothetical single building, is calculated using only the remaining lives of the specialised buildings on that actual site.

The resulting weighted average Remaining Life (and Age/Year if the elemental approach) is adopted) will be adopted for that site's optimised MEA model.

This differs from the current valuation where the weighted average of the Remaining Lives and Ages/Years is calculated to reflect all of the buildings across the two sites being “merged” into one hypothetical building, on one site.