HM Treasury

Financial Reporting Advisory Board Paper

Issue:	An update on the responses to the Exposure Draft on the valuation of non-investment assets, setting out the proposed changes to asset valuation for financial reporting purposes.
Impact on guidance:	Subject to the Board's agreement, the FReM will be updated to reflect the proposals put forward in the Exposure Draft, with any additional changes agreed by the Board following the consultation. Application guidance is being drafted by the VOA, and will be brought back to the Board at a future meeting for approval.
IAS/IFRS adaptation?	Yes – the proposals will change the IAS 16 and 38 adaptations in the FReM.
Impact on WGA?	Yes – the proposals will change the measurement of some IAS 16 and 38 assets in the WGA.
IPSAS compliant?	Yes – the proposals are considered to be substantially compliant with IPSAS. They align with the principles of IPSAS 46 (Measurement) and 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 prescribe a differential valuation regime, based on asset type
Impact on budgetary regimeand Estimates?	Yes – but the changes will remain consistent with accounting treatment
Alignment with National Accounts	No – but WGA asst values and depreciation are not used as a National Accounts data source.
Recommendation:	That the Board consider and agree each of the recommendations made by HM Treasury in response to the Exposure Draft consultation. That the Board review and provide comments on the application guidance being drafted by the VOA.
Timing:	HM Treasury are proposing 25/26 as the effective date of any changes to FReM guidance.

Non-Investment Asset Valuation

Executive Summary

1. Following the November FRAB meeting, HM Treasury published the Non-Investment Asset Valuation Exposure Draft on 14th December 2023, and the consultation closed on 16th February 2024.
2. HM Treasury received 29 responses from a variety of organisations, including central government departments, auditors, valuers, and representatives of the accounting sector.
3. HM Treasury have collated and analysed the responses to each question. Overall, there was broad support for the changes being proposed to the valuation of non-investment assets. It was acknowledged by respondents that the proposals aim to strike a balance between high quality financial reporting, the costs of the valuation regime, and the benefits to users.
4. Some respondents felt that the simplification of the reporting of non-investment assets could have gone further, but still felt that the proposals in the Exposure Draft are a welcome effort to reduce complexity.
5. Following the review of consultation responses, HM Treasury has summarised the key themes below. In some cases, HM Treasury is proposing to make changes to the approach set out in the Exposure Draft, in others HM Treasury is not proposing to make changes; in each case, HM Treasury will set out its recommendation for FRAB's consideration and the rationale.
6. Once FRAB has considered each of the recommendations below, HM Treasury will update the draft FReM text. Smaller points of drafting/detail will also be incorporated, and the updated text will then be circulated to FRAB members for final comments by exception.
7. In addition, HM Treasury is proposing to convene a meeting of the non-investment asset working group to consider any other more minor points raised through the consultation, and in particular areas where requests were made for further clarification/guidance.
8. The VOA have begun drafting application guidance based on the new approach to non-investment asset valuations as set out in the current Exposure Draft. This is attached as Annex A for reference. Following FRAB's discussion of the recommendations in this paper, and comments on the initial draft of the application guidance, HM Treasury will provide feedback to the VOA. The VOA will be invited to present the draft to the non-investment asset valuation working group for further discussion. A refined version of the application guidance will then be brought back to FRAB for approval ahead of publication.

Exposure Draft Responses – Key Themes

<u>Introduction of assets held for operational capacity</u>

9. Respondents were broadly in favour of the introduction of this new asset class - assets held for their operational capacity - and agreed that it would remove uncertainty and the use of judgement in allocating classes. Respondents also agreed that assets held for their financial capacity should not be introduced as an asset category to the FReM.

10. It was suggested that 'assets held for their operational capacity' should be described as a new asset category rather than a new asset class, to avoid the term being used differently to IAS 16 and IFRS 16.
11. One area where some comments were received was around the inclusion of networked assets in the new category of assets held for their operational capacity, given the specific accounting requirements for assets in this category. Comments highlighted the complexity of valuation of these types of assets and information deficit issues specific to the local government sector, rather than more fundamental comments about the changes under proposal. HM Treasury therefore remains of the view that network assets should be incorporated into the new assets held for their operational capacity class, whilst acknowledging that specific guidance relating to the treatment of networked assets may be required. On this basis HM Treasury does not propose to make any changes to the FReM text in the Exposure draft relating to networked assets.
12. **Recommendation:** HM Treasury recommends that the new asset category – assets held for operational capacity – is introduced as set out in the Exposure Draft. The term 'asset category' will be used rather than 'asset class'.
13. Given the variation in the type of networked assets, HM Treasury proposes to include this as an item for the non-investment asset working group to discuss, in conjunction with the VOA as authors of the application guidance.

Proposed processes for asset valuation

14. Respondents were broadly supportive of the move to simplify the options available for asset valuations. Many were also supportive of the proposed use of indexation between valuations, but some respondents had reservations. There was a concern that reliance on indexation could result in volatility at each quinquennial valuation, and some respondents therefore felt that the option to allow more frequent desktop valuations and/or annual valuations where the entity felt it was appropriate in specific circumstances, should be retained.
15. One respondent noted that the process as currently set out would capture downward movements for assets subject to short-term price fluctuations through impairment reviews, but that there was no mechanism for capturing upward movements.
16. A concern was raised that it was not clear what approach an entity should adopt in interim years in circumstances where there is no acceptable index available.
17. Some respondents queried whether the shift in emphasis from valuers to accounts preparers in determining the most appropriate valuation process was appropriate, and highlighted the risk that it could result in entities defaulting to an index-only approach. It was also suggested that terminology could be improved; it may be appropriate for preparers to determine the valuation 'process', but for valuers to determine the appropriate 'methodology'.
18. **Recommendation:** HM Treasury recognises that there is a balance to be found between encouraging consistency of approach and allowing entities sufficient flexibility to respond to exceptional circumstances.
19. HM Treasury therefore proposes allowing entities the option to undertake desktop/interim revaluations of an asset *by exception* in an interim year, for example in years where there has

been significant capital expenditure on an asset, or if there is an indication that the carrying value has materially changed. This flexibility should help to mitigate the risk of a volatility at the point of quinquennial valuations, and would also allow the recognition of unexpected increases to asset value due to unusual local circumstances not captured by a standard index.

20. HM Treasury therefore proposes including the following text in the FReM guidance:

    "In years where it is considered likely that an asset value has changed materially due to exceptional circumstances, and it is therefore considered that revaluation by application of an index would not be appropriate, for example due to significant capital expenditure on an existing asset, entities may choose to undertake a desktop or interim valuation instead of applying index. This option should only be exercised by exception when circumstances mean that the entity considers it absolutely necessary, and the change in value is likely to be material. Entities may also choose to undertake desktop or interim valuations for assets in exceptional circumstances where the entity considers that there is no appropriate index available".

21. At the FRAB meeting in November 2023, it was agreed that accounts preparers should use judgement to determine which revaluation process is most appropriate. However, HM Treasury will replace the word 'methodology' with 'process' in the draft FReM text –

    'It is for accounts preparers (where necessary, in consultation with their valuers and using the RICs Red Book) to determine the most appropriate revaluation process ~~methodology~~ for an asset'.

<u>Revaluation Cycle</u>

22. Most respondents agreed with the proposal to mandate a five-year revaluation cycle, although some suggested this should be a rebuttable presumption rather than a requirement. Some respondents also proposed that more frequent revaluations should be allowed for portfolios where, for example, there has been a significant level of capital expenditure on an asset during the accounting period.

23. **Recommendation:** HM Treasury's position remains that the revaluation cycle should be five years. However, as above, FRAB may wish to consider whether to allow entities some flexibility to undertake interim/desktop valuations by exception, for example in years of significant levels of capital expenditure.

<u>Alternative Site Valuations</u>

24. There was general agreement with the proposal that the consideration of alternative site valuations when valuing an asset using DRC should be removed as an option from the FReM on the basis that this would simplify the valuation process, provide greater clarity to valuers and auditors, and that it would reduce the uncertainty associated with an accounting treatment that relies on a future policy decision.

25. There were, however, concerns about the potentially material impact of this change on accounts, particularly in the health sector. For NHS bodies, a move away from alternative site valuations and a subsequent increase in asset values could have an impact on their revenue position through increased PDC and depreciation payments.

26. Some respondents also raised concerns about the appropriateness of entities maintaining the alternative site valuation measurement basis for some or all of their portfolio throughout the five-year transition period if it is no longer acceptable in the FReM.

27. **Recommendation**: HM Treasury remains of the view that alternative site valuations should no longer be permitted under the FReM, in order to streamline the valuations process and provide greater clarity and consistency overall. HM Treasury is not proposing to prohibit entities from undertaking a full revaluation to eliminate alternative site valuations from their portfolio in the first year of transition. Where entities adopt a phased approach, clear disclosure will be required.

Valuation of Intangible Assets

28. Respondents largely agreed that the historical cost basis was appropriate for intangible assets and were content with the adaptation proposed by HM Treasury.

29. **Recommendation:** No change to proposal for treatment of intangible assets as set out in Exposure Draft.

Indexation

30. Respondents acknowledged the challenge of prescribing indices centrally given the wide asset base held by the public sector. However, concerns were raised that without guidance on what indices are considered acceptable, the audit burden would be increased. The cost of procuring indices was also raised as a concern.

31. A suggestion made by some respondents was that the application guidance should include guidance on the selection of indices, with examples of indices considered appropriate. Some respondents suggested going further and creating a rebuttable presumption that indices listed in the guidance will be used unless the entity can demonstrate that an alternative is more appropriate. Areas where further guidance on indices were specifically mentioned included agricultural land, land held for development, social housing, and geographic variations.

32. **Recommendation:** HM Treasury does not believe it would be feasible or desirable to prescribe mandated indices for all entities, as the choice of appropriate indices is a matter of professional judgement to be undertaken in the context of knowledge of the asset base. However, HM Treasury recommends that, following discussion with the working group and the VOA, a list of possible acceptable indices will be included in the application guidance, to support preparers of accounts. This should encourage consistency in approach across sectors and between public sector bodies with similar asset classes. The guidance will be clear that the list is neither prescriptive nor exhaustive.

Further guidance

33. Areas where respondents felt that further clarification and/or guidance would be helpful included:

- Valuation of peppercorn leases
- Indexation (including appropriate indices, as above)

- Treatment of capital expenditure
- Transition (particularly around the treatment of alternative site valuations)
- Networked assets

34. **Recommendation:** HM Treasury has already shared areas raised in the consultation with the VOA. Following this discussion by the Board, HM Treasury will convene a meeting on the non-investment asset working group and the VOA to discuss the content of the application guidance.

<u>Transition</u>

35. Respondents were broadly content with the proposed implementation date of 2025/26, although some preferred a delay until 2026/27. Some respondents highlighted that the implementation date coincides with the adoption of IFRS 17 and TCFD, and that multiple changes at once could put a strain on resources.
36. The particular challenge associated with moving away from valuations done on an alternative site basis was also raised, as were the current issues in the local audit system. If the implementation date remains 2025/26, respondents emphasised the importance of the publication of guidance as early as possible.
37. **Recommendation:** On balance, HM Treasury recommends that 2025/26 remains the implementation date. HM Treasury will work with the non-investment asset working group and the VOA to finalise the application guidance and publish it as early as possible. HM Treasury has been explicit that changes will be applied prospectively and entities will not be required to restate prior year comparatives as a result of these changes.

<u>Disclosure Guidance</u>

38. Respondents were broadly content with HM Treasury's conclusions on disclosure guidance as set out in the Exposure Draft. Some respondents queried whether the requirements of IAS 8 would need to be applied upon initial application of the accounting policy, including whether narrative would be required in the 24/25 accounts. Respondents also suggested that disclosures should continue to apply throughout the five year transition period as long as the transition impact remains material. It was suggested that standardised wording that had been agreed with the NAO, would be useful for preparers.
39. If entities are permitted to retain alternative site valuations until the end of their cycle of valuations (so throughout the transition period), respondents felt that this should be explicitly stated in the FReM and would require clear disclosure throughout the transition period.
40. **Recommendation:** At the November FRAB meeting, FRAB members agreed that entities should be permitted to retain alternative site valuations until the end of their cycle of valuations, or to revalue all sites valued on an alternative site basis at the point of transition, as they prefer.
41. A decision from FRAB on whether to allow interim/desktop valuations by exception will influence whether a further adaptation to IAS 16 is required.

42. As set out in FRAB 151 (05) HM Treasury recognises that the changes to accounting requirements for the valuation of non-investment assets are a change in accounting policy and a change in accounting standards. HM Treasury remains of the view that these changes should be applied prospectively from 1 April 2025, and entities will not restate prior year comparatives as a result of these changes. HM Treasury therefore proposes the following adaptation to IAS 8:

"Throughout the transition period, entities applying the FReM do not need to follow the requirements of IAS 8 following a change in accounting policy. Changes to the valuation of non-investment assets as set out in the FReM will be applied prospectively, with no restatement of prior year figures, supported by clear disclosure".

Next Steps

43. HM Treasury will update the draft FReM text based on FRAB's response to each of the proposed recommendations above, and incorporating other minor drafting points raised in the consultation. The updated text will be shared with FRAB for comment by exception.

44. Following the Board's discussion, feedback will be provided to the VOA on their initial draft of application guidance. HM Treasury will also convene a meeting of the non-investment asset working group and the VOA to discuss the guidance in more detail. A final version of the application guidance will then be brought back to FRAB for approval.

45. Following FRAB's approval, HM Treasury will make the required updates to the FReM text and publish these alongside the application guidance.