HM Treasury

Application Guidance for Preparers and Valuers Changes to FReM

1. Background

1.1 HM Treasury earlier published an Exposure Draft (ED) to consult on changes that will affect Government 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 Intangible Assets (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.

1.2 These changes have now been approved by FRAB (HM Treasury's Financial Reporting Advisory Board) and are effective from 1st April 2025.

2. Purpose of this Guidance

2.1 The purpose of this guidance is to outline a recommended process for valuers and preparers (where impacted) where the 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.

3. Valuation Significant Changes

3.1 HM Treasury's 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 an asset held for its operational capacity.

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3.2 HM Treasury have reduced the number of processes entities can use when revaluing their assets to three, being:

3.21 A quinquennial revaluation supplemented by annual indexation in intervening years

3.22 A rolling programme of revaluations over a 5-year cycle, with annual indexation applied to the non-inspected proportion of assets during the four intervening years.

3.23 For non-property assets only, to utilise appropriate indices.

3.3 Whilst it is the clear intention of HM Treasury that entities should not undertake full professional revaluations in between the quinquennial intervals other than in very exceptional circumstances, in rare circumstances where an index is not available, entities may commission an interim desktop revaluation at year three of the quinquennial cycle.

3.4 The HM Treasury proposed effective date of financial year 2025-26 for the changes.

4 Recommended Guidance for Preparers and Valuers

4.1 HM Treasury's 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.

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

4.3 2023-24 FReM at 10.1.4 states that “Assets which are held for their service potential (i.e. operational assets used to deliver either front line services or back-office functions) should be measured at their current value in existing use. For non-specialised assets current value in existing use should be interpreted as market value in existing use which is defined in the RICS Red Book as Existing Use Value (EUV). For specialised assets current value in existing use should be interpreted as the

present value of the asset's remaining service potential, which can be assumed to be at least equal to the cost of replacing that service potential".

4.4 However, the valuation "Basis" remains at "Current Value in Existing Use" (EUV).

4.5 From a valuation perspective there is no change to the valuation method to be adopted in arriving at the EUV basis of valuation, this will still follow the existing RICS Red Book definition at UKVPGA 6.

4.6 Where in the valuer's opinion a property asset is so "specialised in nature" (for example a prison wing or a hospital ward block) that a market does not exist for the valuer to draw a satisfactory body of transactional evidence in order to establish a valuation to Current Value in Existing Use (EUV), then the valuer will adopt Depreciated Replacement Cost (DRC) methodology as set out in RICS Depreciated Replacement Cost Method of Valuation for Financial Reporting Guidance Note 2018, to arrive at the EUV valuation.

4.7 Equally, where sufficient market transactional evidence is available (ie the property is not so specialised in nature for example an office building) 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 and UKVPGA6.

4.8 HM Treasury states in the revised 2025-26 FReM at para 10.1.11 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.

4.9 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.

4.10 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'.

4.11 For **Northern Ireland** entities can continue to use (Social Housing) Stock Valuations for Resource Accounting guidance as this is an exceptional case: Notwithstanding that it is the clear intention of this HM Treasury process that entities will, other than in very exceptional circumstances, only commission professional revaluations each five years, given the exceptional circumstances and need for consistency with Local Government in GB, Northern Ireland Housing Executive (NIHE) can continue with the (Social Housing) Stock valuation for Resource Accounting.

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

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

5.2 Instructions to provide valuation advice will be limited to those entities requiring valuations in line with paragraphs 3.21 or 3.22 above.

5.3 The intervening years can be dealt with in-house by the entities adopting indexation.

5.4 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 (for DRC valued assets).

6. 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).

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

6.2 However, the following are published national indices:

- "BCIS all-in TPI (Tender Price Index)" 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.

As an index of building cost inflation only this should only be used for cost-based DRC valuations and is not suitable for valuations of land or assets on an EUV (comparable) basis.

- Land Registry currently produces it's UK House Price Index by region.
- ONS publish it's "Private Rents and House 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.
- Some larger national firms of surveyors do publish monthly reports of general movements in the market such as CBRE and Jones Lang Le Salle among others.

6.3 **Other Potential Sources**

a) MSCI- the American finance company who took over what used to be the Investment Property Databank Index may be able to assist entities with commercially available indices for property market movements.

b) Costar- a commercially available database may also be in a position to assist entities.

c) PROMIS- another commercially available database using source data from sources including MSCI.

6.4 HM Treasury is not proposing to mandate the use of any particular index, but a couple of points should be borne in mind by entities when considering the options:

6.41 Any index which is not based on actual market evidence is more likely to lead to a risk of divergence in indexed values compared to the professional valuations produced by market evidence at the quinquennial revaluation at year five.

6.42 Commercially provided indices are typically based on a relatively limited transactional database.

6.43 BCIS is only a measure of building construction cost inflation or deflation. It is inherently unsuitable as a proxy for the valuation of in use non-DRC valued "non-specialised" in nature assets valued to EUV.

6.44 For example, during the aftermath of the financial crisis in 2008/9 the BCIS building construction cost index fell by between 10 and 12%, but as this is not related to

market value, a considerable gap opened up between the indexed values and market values.

6.45 Similarly in the post pandemic period and with the impact of the Ukrainian conflict building costs rose as reflected in the BCIS index, and hence, again these then diverged from market values. Such a divergence from market values could be problematic, and indeed potentially exacerbated further by entities each opting for a different indexing option, and understandably leading to additional audit scrutiny.

6.46 The recommended pathway forward regarding indexation would be:

i) For property assets valued to DRC the use of BCIS “All in TPI” indices would be an acceptable index. Indeed, this index is already a key element in any DRC revaluation process. Entities will need to make arrangements for access with BCIS directly.
ii) For property assets which are valued to EUV by market comparison (non-specialised in nature) an index properly evidenced by property transactional evidence and by economic or government region would be preferred. This would apply to main categories of EUV valued property such as Offices, Industrial and Residential.
iii) For Land an index of movement by region in valuation properly evidenced by market transactional evidence in respect of categories of land including Residential, Industrial and Agricultural.

7 Impairment

7.1 The cost of enhancements to existing assets (such as building of a new wing within an existing prison) should be capitalised during the construction phase as an asset under construction. At the first valuation after the asset is brought into use, any write down of cost should be charged to the Statement of Comprehensive Net Expenditure.

7.2 In assessing whether there is any indication that an asset may be impaired, a entity shall consider the indicators set out in IAS 36 (see Appendix 1).

7.3 Undertaking a full revaluation should not be a default process to demonstrate there has not been a material impairment of an asset and comply with IAS 36. Rather, it should be the consideration of impairment indications which determine whether the

recoverable amount of an asset needs to be calculated and therefore whether a full revaluation is needed or not before the next revaluation. IAS 36 paragraphs 12-14 sets out the indicators entities must consider when determining whether an asset is impaired.

7.4 IAS 36 paragraphs 12-14 do not necessarily require entities to undertake full revaluations each year to comply with the Standard. As such, HM Treasury do not expect entities to undertake a full, professional revaluation of an asset to demonstrate it is not impaired.

8 Choice of revaluation process

8.1 Should the entity choose a quinquennial revaluation with indexation in intervening years, 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.

8.2 Alternatively, should the entity select 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.

8.3 There is additionally a limited option of last resort to hold in interim desktop revaluation at year 3, should reliable indices not be available without undue cost or effort.

9 Effective date of financial year 2025-26 for the changes.

9.1 This has no direct impact on the valuer or preparers’ processes other than it is understood that revaluation instructions will not be required for prior year in the transitional period, as HM Treasury have not required the changes to the valuation regime to be retrospectively applied; they are applied prospectively.

10. IFRS16 RoU (Right of Use) and Peppercorn leases

10.1 There is no change to the valuation methodology under the new regime aside from those already described above.

11. Worked Example with CAPEX (Capital Expenditure)

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

11.2 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).

11.3 If the valuer is adopting the “Top Down” Holistic approach they will adjust the GRC by an appropriate percentage adjustment.

11.4 In the case of an “elemental build up” valuation both the year will be adjusted and remaining life, so for example, if the windows had all been original in 1970 and only say 5 years remaining life before the replacement, the valuer will change this to 2024 and 60 years remaining life. This has the effect of increasing the Net Replacement Cost but reducing the annual depreciation for that element (windows) of the DRC valuation.

11.5 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.

11.6 The DRC valuation will be based on a cost per m^2 provided by specialist-chartered building surveyors or other source such as BCIS.

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

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

12.1 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.

12.2 Where the building is "non-specialised in nature", as an example, a building in the ownership of a single entity such as a Central Government Department, mainly used as offices of say 2,000m2 NIA (Net Internal Area) but part used as an occupational health facility of 1000m2 NIA. The valuer will adopt a rent per m^2 appropriate for the identified uses within the building, and also adopt market yields appropriate to that use.

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

12.4 In this example, as separate uses, the EUV would be calculated as follows:

Offices: 2,000m2 NIA at market rent of £120 pa = £240,000

Capitalised in perpetuity at a yield of 8% hence YP (Years Purchase) 12.5

Producing a capital value of £3,000,000.

Occupational Health: 1,000m2 NIA at £150/m2 = £150,000

Capitalised in perpetuity at a yield of 8% and YP (Years Purchase) 12.5

Producing a capital value of £150,000 X 12.5 = £1,875,000

Total EUV valuation for the asset is £3,000,000 plus £1,875,000 = £4,875,00

Appendix 1

IAS 36 Indicators with commentary.

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 in nature asset values but not specialised in nature assets valued to DRC.

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

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- 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.

- For the entity to assess internally.

(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.

- For the entity to assess internally.

(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.