



HM TREASURY

Financial Reporting Advisory Board Paper

Capital Charging and Asset Valuations Group

Issue:	A report on the work of the Capital Charging and Asset Valuations Group
Impact on guidance:	We are too early in the process to assess the impact on guidance.
UK GAAP adaptation?	N/A at this stage
IAS/IFRS compliant?	N/A at this stage
IPSAS compliant?	N/A at this stage
Impact on budgetary regime?	We are too early in the process to assess the impact on budgets.
Recommendation:	To note the progress made by the Group
Timing:	A further update to be provided at the May 2006 meeting

DETAIL

Background

1. In October of 2005 the Treasury established a Capital Charging and Asset Valuations group. The purpose of the group is to consider the incentives, or otherwise, that capital charging and impairments bring to asset management – in particular the incentives for disposals. The issue first came to the Board's attention during the discussion of the paper on capital charging in the NHS (FRAB (70)03), prepared by the NHS, at the 9th December 2004 meeting.

2. The group has focused on the impact the various regimes have on the ability of public sector bodies to manage their estates, looking particularly at specialised buildings. Many within the Accountancy and Valuation communities felt that the interaction of the Royal Institute of Chartered Surveyors (RICS) Depreciated Replacement Cost (DRC) guidance with the accounting and budgeting regimes, in certain circumstances, created perverse incentives. Public Sector bodies were

frequently unable to dispose of unwanted buildings because they cannot afford the impairment incurred on the write down of the asset from one in use to one available for sale. Similarly, modernisation of an estate was often penalised through the impairment of new builds written down from construction cost to valuation.

3. At an early stage in the process the group discussed what it perceived to be the root causes of these issues. The following were identified:

- the site values assigned by the valuer when providing DRC valuations;
- the use of identical replacement cost (including the impact of DRC and modern replacements cost) by valuers;
- the difficulty in establishing functional obsolescence;
- the differing treatment of finance costs in valuation and accounting guidance;
- the impact of impairments;
- the difficulties involved in assessing building condition;
- the impact of indexation on asset values;
- the lack of consistency in the creation of the revaluation reserves for assets when resource accounting and budgeting commenced;
- the differing depreciation periods used by accountants and valuers for buildings; and
- existing use value vs. alternative use value

4. Sub groups were created to examine each of these issues. Each sub group took away one or more issue and was asked to consider each afresh. No pre-conditions were placed on the sub groups: the terms of reference provided to them were to consider the problem, identify its cause and propose solutions.

5. The solutions proposed were presented to a full meeting of the group in January of this year. HM Treasury's Central Accountancy team consolidated the work of the sub group bringing together the proposed solutions. These solutions fell into 3 categories:

- those that required changes to the RICS DRC valuation guidance;
- those that required changes to HM Treasury's budgeting guidance; and
- those that required changes to HM Treasury's accounting guidance.

RICS DRC guidance

6. The Public Sector Valuation Group (PSVG) of RICS has as part of an unrelated exercise re-examined the DRC guidance. This re-examination has resulted in the preparation of revised draft

guidance which, through changes in emphasise and clarification, address most of the problems identified by the sub groups as being caused by the existing guidance.

HM Treasury' budgeting guidance

7. The main suggestion made by sub groups was that impairments (other than those relating to accidental damage) are scored in Resource Annually Managed Expenditure (RAME) rather than Resource Departmental Expenditure Limit (RDEL). This change relieves Departments of the impairment burden, as it would in future score such expenditure outside the budget over which the Department is deemed to have direct control. We have indicated to the group that taking this proposal forward will be difficult but we have undertaken to consider the proposal in detail.

HM Treasury accounting guidance

8. The main suggestion made by sub groups was that the requirement to index assets for the purpose of current cost accounting should be withdrawn. This requirement is an adaptation of FRS 15. We have indicated to the group that we are happy to consider the proposal in detail as we believe it has merit as it reduces volatility and relieves the burden that the application of full modified historical cost accounting (MHCA) places on departments. However, the proposal can only be taken forward as a move to full application of FRS 15.

Next Stage

9. We have created further sub groups to consider the proposed changes in accounting and budgeting guidance and will report further at the May FRAB meeting.

Summary and recommendation

10. That FRAB note the progress made by the Capital Charging and Asset Valuations group.

HM Treasury
20 March 2006