



HM TREASURY

Financial Reporting Advisory Board Paper

ASSET VALUATION

Issue:	Giving greater freedom to entities in the way in which they meet the FRS 15 requirement to carry assets at value; aligning the text on FRS 11 with the changes to the Consolidated Budgeting Guidance; providing additional guidance on the interpretation for the public sector on depreciated replacement cost and asset valuation generally.
Impact on guidance:	Minor amendments to the text for FRS 15 (Annex A); additional text on FRS 11 (Annex B); stand-alone guidance is attached at Annex C.
UK GAAP adaptation?	Yes
IAS/IFRS compliant?	No, since it is a UK GAAP adaptation
IPSAS compliant?	No, since it is a UK GAAP adaptation
Impact on budgetary regime?	No. The proposal to value the actual site under DRC and not a notional site is made from a budgetary context.
Recommendation:	That the Board approve the amendments to the FReM in Annexes A and B and the guidance at Annex C.
Timing:	2007-08

DETAIL

Background

1. At its meeting on 12 February 2007, the Board agreed the amended wording for FRS 15, but asked for additional time to consider the proposals in respect of impairments (FRS 11) and the additional guidance. Board members were asked to contact the Treasury to raise any specific concerns. This paper responds to those concerns and seeks the Board's approval to the proposed changes.

Accounting treatment of impairments and revaluations

2. Some Board members were concerned that entities are accounting for impairments and revaluations inconsistently. The Treasury agrees that there might be some inconsistent treatment, but believes, from the work it has done on asset valuation, that there is a more fundamental source of confusion – and that is that the difference between impairments and revaluations is not clearly understood.
3. Under FRS 11 and FRS 15, impairments should be accounted for through profit and loss where there is a permanent diminution in value as the result of a clear consumption of economic benefits (or, in the public sector context, service potential). Other movements in value will be accounted for through the Statement of Total Recognised Gains and Losses (that is, through reserves). In the public sector, the accounting treatment should follow exactly these requirements – but, in practice, there are some differences. The main difference is that some departments did not establish revaluation reserves at the inception of resource accounting and so had (and some continue to have) no revaluation reserve against which they might set downward valuation movements that are not impairments.
4. The revised text for FRS 11 (Annex B provides the existing FReM text for FRS 11, marked up to show the proposed changes) is designed to clarify the difference between a revaluation and an impairment; tells accounts preparers that impairments should always be charged to the Operating Cost Statement; and explains that an impairment might also result in a movement between reserves (from the revaluation (or donated asset or government grant) reserve to the General Fund or equivalent).
5. The National Audit Office raised the question of what impact the revised classifications of impairments might have on the audit of financial statements. In particular, the National Audit Office is concerned that its auditors will become the arbiters of what is DEL and what is AME. The Consolidated Budgeting Guidance (CBG) impairment categories (now included in the FReM text for FRS 11 at Annex B) are based on the requirements of National Accounts and have been agreed by the Office for National Statistics' National Accounts Classifications Committee.
6. In developing the proposals, the Treasury recognised the risk that departments would seek to claim impairments inappropriately as AME, thereby reducing the DEL impact. After discussion with departments represented on the Asset Valuation and Capital Charging Group, the Treasury concluded that there are sufficient controls in place to prevent this from happening. DEL impairments represent management failure, and the Treasury would not normally, therefore, expect bids for DEL impairment cover in the main Estimates. AME impairments would, in the main, be unforeseeable and so the main Estimate should only (in rare cases) detail those pre-approved, foreseeable AME impairments. In practice, the Treasury expects that AME impairments will be asset specific and only reflected in the winter or spring supplementary Estimates as appropriate.

Interpreting Valuation Information Paper 10 for the public sector context

7. The Treasury proposes that the guidance issued by the Royal Institution of Chartered Surveyors' (RICS) in its Valuation Information Paper 10 *The Cost Approach for Financial Reporting* (VIP 10) should be interpreted for the public sector context, in order to achieve consistency without uniformity and to support the measurement of the cost of government policy – which valuing a notional site would not provide. The RICS Public Sector Valuation Group (PSVG), when developing VIP 10, acknowledged that additional guidance would be required precisely for these reasons and, initially,

intended to include some of our proposals (for example, 'instant build') into VIP 10. For various reasons, this turned out not to be possible, and so the PSVG agreed that the Treasury would need to issue the guidance itself. The Treasury recognises that this will mean changes in valuation approaches in some areas, and Treasury spending teams stand ready to discuss their impact with spending departments.

8. The Treasury has aimed to keep any interpretation of VIP 10 to a minimum, but believes that it is appropriate to require consistency in application across the whole of the public sector. The Treasury does not believe that in so doing it is preventing valuers from using their professional judgement. The Treasury is proposing that certain options be removed, and that, for the reasons given in paragraph 5, some interpretations are needed, as set out below.

- VIP 10 argues that it is nearly always inappropriate to value a reproduction, and the Treasury agrees. Entities should, therefore, always follow VIP 10 and value a modern equivalent building (unless, exceptionally, the relevant authority approves otherwise); but
- entities should not follow VIP 10 when deciding on the site on which the modern equivalent building would sit. Instead, entities should normally value the existing site by reference to the prevailing use in the vicinity, thereby reflecting government policy to deliver services from that site (and the cost of that policy). The exception is where an entity has clearly documented and agreed plans to relocate, when the entity should follow the requirements of VIP 10 and value the alternative site.
- Other changes have been made to ensure that, when valuing the existing site, valuers will be able to take account of the difficulties of valuing a site that is sub-optimal in that there will not be, for example, the unfettered access that is assumed when valuing a notional (alternative) site; and
- entities are required to use the 'instant build' approach, in order to remove the subjectivities associated with assuming that the works will be phased. This has several advantages: the date of land values and buildings values will align (no such alignment exists when using the phased works approach); there will be no need to determine a reasonable length for the contract; and finance costs can be ignored (which is in line with existing policy).

Amendments to the application of FRS 15

9. In the light of comments made by Board members, changes have been proposed to the text relating to FRS 15 to:

- recognise the primacy of the FReM over the additional guidance by bringing into the FReM (paragraph 5.2.7(d) at Annex A) the interpretation for the public sector context that, in applying the RICS VIP 10, entities should value the site they occupy, with reference to the prevailing use in the vicinity, except where there is a clear and agreed relocation plan. This interpretation is needed to ensure that financial statements represent faithfully the financial consequences of government policy;
- require reference (paragraph 5.2.7(g)) in the management commentary to the values of the existing sites where alternative sites have been valued; and

- correct the misleading impression in paragraph 2.4 of the Guidance on Valuations (Annex C) that interim valuations depend on materiality. The sentence was intended to refer to any valuations in the years between the quinquennial valuations and interim valuations. The word 'additional' is now used to refer to these valuations.

10. In the light of the Treasury's consideration of concerns raised, no changes have been made to the text in the following areas:

- the concept of materiality has not been introduced to paragraph 5.2.7(g) in Annex A, which allows entities to elect to use depreciated historical cost as a proxy for current value. The Treasury has re-considered its position, expressed at the last meeting, that we need this form of words to ensure departments can avoid the burden they would face in proving to their auditors each year, through calculating the current value, that the differences were not material. The Treasury believes that the experience built up since the inception of resource accounting, taken with the requirement that the assets should be of low value or short life or both and that the depreciation methodology should be relevant to that asset class, should be sufficient for accounts preparers and auditors to reach a reasonable conclusion on whether the depreciated historical approach is appropriate; and
- the FReM text (paragraph 5.2.7(a) of Annex A) continues to allow a rolling programme of valuations for specialised properties. The Treasury believes this to be consistent with paragraph 44 of FRS 15, which recognises that the details in paragraphs 45 to 52 of FRS 15 might not be appropriate for public sector organisations on cost/benefit grounds and permits alternative approaches. The Ministry of Defence has adopted this a rolling programme of valuations for its portfolio of specialised assets since the inception of resource accounts.

Summary and recommendation

11. The Treasury has considered the concerns raised by Board members at or following the February meeting and, in the light of those concerns, has reconsidered the amended text for the FReM relating to FRS 11 and FRS 15 and the additional guidance, as brought to the FRAB at that meeting.

12. The Treasury has concluded that it is appropriate to interpret the RICS VIP 10 to ensure consistency without uniformity in accounting practice, although the Treasury recognises that this will change valuation approaches in some areas and that departments will want to discuss impacts with their spending teams. However, recognising the primacy of the FReM over the additional guidance, amendments are proposed to the FRS 15 text to incorporate the interpretation that the actual site should normally be valued and to require additional commentary where alternative sites have been valued.

13. Preparers and auditors have built up considerable experience since the inception of resource accounting. That, taken with the requirement that the non-property assets should be of low value or short life or both and that the depreciation methodology should be relevant to that asset class, should be sufficient for reasonable conclusions to be reached on whether the depreciated historical approach is appropriate.

14. The text on FRS 11 has been extended to incorporate the definitions of impairments already included in the Consolidated Budgeting Guidance and agreed by the Office for National Statistics' National Accounts Classifications Committee. The Treasury believes that, in practice, the classification of impairments between DEL and AME will be policed by the Treasury as part of the routine financial monitoring and as part of the supplementary Estimates process (and, probably rarely, as part of the Main Estimates process).

15. The Board is invited to approve the changes to the FReM as presented in Annexes A and B and the additional guidance in Annex C.

HM Treasury

19 March 2007

PROPOSED AMENDMENT TO THE GOVERNMENT FINANCIAL REPORTING MANUAL
FOR FRS 15

5.2 Tangible fixed assets

5.2.1 The following accounting standards and UITF Abstracts deal with accounting for tangible fixed assets:

FRS 15 Tangible fixed assets (paragraphs 5.2.2 to 5.2.23);

SSAP 19 Investment properties (paragraphs 5.2.24 and 5.2.25);

FRS 5 Reporting the substance of transactions (paragraphs 5.2.26 to 5.2.29);

SSAP 21 Accounting for leases and hire purchase contracts (paragraphs 5.2.30 and 5.2.31);

FRS 11 Impairment of fixed assets and goodwill (paragraphs 5.2.32 to 5.2.36);

SSAP 4 Accounting for government grants (paragraphs 5.2.37 to 5.2.41);

UITF Abstract 5 Transfers from current assets to fixed assets (chapter 6);

UITF Abstract 24 Accounting for start up costs (paragraphs 5.2.42 and 5.2.43);

UITF Abstract 28 Operating lease incentives (paragraphs 5.2.44 and 5.2.45);

UITF Abstract 29 Website development costs (paragraphs 5.2.46 to 5.2.48); and

UITF Abstract 31 Exchanges of businesses or other non-monetary assets for an interest in a subsidiary, joint venture or associate (paragraphs 5.2.49 to 5.2.51).

UITF Abstract 23 (Application of the transitional rules in FRS 15) is not likely to be relevant and is not discussed further in this Manual. However, if it is applicable, it should be applied in full.

FRS 15 Tangible fixed assets

Applicability

5.2.2 FRS 15 applies, as adapted in paragraph 5.2.5, to all entities covered by this Manual. Owing to their importance to the entities covered by the requirements of this Manual, separate guidance is included on:

infrastructure assets (paragraphs 5.2.9 to 5.2.12);

donated assets (paragraphs 5.2.13 to 5.2.17);

asset transfers (paragraph 5.2.18); and

heritage assets (paragraphs 5.2.19 to 5.2.23).

- 5.2.3 A worked example of accounting for a fixed asset using modified historical cost accounting and guidance on valuation issues are provided on the Manual's dedicated web site. *Additional Guidance on Asset Valuation* is also available on the web site.

Objectives of FRS 15

- 5.2.4 The objectives of FRS 15 are to ensure that consistent principles are applied to the initial measurement of tangible fixed assets, that valuations are performed on a consistent basis, kept up-to-date with gains and losses on revaluation being treated consistently, that depreciation is calculated consistently and recognised over the assets' useful lives, and that sufficient information is disclosed in the financial statements to enable users to understand the impact of an entity's accounting policies regarding measurement, valuation and depreciation of tangible fixed assets on the financial position and performance of the entity.

Adaptation of FRS 15 for the public sector context

- 5.2.5 The following general adaptations to FRS 15 apply to entities required to prepare their financial statements in accordance with the guidance in this Manual.

Recognition and measurement

- a) Gains on revaluation of fixed assets should be credited to the relevant reserve as follows:

Assets financed by grants in aid - the revaluation reserve (7.4.58)

Donated assets – the donated asset reserve (7.4.59)

Assets financed by grants, including any from the EU – the government grant reserve (7.4.60)

- b) Losses on revaluation (other than impairment losses reflecting losses of economic benefits (see FRS 11)) should be debited to the relevant reserve (see above) to the extent that gains have been recorded previously, and otherwise to the operating cost statement, unless it can be demonstrated that the recoverable amount is greater than the revalued amount in which case the impairment can be taken to the statement of recognised gains and losses.

Interpretations of FRS 15 for the public sector context

- 5.2.6 In applying FRS 15, entities should be aware of the following general interpretations for the public sector context.

Recognition and measurement

- a) All tangible fixed assets shall be carried at valuation so as to give a true and fair view of the value of those assets at the balance sheet date – that is, the option given in FRS 15 to measure at cost has been withdrawn, as has the option to value only certain classes of assets.

- b) It is not necessary to disclose the historical cost carrying amounts (where available) as required by FRS 15.
- c) Tangible fixed assets should be valued at the lower of replacement cost and recoverable amount, which is the higher of net realisable value or value in use. Where an entity cannot measure value in use in terms of income, value in use should be assumed to be at least equal to the cost of replacing the service potential provided by the asset (subject to any impairment of that service potential).
- d) Entities shall not capitalise any finance costs that are directly attributable to the construction of tangible fixed assets.

Valuations

5.2.7 In considering how best to apply the valuation requirements of FRS 15 so as to ensure that the balance sheet gives a true and fair view of the value of the assets at the balance sheet date, entities should consider the following guidance on property and non-property assets. (More detailed guidance is available on this Manual's dedicated web site.)

Property

Recognition and measurement

- a) Entities should value their estates using the most appropriate valuation methodology available in FRS 15. Such methods might include:
 - the approach set out in paragraphs 42 to 62 of FRS 15;
 - a quinquennial valuation supplemented by annual indexation and no interim professional valuation;
 - annual valuations; or
 - a rolling programme of valuations of properties (whether specialised or non-specialised).
- b) It is for valuers, using the Royal Institution of Chartered Surveyors' (RICS) 'Red Book' (RICS Appraisal and Valuation Standards), and following discussions with the entity, to determine the most appropriate methodology for valuing property. Where a valuer, following discussion with the entity, determines that a cost approach (otherwise known as depreciated replacement cost (DRC)) is the most appropriate, entities and their valuer should have regard to the RICS Valuation Information Paper No. 10 The Cost Approach for Financial Reporting, as supplemented by the additional guidance available on this Manual's dedicated web site.
- c) Where DRC is used as the valuation methodology, entities should normally value a modern equivalent asset in line with the Red Book. An entity should discuss with the relevant authority (through sponsoring bodies where appropriate) any plans to value a reproduction of the existing asset and determine whether such an approach is appropriate to the entity's circumstances.

- d) Where DRC is used as the valuation basis, entities should value the actual site from which they operate, with reference to the prevailing use in the vicinity, except where there is a clear and agreed plan to relocate (which might be medium term) when an alternative (notional) site can be used in line with the Red Book.
- e) The cost of enhancements to existing assets (such as the building of a new wing within an existing prison or adding a lane to a motorway) 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 treated as an impairment and charged to the operating cost statement.

Disclosure

- f) Entities should:
 - disclose in the accounting policies note: the fact that assets are carried at valuation in existing use. Entities should provide information about the approach to valuing their estates, including a statement (where applicable) that alternative sites have been used in drc valuations as a result of a relocation programme;
 - disclose in the notes on tangible fixed assets: the dates of the last valuations of those property assets that are subject to revaluation and the names and qualifications of the valuer; and
 - discuss in the Management Commentary, where they hold extensive estates: their estate management strategies; the indicative alternative use values provided by the valuer as part of the routine valuation work, and what those alternative use values mean in terms of their estate management policy. Where a notional site has been valued for a DRC valuation (because an agreed relocation plan is in place), entities should provide information about the value of the existing site, with reference to the prevailing use in the vicinity.

Non-Property

Recognition and measurement

- g) Entities may elect to adopt a depreciated historical cost basis as a proxy for current valuations for assets that have short useful economic lives or low values (or both). For depreciated historical cost to be considered as a proxy for current value, the useful economic life must be a realistic reflection of the life of the asset and the depreciation method used must provide a realistic reflection of the consumption of that asset class.
- h) Assets that are not covered by the above paragraph should be carried at current value. Entities should value such assets using the most appropriate valuation methodology available in FRS 15.

Disclosure

- i) Entities should disclose the following in the notes to their accounts in relation to the valuation of non-property assets:

in the accounting policies note: the fact that assets are carried at valuation in existing use; that depreciated historical cost is used as a proxy for current value for named classes of assets (where appropriate) and the reasons why; information about any significant estimation techniques (where applicable);

in the notes on tangible fixed assets: the dates of the last valuations of any non-property assets that are subject to revaluation and the names and qualifications of the valuer.

Other requirements

5.2.8 The following requirements should be observed by entities covered by this Manual.

- a) Following the annual review of the economic useful lives of assets or asset categories required by FRS 15, entities should discuss any significant proposals to change these lives with the relevant authorities (through sponsoring bodies where appropriate) to ensure that the budgeting implications have been properly considered.
- b) Entities might from time to time review their capitalisation thresholds or asset measurement methods. Any proposals for significant change to either must be discussed with the relevant authorities (through sponsoring bodies where appropriate) to ensure that the budgeting implications have been properly considered.

Infrastructure assets

5.2.9 Infrastructure assets comprise assets that form part of an integrated network servicing a significant geographical area – for example, road networks.

Adaptation of FRS 15 in respect of accounting for roads

5.2.10 Renewals accounting as applied to roads is an adaptation of FRS 15. The relevant authorities have determined that renewals accounting as set out in FRS 15 shall be used as a method of estimating depreciation for infrastructure assets, even where entities do not calculate the level of annual maintenance expenditure by reference to an asset management plan.

5.2.11 The road network is carried on the balance sheet at current replacement cost, adjusted to reflect the condition of the network. A full valuation of the network shall be undertaken at least every five years, supplemented by annual condition surveys. The condition surveys must be undertaken on a consistent basis and cover a significant and representative proportion of the road network. All renewals expenditure should be charged to the operating cost statement. If a condition survey reveals that the network has been maintained in a steady state since the previous survey, then no depreciation charge is required. However, if the condition of the network has deteriorated/improved between condition surveys, the value of the deterioration/improvement, if material, should be charged/credited to the operating cost statement and the carrying value of the assets adjusted accordingly.

5.2.12 In the years between the full valuations, the value of the network should be adjusted to reflect:

- a) material movements in prices using appropriate published indices;

- b) any expenditure on new schemes or enhancements which increase the capacity of the network in line with the treatment of enhancements to existing assets set out in paragraph 5.2.7 (c); and
- c) detrankings. Detrankings should be accounted for as disposals of assets for no consideration.

PROPOSED AMENDMENTS TO THE GOVERNMENT FINANCIAL REPORTING MANUAL FOR FRS 11

FRS 11 Impairment of fixed assets and goodwill

Applicability

5.2.31 FRS11 applies, as adapted in paragraph 5.2.34, to all entities covered by this Manual.

5.2.32 The worked example of accounting for a fixed asset under modified historical cost accounting includes the accounting entries required when the asset is impaired.

Objectives of FRS11

5.2.33 The objectives of FRS11 are to ensure that fixed assets and goodwill are recorded in the financial statements at no more than their recoverable amount and that any resulting impairment loss is measured and recognised on a consistent basis. In addition, sufficient information should be disclosed in the financial statements to enable users to understand the impact of the impairment on the financial position and performance of the reporting entity.

Adaptation of FRS11 for the public sector context

5.2.34 The following adaptations to FRS11 apply to the non-profit making activities of entities required to prepare their financial statements in accordance with the guidance in this Manual. Entities should apply FRS11 without adaptation to any income-generating activities.

Recognition and measurement

- a) References in FRS11 to the statement of total recognised gains and losses should be read to mean the revaluation (or donated asset or government grant) reserve. Only those impairment losses that do not result from a loss of economic value or service potential should be taken to reserves. Where such losses, which will generally be as a result of downward price movements, are taken to one of the reserves, it should be to the extent only that there is a credit value in the reserve relating to the impaired asset and only until the carrying value becomes equal to the depreciated historical cost. (For this purpose, 'historical cost' means the value at which an asset was taken on to the fixed asset register if no historical cost is otherwise available.) All losses that are as a result of a loss of economic benefit or service potential should be taken to the operating cost statement.
- b) Impairment charges in excess of the credit in the revaluation or other reserve or that lead to a reduction in value to below the depreciated historical cost should be charged to the operating cost statement unless it can be demonstrated that the recoverable amount is greater than the revalued amount in which case the impairment can be

taken to the statement of recognised gains and losses. For the recoverable amount to be greater than the revalued amount, entities must demonstrate that:

- I. they are not aware of any factors that have caused a substantial fall in usage or decline in the condition of the asset – that is, that the fall in value has not been caused by a consumption of economic benefits;
- II. for assets valued on an existing use value or other market-based valuation, the reduction is due to a short-term reduction in market prices, which informed opinion believes will be reversed in the medium term; or
- III. for assets valued on a depreciated replacement cost basis, changes in technology in the relevant sector are small, so that any downward movement in prices is likely to be short-term, as there are no noticeable improvements in technology or sustained falls in commodity prices that would cause prices to fall over the medium term.

Interpretation of FRS11 for the public sector context

5.2.35 In applying FRS11, entities should be aware of the following interpretations for the public sector context.

Recognition and measurement

- a) Where an asset is not held for the purpose of generating cash flows, value in use should be assumed to be equal to the cost of replacing the service potential provided by the asset, unless there has been a reduction in service potential.
- b) A reduction in service potential might arise for various reasons, including:
 - I. the purpose for which the asset was acquired is no longer carried out and there is no alternative use for the asset;
 - II. the asset is to be sold;
 - III. the asset cannot be used;
 - IV. the asset is otherwise surplus and has no alternative use; or
 - V. the asset is over-specified for its current use (for example, a hardened aircraft hangar used as a store).
- a) Where there is a reduction in service potential, the asset will be written down to its recoverable amount, with the impairment being charged to the operating cost statement. In the case of I to IV above, the recoverable amount will be the asset's net realisable value – that is, the amount at which the asset could be disposed of, less any disposal costs. In the case of the example in V, the net realisable value will relate to the store – that is, not to the over-specification.

Other relevant factors

- 5.2.36 In budgetary terms, certain impairments will score as DEL and others as AME, and departments will enter the type of impairment onto COINS using the relevant account code. The Consolidated Budgeting Guidance (CBG) contains more detail. The budgeting treatment does not influence the accounting treatment, but entities might wish to consider whether information about the type and cause of impairment could usefully be included in the relevant notes to the accounts. Impairment categories are defined below.
- 5.2.37 Capitalised development expenditure that is directly linked to a tangible fixed asset should be impaired only where the tangible fixed asset becomes impaired. Where the intangible asset relates to a group of tangible fixed assets, any impairment will be charged only where the entire group is impaired and will be proportionate to the impairment of the group of tangible assets. For example, development expenditure related to a fleet of aircraft will be impaired only where the entire fleet is impaired and not if less than the whole fleet is impaired.

Definitions: impairments that score as DEL

- 5.2.38 The following types of impairment will score as DEL. All of them will be accounted for through the Operating Cost Statement as permanent diminutions in value as a result of a clear consumption of economic benefits or service potential. The relevant proportion of any balance on the revaluation (or donated or government grant) reserve should be transferred to the General Fund or equivalent (but not through the Operating Cost Statement).

Loss or Damage resulting from normal business operations

All losses of, and damage to, tangible fixed assets that reduce the recoverable amount to below the book value other than those caused by a catastrophe (see below). Normal business operations covers all loss and damage to assets that result from management and staff action (or inaction), and the actions of third parties. This category includes theft.

Abandonment of assets in the course of construction

The impairment of assets in the course of construction as a result of a management decision to abandon the construction process, i.e. management decides that it no longer requires the facility under construction and the construction costs to date are completely written off or substantially written off to reflect reduced utility. This category includes the abandonment of software assets in the course of construction.

Over Specification of Assets (Gold Plating)

Gold plating is the unnecessary over-specification of assets at the point at which the asset is first constructed or purchased. This category should be used where the gold plating of assets leads to an impairment either because the asset is valued at its utility value to the business, or because the gold plating cannot be reflected in the recoverable amount.

Care should be taken not to impair assets as being gold plated where they are of a high specification by necessity. For example, the high specification of embassies is in part a result of security and other factors relating to location and the needs of a representational building. The higher specification due to justified security and operational considerations should not lead to an impairment down to the value of ordinary office accommodation. The

key is that the higher specification must be justifiable: if it is not an impairment should be taken.

Definitions: impairments that score as AME

5.2.38 The following types of impairment will score as AME (with the agreement of the relevant authority (through sponsoring bodies where appropriate), where indicated in the CBG). All of them will be accounted for through the Operating Cost Statement as permanent diminutions in value as a result of a clear consumption of economic benefits or service potential. The relevant proportion of any balance on the revaluation (or donated asset or government grant) reserve should be transferred to the General Fund or equivalent (but not through the Operating Cost Statement).

Loss as the result of a catastrophe

Damage to tangible fixed assets as a result of a catastrophe. The System of National Accounts (SNA93) which forms the basis of recording transactions in the National Accounts defines a catastrophe as: 'such events as will be generally easy to identify. They include major earthquakes, volcanic eruptions, tidal waves, exceptionally severe hurricanes, droughts and other natural disasters; acts of war, riots and other political events; and technological accidents such as major toxic spills or release of radioactive particles into the air'.

Such events are very rare in global terms and exceptionally rare in the UK. Where a department believes an impairment should be scored as a Catastrophic Loss rather than 'Loss or Damage resulting from normal business operations' it should first contact the relevant authority.

For the avoidance of doubt, the following are not catastrophes within the meaning of this definition. Prison or street riots; loss or damage due, for example, to an ingress of water that could have been avoided by better maintenance; and relocation to a site where flooding is likely. These are all examples of losses resulting from management action or inaction.

Unforeseen Obsolescence

All assets are subject to obsolescence. However, the rate of obsolescence tends to be category specific: e.g. IT assets suffer a faster rate of obsolescence than do buildings. Departments will take account of foreseeable obsolescence when establishing asset lives. Unforeseen obsolescence will generally only occur either as the result of the introduction of a completely new technology or a change in legislation rendering the asset illegal. As such events are exceptionally rare, the relevant authority should be contacted prior to the use of this category.

Other Impairments.

This category includes impairments that cannot be scored to another impairment category.

- **Write Down to Depreciated Replacement Cost** – This occurs where specialised building assets or enhancements (e.g. the construction of a new wing) to such assets are written down to depreciated replacement cost (DRC) following the first professional valuation.

- **Write Downs of Development Land** – This occurs where land is purchased for some form of social development. The cost of the land and any clean up cost can be greater than the disposal value resulting in an impairment.
- **Changes in Use** – This usually occurs where specialised assets no longer required for their original purpose are put to a non specialised use (e.g. a hardened aircraft hangar used as a store). However, impairment can result from the change of use of any asset including non-specialised assets.
- **Disposals** – Impairments can occur where assets are moved from ‘in use’ to ‘available for sale’.
- **Uncompensated Seizures** – The seizure of assets by governments or institutional units, other than for the settlement of fines or taxes, for which full compensation is not provided.
- **Other impairments not detailed** – Please contact the relevant authority for advice.

Revaluations

5.2.39 Downward revaluations result in an impairment only where an asset is revalued below its historical cost carrying amount. In these cases, the accounting treatment is as for any other impairment. All other downward movements (for example, as a result of market fluctuations) should be accounted for through the revaluation (or donated asset or government grant) reserve to the extent that there is a credit in that reserve that relates to the revalued asset or portfolio of assets.

GUIDANCE ON ASSET VALUATION

Introduction

This guidance should be read in conjunction with the text in the Government Financial Reporting Manual (FReM) about the application of FRS 15 by entities covered by the requirements of the FReM. It has been developed with the assistance of a Working Group set up to consider issues around asset valuation and capital charging. Separate from, but critical to, the Working Group's deliberations was the review by the Royal Institution of Chartered Surveyors' (RICS) Public Sector Valuation Group (PSVG) of its guidance on preparing valuations using the depreciated replacement cost methodology. RICS has now published its Valuation Information Paper (No 10) The Cost Approach for Financial Reporting. This guidance interprets that Valuation Information Paper for the particular circumstances faced by the entities covered either directly by the FReM or by guidance derived from the FReM (for example, the NHS Manuals of Accounts).

This guidance does not address the valuation of Heritage Assets. Separate guidance on Heritage Asset Valuation is being developed.

This guidance covers two areas: Valuation Information Paper No 10; and valuation policy.

Valuation Information Paper No. 10: The Cost Approach for Financial Reporting

- 1.1. This section of the guidance supports Valuation Information Paper (VIP) No. 10 by interpreting for the central government sector those requirements of the VIP that need to be explained further so that valuers and accountants achieve consistency (but not uniformity) across the many types of entity in the sector.
- 1.2. VIP No. 10 provides supplementary information about the use of the cost approach for financial reporting as set out in IVSC Guidance Note 8 The Cost Approach to Financial Reporting – (DRC) (Revised 2005). (Valuation standards are published by RICS in its 'Red Book' (RICS Appraisal and Valuation Standards)). The terms 'Cost Approach' and 'depreciated replacement cost' (DRC) are considered to be synonymous, since both are in common use world-wide to describe the same valuation technique. The VIP is available from RICS at [insert relevant address once obtained from RICS].
- 1.3. This part of the guidance follows the order of the VIP for ease of access, although it does not comment on all the sections of the VIP. Paragraph references are to VIP paragraphs.

When is DRC used?

DRC is a valuation method of last resort

- 1.4. DRC should only be used as a last resort. It should be used only where there is no useful or relevant evidence of recent market transactions due to the specialised nature of the asset (paragraph 3.1). The

specialised nature may be a result of the size or location of the asset, as well as the service provided. But it does not follow that, where DRC has been the valuation method in the past, it remains appropriate to use DRC for the latest valuation, since there might be sufficient evidence of an emerging market; the VIP gives the healthcare and leisure sectors as examples.

- 1.5 Some specialised assets in the central government sector may generate material cash flows; these specialised assets should be valued by the income or profits test approach.

Buildings of conventional appearance that have specialised features

- 1.6 VIP 10 notes that there will be some buildings that have a conventional basic design that is superficially similar to other buildings that are regularly bought and sold in the market, but on closer inspection have specialised features designed to meet the requirements of the actual occupier.
- 1.7 A typical example of this is a purpose-built embassy, which, although built to perform an office function, is situated on a site that includes extra stand-off land and includes designed-in security features such as thickened walls and toughened glazing. This type of building will often cost considerably more to develop and build than a normal office building, but provide extra service potential (in the form of security for its occupants) which cannot be replicated through the purchase of a normal office building.
- 1.8 In these instances, provided that the occupying entity continues to require the extra service potential, it is likely that the building should be treated as specialised and valued to DRC with full account taken of the extra cost of the specialised features and requirement for stand-off land.

Buildings that include specialised adaptations

- 1.9 Some buildings will comprise conventional structures that have been adapted to the requirement of the occupier. For example, a commercial office building may have been purchased by a government department and adapted by provision of enhanced security features such as perimeter barriers or toughened glazing. Where an entity has opted to treat the cost of such specialised adaptations as a separate item in its financial statements, the valuer will value the conventional building (paragraph 3.9). Where the entity has not accounted for the costs of adaptation separately, the valuer will need to consider whether the adaptations are such that the building meets the definition of a specialised property (paragraph 3.10).
- 1.10 Central government entities can choose whether or not to account for adaptations as a separate item in their financial statements. As a guide, while specialised features designed-in to purpose-built buildings should normally be accounted for as part of the whole building, adaptations to existing buildings should normally be accounted for separately.
- 1.11 Where an entity opts to account for the costs of the adaptations as a separate item, those costs should be depreciated over a maximum of the useful economic life of the property to which they relate, subject to this not exceeding the useful economic life of the adaptations themselves. Where the costs are material, the entity should ensure that the net book value of the adaptations continues to give a true and fair view at the balance sheet date and make any necessary adjustments.
- 1.12 Where an entity opts to include the adaptation costs within the property interest, the entity will need to ensure that the valuer understands the general nature of the adaptations. It will not be appropriate, for example, for a valuer to value an embassy's additional stand-off land as surplus land: it is a necessary part of the property. Nor will it be appropriate for a valuer to value a newly built embassy building as a conventional office block.

Assessing replacement cost

- 1.13 Where DRC is being used to value specialised property (regardless of whether or not the property is historic or listed), it will rarely be appropriate to cost a modern reproduction of the asset (i.e. using an identical replacement or modified reconstruction approach). The value of the property should normally be based on the cost of a modern equivalent asset that has the same service potential as the existing asset and then adjusted to take account of obsolescence.

The Site value of a Specialised property

- 1.14 In selecting the site on which the modern equivalent asset would be situated, the valuer will consider whether the actual site remains appropriate (VIP section 7). For a central government entity, the choice of whether to value an alternative site will normally hinge on policy in respect of locational requirements of the service that is being provided.
- 1.15 So it could be that buildings that serve the community in which they are located – schools, hospitals, and other buildings used to deliver front-line services – might need to be on expensive inner-city sites or in town and city centres rather than on the outskirts. In these cases, the actual site is the site that should be valued.
- 1.16 Other buildings might not need to be located on the actual site. But alternative sites should only be used for valuation purposes when it is clear government policy that the actual sites would no longer be used and there is a clear and agreed plan to relocate (which might be medium term) to an identified site or general location. If there is no plan to relocate from a property being valued, then the actual site should be valued, even if similar properties on other sites are included in relocation plans. An entity that values its estate (in whole or in part) using alternative sites, should disclose the fact in its accounting policies note and give, in the notes to the accounts, the alternative use value, less costs of sale, of the existing site. The Management Commentary should also include a brief discussion of the relocation plans.
- 1.17 Where an entity could deliver its services from any site, and there is no stated government policy that the service has to be delivered from the actual site, but there is no clear and agreed plan to relocate, the entity should value the actual site and give the same disclosures as an entity that has used alternative sites in its valuation (for example, the alternative use value of the actual site in accordance with the Red Book..

Calculating the cost of the buildings and site improvements of a specialised property

The buildings and site improvements

- 1.18 Guidance on enhancements to existing assets is given in the section on valuation policy.

Historic buildings

- 1.19 It is rarely appropriate to value historic buildings on the basis of costing a modern reproduction by use of an identical replacements or modified reconstruction approach.
- 1.20 Where the historic nature of the property itself contributes to the service provided, it would be appropriate to reflect the cost of reproducing the existing asset in the cost of the modern equivalent (paragraph 8.7). The example of a parliament building is given. However, where it would be impossible for a modern reproduction to recreate the original's historic significance, entities should not cost such a reproduction (paragraph 8.8). (An example might be the Tower of London.)

- 1.21 Where an entity does cost on the basis of creating a modern reproduction using the identical replacement or modified reconstruction approach, it must be able to demonstrate that it is not valuing a mere facsimile of the existing asset and that the historic property itself is intrinsically part of the service potential. Before undertaking a valuation using a modern reproduction approach, an entity should discuss with the relevant authority (through the sponsoring department as necessary) whether such an approach is appropriate. Entities should start from the premise that it will not be.
- 1.22 Buildings of iconic status (which might or might not be historic or listed) that would be replaced by similarly iconic buildings, should be valued on the basis of a modern equivalent asset but including the costs of achieving that iconic status. That might mean, using the Royal Courts of Justice as an example, a modern court house that has either a façade in keeping with the surrounding buildings, or even a reproduction façade.
- 1.23 Further guidance on valuing heritage assets is being developed.

Sources of cost information

- 1.24 The VIP notes that the cost of a modern equivalent asset will reflect the cost that would be incurred if the works were commissioned on the date of valuation (paragraph 8.11). But it goes on to note (paragraph 8.12) that there are factors that may result in the cost of a notional replacement being different from that of creating the actual asset. These factors are:
- Site preparation. The VIP refers to works that may have been undertaken to prepare the actual site for occupation that would not need to be carried out on an assumed equivalent site. Entities should instruct the valuer to assume that the site being valued, whether on the basis of the actual or an alternative location, is level and serviced and ready for development. (Entities should refer above for guidance on the circumstances when a site in an alternative location can be valued.)
 - Phasing of work. The VIP notes that a large site may have been developed in phases and that the cost of a modern equivalent reflects a single phase development. Entities should instruct the valuer to assume a single phase development at the building cost at the date of valuation. Entities should also instruct the valuer to assume that the construction has happened ‘instantly’. As a consequence, it follows that there will be no phasing of payments, and there will be no reflection of the cost of capital in the valuation.
 - Optimal working conditions. Abnormal working conditions at the actual site are ignored if an alternative site is being valued. If, for policy reasons (as outlined above), however, the actual site is being valued, entities should instruct the valuer to consider any additional costs that might necessarily be incurred in developing the site and make suitable adjustments (although these might already be factored into the market value of the site). For example, the access to the actual site might be such as to prevent the use of large plant and machinery in the construction of the replacement building, thereby increasing the contract costs because of the additional construction time required.
 - Additional costs arising from extending an existing property. These costs should be ignored, since the norm is that the valuation will be of a modern equivalent asset.
 - Contract variations. Additional construction costs because of design or specification changes should be ignored. The modern equivalent asset being valued will have the same service potential as the existing asset.
 - Planning changes. Entities should consider with the valuer whether planning consent would need to be obtained were the modern equivalent asset to be constructed on the actual site.

Assessing Depreciation

Functional obsolescence

- 1.25 Paragraphs 9.7 to 9.11 discuss functional obsolescence. One factor that might cause functional obsolescence is technological advances. This need not reflect only technological advances in, say, the delivery of healthcare. For example, the Ministry of Defence will need to consider whether the technological advances in military materiel mean that its hardened aircraft hangers would be replaced by different types of structures, and the effect this would have on the valuation of its existing hangers.

Economic obsolescence

- 1.26 References to the impact of changing demand for goods or services should be read to include, for non-revenue generating assets, references to future service potential.

Guidance on the valuation policy outlined in the FReM

- 2.1 Entities are reminded that their balance sheets must give a true and fair view of the value of the assets at the balance sheet date, but that, within the constraints imposed by the FReM, entities are free to adopt practices that are most appropriate to their circumstances.

Valuation of Property Assets

- 2.2 Entities have, within the confines of FRS 15, total discretion in how they determine the most appropriate valuation approach for their estates. When their valuers advise that DRC is the most appropriate valuation methodology, entities should refer to the guidance notes above when discussing the approach with their valuers.
- 2.3 Early and ongoing dialogue with the valuer is vital. Neither RICS guidance nor FRS 15 are tightly prescriptive regarding aspects of asset valuation methodology, particularly at the detail level of DRC. Within their confines, many subtle variations in approach or interpretation are possible and these can have a significant impact on the resulting figures produced. An instruction which simply asks for an asset valuation to be undertaken in accordance with RICS and FRS 15 will be insufficient to ensure that the entity receives a common result and consistency of approach over time, regardless of which valuer is used. Discussion between entity and valuer about the exact nature of the entity's bespoke requirements and how these can best be fulfilled is essential. Sufficient details about the exact approach employed must be captured for the benefit of future valuations, when it is likely that there will have been a change of valuer.
- 2.4 FRS 15 states that the objective of a revaluation is to reflect current values as at the balance sheet date. Full quinquennial valuations of properties, and an interim valuation every three years, will meet this objective. Additional valuations should only be carried out in the intervening years where it is likely that there has been a material change – and it is likely that the annual impairment review will give an indication of whether this is the case. Interim valuations are not the same as full valuations: paragraphs 47 and 49 of FRS 15 set out the differences: no need for a detailed inspection of the building or locality, unless the valuer feels it necessary; and no enquiries of the local planning and similar authorities nor of the entity or its solicitors. The valuer will seek confirmation that the property has not been altered in any way, and that there are no significant changes to legal rights or planning considerations. See below for more guidance on what to do when a property has been altered.

- 2.5 Entities with large estates might consider carrying out a rolling programme of revaluations following the guidance in paragraph 46 of FRS 15. In addition, entities with large estates comprising homogeneous properties (such as hospitals or prisons) might consider using an approach that bases the gross valuations on standard models. For example, it might be hypothesised that, ideally, an entity would use one of three building models or beacons to deliver a service, depending on location – inner city, town and rural. The valuer will be able to discuss and advise on how many beacons may in practice be required, having regard to the nature of the estate. An entity could derive a standard gross replacement cost for each building beacon, and then assess depreciation in line with the VIP (section 9; and also see above) for each of the individual property assets. Local land values would then be added to arrive at the DRC valuation.
- 2.6 Entities are permitted, but not required, to re-appraise the valuations of their properties using indices in the years between their quinquennial valuations. Interim valuations are not required where entities choose to use annual indexation. However, in the light of experience shared by the Working Group, entities should consider carefully the appropriateness of annual indexation in their particular circumstances and make a careful judgement as to whether annual indexation will result in a true and fair view of the value of their estates at the balance sheet date.

Valuation of Non-Property Assets (other than infrastructure assets)

Depreciated historical cost basis as a proxy for current valuations

- 2.7 Entities may elect to adopt a depreciated historical cost basis as a proxy for current valuations for assets that have short useful economic lives or low values (or both). Examples where using depreciated historical cost as a proxy for current value might be appropriate are described below.
- 2.8 Motor vehicles: generally of relatively low value, and depreciated over a short useful economic life. The life should reflect established fleet management practice. Depreciation should be estimated in accordance with the expected reduction in vehicle values – which is not likely to be straight-line.
- 2.9 IT: the pace of technological change and reduction in values are generally reflected in a very short useful economic life. In some (more extreme) cases, IT might be expensed on purchase. Where IT is carried as an asset, depreciation should be estimated in accordance with the expected reduction in IT values – which might not be straight-line.
- 2.10 Furniture (and fixtures and fittings generally): normally of relatively low value in relation to other assets. In some cases, office fixtures and fittings are expensed on purchase. Where they are capitalised, depreciation should be estimated in accordance with the expected deterioration – which is likely to be straight-line.

Non-property tangible fixed assets with longer useful lives should be carried at current value

- 2.11 Indices or other appropriate information sources should be used to determine the gross valuation of non-property assets where depreciated historical cost is not a suitable proxy for current value (unless there are specific requirements set out in the FReM for specific asset classes).

Enhancements

- 2.12 Enhancements to assets in the public sector invariably give rise to additional expenditure as a result of health and safety, security or operational requirements. Examples include the need to keep two lanes of a motorway operating, but at the same time ensuring the safety of the workers building a third lane; safeguarding prison's security while an additional wing is built within the curtilage; and the need to keep

a hospital open, but at the same time safeguarding the health and safety of patients and visitors while a new wing is build, and additional costs associated with linking new infrastructure to old.

- 2.13 When the enhancement is brought into use, a new asset comes into existence. On the first valuation of this new asset the valuer will value it as a single asset, and will not take account of the additional costs arising from the above requirements. (This expenditure could be described as the immediate revenue consequence of a capital project.) The difference between the construction cost and the initial valuation of the new asset will be written off to the operating cost statement.