ICAEW
REPRESENTATION 44/23

NON-INVESTMENT ASSET VALUATION

Issued 18 May 2023

ICAEW welcomes this opportunity to contribute to the Thematic Review of Non-investment Asset Valuation for Financial Reporting Purposes being undertaken by HM Treasury. A copy of the consultation paper published on 8 March 2023 is available from this link.

ICAEW welcomes reforms to the measurement of non-current assets by public bodies

- How assets and liabilities are measured is a critical component of accounting and financial reporting and can change the shape of the balance sheet materially depending on the model and basis chosen.
- The accounting policy choices discussed in the consultation paper on how to account for non-current non-investment assets could therefore have a major impact on financial statements in the public sector in both central and local government.
- We concur with proposals in the consultation paper to adopt a mixed measurement model depending on type of asset, which we believe will improve the reliability and understandability of accounts and make them more accessible to users.

We have reservations about the use of depreciated replacement cost (DRC)

- We do not believe that applying DRC to local authority network assets will improve the reliability or usefulness of local authority financial statements. We are also disappointed that the use of DRC for central government network assets, such as the railway network, has not been reconsidered.
- The high level of subjectivity in DRC calculations hampers the reliability of reported asset balances, risks inconsistency of valuation between similar assets, often overvalues assets, and focuses preparers, auditors and regulators on numbers that are perceived to be of limited relevance to users. In some circumstances, additions to fixed asset are immediately impaired on technical grounds when applying DRC, which can obscure the stewardship role of financial statements, hampering accountability.
- There may be a case for a ‘deemed income’ valuation approach for network assets that takes into account tax revenues allocated by the state to those networks.

Good recordkeeping is essential, irrespective of measurement basis

- Changing the measurement basis used for recording assets will not address weaknesses in recordkeeping identified in some public bodies.
- Whether assets are recorded at historical cost or use a current valuation, understanding the condition of assets and the accuracy and completeness of asset records is essential to good public financial management.

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As a regulator of the accountancy and audit profession, ICAEW is currently the largest Recognised Supervisory Body (RSB) for local audit in England. We have ten firms and over 85 Key Audit Partners registered under the Local Audit and Accountability Act 2014.

This response has been prepared by ICAEW's Public Sector team in consultation with ICAEW's Public Sector Advisory Group. ICAEW's Public Sector team supports members working in and with the public sector to deliver public priorities and sustainable public finances, including over 11,000 in ICAEW's Public Sector Community. ICAEW engages with policy makers, public servants, and others to promote the need for effective financial management, audit and assurance, financial reporting and governance and ethics across the public sector to ensure public money is spent wisely.

For questions on this response please contact our Public Sector team at representations@icaew.com quoting REP 44/23.

INTRODUCTION

We welcome HM Treasury's thematic review of how non-investment assets are measured in financial statements

1. Asset recognition, measurement and disclosure are key financial reporting components and play an important role in holding reporting entities to account. We therefore welcome HM Treasury's thematic review of non-investment asset valuations for financial reporting (the Review) and we are pleased to be able to respond to the consultation paper published on 8 March 2023.
2. Asset measurement is particularly important in the public sector, where public bodies are responsible for managing £1.3 trillion of non-investment assets on behalf of the nation, based on the most recently published Whole of Government Accounts.
3. We agree with the case made in the consultation paper for changing how assets are measured in public sector financial statements and how it addresses the delicate balancing act between the needs of users, value for money, and timely financial reporting.
4. Significant time, cost and effort goes into preparing, and auditing, operational property valuations despite the limited usefulness of those valuations to decision makers or to those holding public bodies to account. We therefore welcome the overall proposals, which will improve the reliability of reported balances and simplify the accounting for non-current assets without, we believe, detracting from the usefulness, quality, or relevance of financial statements to stakeholders.
5. Although the Review primarily relates to how assets are measured in central government financial statements, it will also affect local government as many of the changes to the Government's Financial Reporting Manual (the FReM) are likely to flow through to the Code of Practice on Local Authority Accounting.

Overview of our response

6. The following summarises our perspectives on the options set out in the consultation paper.

Option	Benefits	Challenges	HMT conclusion	ICAEW perspective
1: Historical deemed cost model	Easy to apply Well understood Reliable basis Less costly to administer	Gap from current values Similar assets valued differently based on date of purchase? Undervalue may limit stewardship ability	Deemed cost would be needed for many existing assets Challenges outweigh benefits	Agree with analysis, although think some impairment challenges are missing. Agree with conclusion.
2: Fair value for all non-investment PPE and intangibles	In theory, most relevant information to users	In practice, wouldn't be relevant for most assets Huge practical difficulties in valuing many assets	Time and effort would not be worth it. Challenges outweigh benefits.	Agree with analysis and conclusion.
3: Measurement based on asset class	Relevant current values where appropriate Practical and achievable Optimal cost/benefit depending on asset type	Mixed model: total book value is not meaningful Introduces judgment into classification decisions	Proposed option. Balances cost and effort with relevance of information to users	Agree with overall analysis and conclusion to adopt mixed measurement model, subject to reservations about the use of DRC for network assets.
4a: Periodic valuation of historical deemed cost to current value	Benefits of option 1 of simplicity in day-to-day accounting, but with more current values	Doesn't comply with conceptual framework Huge practical difficulties in valuing many assets	Prefer not to diverge from conceptual framework Challenges outweigh benefits.	Interesting concept but potentially open to misleading swings in values.
4b: Periodic valuation of current value	Benefits of option 2 but more practical with five-yearly valuations (with or without indexation in between)	Same challenges as option 2, but less cost Issues if current values move significantly between valuations	Time and effort would still not be worth it. Challenges outweigh benefits.	Worth considering in a modified option 3 for specific asset classes. Benefits of current value (relevance) yet less cost than annual valuations.

7. We broadly agree with the analysis set out in the consultation paper and support its conclusion as set out in Option 3 that a mixed measurement model is the best approach, with some assets recorded at historical cost and others recorded at current values.
8. In particular, we support changing the measurement basis for specialist property, plant and equipment (PPE) and intangible assets to historical (deemed) cost and for non-specialised PPE to fair value.
9. However, we have reservations about the use of depreciated replacement cost (DRC) for network assets. While DRC can provide useful information for some purposes, we believe that there are significant challenges to its use in financial statements outside of calculating acquisition fair value in the context of private sector business combinations.
10. We also do not believe that adopting DRC in local authority financial statements would mitigate current weaknesses in recordkeeping. A good understanding of the condition of assets and having accurate and complete asset records is still essential, irrespective of the measurement basis adopted.
11. We concur with the proposal to treat the then book values of specialised and intangible assets as their deemed historical cost on transition.

Crisis in local authority financial reporting and audit

12. The Review is timely as the local audit and reporting system in England is in crisis.
13. Only 9% of 2020/21 local authority audited accounts were published by the 30 September 2021 deadline with that figure only increasing to 12% in 2021/22 despite an extension to the deadline to 30 November 2022. Urgent and radical ‘whole system’ action is required to address this.
14. ICAEW sees the proposed changes to the valuation of non-investment property in local government as helpful to addressing the crisis in local authority financial reporting and audit. There is currently a perception that regulatory focus is resulting in disproportionate work effort by auditors and finance teams on the valuation of operational property when it is not seen by preparers, or most users of accounts, as an area of significant risk.
15. The situation in local government audit has been exacerbated by issues relating to the accounting for infrastructure assets that came to light during 2021/22. ICAEW supported the temporary statutory override introduced by the Department for Levelling Up, Housing and Communities (DLUHC) to prevent the issue causing further avoidable delays to the completion of local authority audits. The statutory override allows preparers to presume that infrastructure assets being replaced or renewed are fully depreciated and hence carried at a net nil balance when they are derecognised.
16. Local authorities are currently exempted from the requirement to measure assets such as local road networks at DRC. The consultation paper implies that this exemption may be dropped from 2025 onwards, which would have the benefit of aligning the accounting treatments adopted between central and local government. We have reservations about the use of DRC as an ongoing asset measurement basis in any case, but we are concerned about what this means for local authorities and local auditors in terms of meeting statutory deadlines. We are also doubtful that the adoption of DRC for local authority network assets would resolve issues in record keeping that have been identified in some local authorities. In some cases, changing to DRC may exacerbate the materiality of these issues to reported balances.

Relevance to Parliament as primary user of central government financial statements

17. We welcome the qualitative analysis of the costs and benefits of the current approach as well as the evaluation of the advantages and disadvantages of potential solutions.
18. The FReM states the primary user of central government annual reports and accounts is Parliament. We believe it will be helpful if the Review conclusions provide a more explicit commentary on how the proposals meet the needs of Parliament in holding public bodies to account and in making decisions about resource allocation.
19. The Consultation Paper references a review that was commissioned by HM Treasury upon which its recommendations are based. We have not seen the contents of this review and so

our response may not address all the matters raised or that might have influenced our response.

Measurement choice under IFRS

20. We strongly support basing public sector accounting requirements on IFRS. IFRS is a set of high-quality financial reporting standards that are used by millions of organisations around the world, providing a common international language for the communication of financial results and position in and across sectors.
21. In the absence of a more specific public sector financial reporting standard within IFRS, we believe that the Financial Reporting Advisory Board (FRAB) and the CIPFA LASAAC Local Authority Code Board (CIPFA-LASAAC) are right to adapt IFRS to the specific circumstances of central and local government respectively and to interpret how IFRS should be applied in the public sector context. This is in addition to their roles in approving common accounting policies in each sector and in providing guidance to preparers.
22. We believe that adaptations from IFRS should be limited to where the circumstances of public sector bodies differ from private sector bodies. We believe that this is the case with the valuation of non-investment assets as many are highly specialist in nature, held for reasons other than generating income, and lack an active market.
23. ICAEW believes that, where possible, reporting requirements should be aligned across the public sector. One of the reasons the Comptroller and Auditor General (C&AG) qualified the opinion of the Whole of Government Accounts (WGA) is because infrastructure assets are valued on a different basis in local government compared to central government. Qualifications to the opinion, as well as delays to the publication, have undermined the usefulness of the WGA as a key document for decision making and accountability.

Reservations regarding DRC

24. We recognise that DRC is a valid technique to calculate existing-use value (EUV) and that for some highly specialised assets where no market data exists, it may be the only practical option apart from historical cost. IFRS 13 *Fair Value* includes an option to apply a cost methodology for working out fair value, and DRC is one method for doing so in the absence of market data inputs.
25. In the private sector, DRC is sometimes used in a business combination as a method of calculating acquisition fair value, in effect the deemed historical cost at that point, with subsequent measurement on a deemed historical cost basis. It is extremely rare, if not unheard of, for private sector entities to measure assets at DRC on an ongoing basis.
26. We set out the advantages and disadvantages we see with the application of DRC on an ongoing basis for network assets. A key benefit is being able to obtain a current valuation in the absence of an active market. A key detriment is that in practice the assumptions needed to achieve this can result in a less reliable measurement of the value of an asset that is often of little relevance to the user.
27. There are some advantages of using DRC on an ongoing basis:
    - DRC provides an up-to-date value, overcoming one of the challenges with historical cost accounting, which can see inflation over time result in measured asset values that are significantly below their current value.
    - DRC may be the only practical method in many circumstances to calculate a current value, particularly in the context of public sector assets where there is no external market that can be referenced, where an asset does not generate any income, or where significant public subsidy is required.
    - The use of DRC is also helpful in minimising the differences between the amounts recorded in public sector financial statements and the National Accounts.
    - Some argue that the DRC process provides entities with useful information used to manage assets more effectively.
28. We have also identified some significant disadvantages to using DRC on an ongoing basis:

- The high level of subjectivity in DRC calculations can hamper the reliability of reported asset balances, risks inconsistency in how similar assets are measured, can overvalue assets, and focuses preparers, auditors and regulators on numbers that are perceived to be of limited relevance to users.
- In cases such as the national railway network the use of DRC has led to recorded book values substantially in excess of might be considered to be a reasonable fair value based on what society is reasonably willing to pay for the use of that asset.
- DRC has some significant adverse consequences for the income and expenditure statement when newly constructed network additions have to be immediately impaired. Such technical asset impairments can obscure the stewardship role of financial statements, hampering accountability.
- DRC can be expensive to apply as it frequently relies on the use of expert valuers by both preparers and auditors. Disagreements among professional valuers can also lead to delays in completing audits of financial statements.

29. DRC often relies on the assumption that an asset would be replaced on a like-for-like basis to deliver a similar level of service potential. This assumption if often not valid as the choices that would be made today if setting out to build a replacement asset are unlikely to be the same as those at the points in time the asset was originally constructed. This abstract nature of DRC-calculated values for assets is generally not well understood by users of accounts.

ANSWERS TO SPECIFIC QUESTIONS

Question 1

Do you agree with the assessment HM Treasury has presented for Option 1? If so, why? If not, why not and what alternatives do you propose?

30. Yes, we broadly agree with the assessment for option 1.
31. We concur that historical cost is generally reliable as a measurement basis and its relative simplicity can result in less costly and more timely reporting.
32. We also agree that annual price changes (inflation) can result in significant disparities between carrying values recorded using the historical cost model and current values, hindering comparability of assets that have been acquired at different points in time. In addition, historical cost can result in large surpluses on the disposal of assets that primarily reflect the time value of money rather than genuine economic gains.
33. One way to negate the effects of capital erosion would be to adjust historical cost for the effects of inflation. Indices are often too specific to particular assets but adjusting assets based on a broad inflationary measure could make historical cost more meaningful.
34. We disagree though with the implication in the assessment that deemed historical cost is always less relevant than current values. For example, assets subject to a significant degree of renewal and replacement will typically reflect a greater level of currency in the amounts that are recorded in the balance sheet under a historical cost approach, especially where the componentisation approach for renewal expenditure in IAS 16 applies.
35. However, on balance we agree that a blanket approach of deemed historical cost for all non-investment assets may not be appropriate.

Question 2

Do you agree with the assessment HM Treasury has presented for Option 2? If so, why? If not, why not and what alternatives do you propose?

36. We agree with the benefits and challenges described in paragraphs 3.37 to 3.39.
37. Drawing on some of the recent IPSASB discussions in relation to their measurement project, it was generally felt that fair value was most appropriate for assets held for their financial capacity, which is for their ability to generate cash flows (income streams and or sale proceeds). Fair value is indeed defined as an exit value.

38. IPSASB has developed an alternative current value measurement basis called ‘current operational value’ as an appropriate measurement basis for assets held for their operational capacity. Assets held for operational purposes tend to focus on service delivery, either directly or indirectly, and are not always utilised at their most optimum capacity. Such a measurement basis differs from the IFRS 13 definition of fair value that values assets at their highest and best use from the point of market participants, which will often not be suitable for operational assets in use within the public sector that, for example, cannot be sold in most realistic scenarios.

Question 3

Do you agree with the assessment HM Treasury has presented for Option 3? If so, why? If not, why not and what alternatives do you propose?

39. Yes, we agree with the assessment presented for option 3 which is to apply an appropriate measurement basis to individual asset classes.
40. As briefly noted in paragraph 3.42 of the consultation paper, one of the key challenges will be the allocation of assets to the appropriate asset class. This will be particularly important if the proposed measurement basis for networked assets and specialist assets are maintained since the former applies DRC and the latter historical (deemed) cost. There may be some temptation to classify assets as a specialist asset as opposed to a network asset due to the perceived simplicity of applying historical cost.
41. Furthermore, the differentiation between specialist and non-specialised assets will not be obvious in some instances and will require careful judgement. For example, significant judgement will be needed where similar assets could be classified differently depending on circumstances, such as concluding whether a military office building in a secure armed forces base with restricted access should be accounted for as if it were a non-specialised commercial office building or as a specialised asset.
42. In the private sector, the DRC method is rarely used as a valuation method outside of the context of business acquisitions and generally where it is lower (rather than higher) than income-based valuation methods, becoming the equivalent of deemed historical cost subsequently.
43. We have concerns about the usefulness and relevance of this method, especially when the asset in question cannot be sold and is unlikely to be replaced in the foreseeable future. For example, under the DRC method, a 50-year-old hospital, with various extensions over the years, can be valued as if it were equivalent to a more modern asset with the same level of service potential, albeit it with appropriate adjustment for its condition.
44. However, this theoretical value may be significantly different to the cost that would be incurred if that hospital were to be replaced given that service requirements will have changed over time, the desired location may be significantly different, and how such a hospital would be configured. As a consequence, the DRC-calculated value of an existing hospital may not be an appropriate way of measuring its current value as a public asset. As a consequence, the benefits of using DRC in place of deemed historical cost may not be as beneficial as the theoretical basis used to justify the use of DRC.
45. One alternative to consider for network assets would be the use of fair value based on a deemed income approach, taking account of both tax revenues allocated to a network asset and the fees and charges it generates to calculate the income stream that supports the use of the asset. The inclusion of a presumed margin that such an asset might reasonably be expected to generate if leased from the private sector would provide a method for calculated a current value for that asset, either on an ongoing current value basis or (as would be our preference) as a deemed historical cost for subsequent measurement on a historical cost basis.

Question 4

Do you think land and buildings should be considered as their own asset category under any of the options HM Treasury has presented? If so, why? If not, why not and what alternatives do you propose?

46. No, although we believe consideration should be given to whether land should be separately categorised from buildings, facilities or other assets which sit on that land. (Hence this would not apply to network assets such as roads or to assets where land is integral, such as public parks).
47. Land, with some exceptions, has an unlimited useful life and is therefore not depreciated whereas buildings are. A class of property, plant and equipment is a grouping of assets of a similar nature or function, and we therefore believe that there is a case for categorising separable land as a distinct asset class.
48. It may also be worth considering measuring separable land at fair value given that it can have a substantial value and is generally straightforward to obtain independent valuations. Such an approach would reduce the gap between current values and historical cost where buildings, facilities or other assets sitting on such land are recorded at historical cost.

Question 5

Do you agree with the assessment HM Treasury has presented for Option 4a? If so, why? If not, why not and what alternatives do you propose?

49. No, although we sympathise with the motivation behind Option 4a as it seeks to maintain some of the advantages of applying a current value measurement approach while limiting the costs associated with annual valuations.
50. ICAEW opposes Option 4a as it does not resolve the difficulties in valuing assets in the public sector. We have concerns about the relevance and usefulness of certain valuation bases used in the public sector, particularly DRC, and do not believe obtaining these valuations every five years assists users. In addition, it leads to the potential for large and misleading movements in the total value of a body’s assets for reasons that are not relevant to decision making or accountability. For example, it is counterintuitive that inflation in the cost of building materials results in higher asset book values, when the practical use value of that asset has not changed.
51. There is also the potential for five yearly revaluations to have significant and unpredictable impacts on budgets. While property revaluations do not normally directly affect outturn against control totals, they do impact on balances that do such as depreciation. Revaluing assets every five years makes budget setting more challenging and increases the risk of excess votes that could not easily be anticipated.
52. We also believe that Option 4a is not in line with the objective of ensuring high quality financial reporting.
53. There is also a risk of significant delays in financial reporting and audit occurring on a five yearly basis given the extra workload. Significant fluctuations in work effort required are not conducive to effective resourcing of finance or audit teams.

Question 6

Do you agree that Option 4a can be applied in conjunction with Option 3? If so, why? If not, why not and what alternatives do you propose?

54. We agree that Option 4a would be better if adopted in conjunction with Option 3, where only specific asset classes would be subject to periodic resets to current valuation.
55. However, we are not in favour of this hybrid option of mixing periodic current valuations with historical cost accounting in between, which is a departure from accounting principles.
56. In our view, the benefits of diverging from IFRS do not outweigh the challenges.

Question 7

Do you think there is a risk that Option 4a would not be considered true and fair, and so a pronouncement from the regulator would be necessary to address any ambiguity? If so, why? If not, why not and what alternatives do you propose?

57. Yes, we do believe this is a risk and an explicit pronouncement would be required.
58. However, we do not believe this option should be pursued and so such a pronouncement should not be necessary.

Question 8

Do you agree with the assessment HM Treasury has presented for Option 4b? If so, why? If not, why not and what alternatives do you propose?

59. Yes, we concur with the analysis.
60. Whilst we are more sympathetic to Option 4b compared with Option 4a, we believe it remains a problematic approach that is not in line with recognised valuation methodology. It carries several of the same problems as Option 4a, with added complications in terms of selecting sufficiently robust indexes to apply between periodic valuations.
61. While we support departure from IFRS for public sector specific reasons where there is good reason to do so, we are not convinced that the benefits of Option 4b are sufficient to warrant doing so in this case.

Question 9

Do you agree that Option 4b can be applied in conjunction with Option 3? If so, why? If not, why not and what alternatives do you propose?

62. Yes, there is more merit in applying such an approach as compared with Option 4a, particularly in the context of assets measured using DRC, where multiple inflation indexes are commonly used as part of the valuation approach. There could be a case for using a weighted average of the inflation indexes used in the most recent periodic DRC calculation to calculate intermediate values for those assets.
63. However, we still don’t believe that even on this limited basis that the benefits of such an approach would make it worthwhile to diverge from IFRS.

Question 10

Do you think there is a risk that Option 4b would not be considered true and fair, and so a pronouncement from the regulator would be necessary to address any ambiguity? If so, why? If not, why not and what alternatives do you propose?

64. Yes, ICAEW believes that Option 4b would risk not being considered as true and fair. Periodic valuation is not a recognised valuation approach and not currently permitted by IFRS.
65. Nevertheless, we recognise that a true and fair valuation for specialised assets that do not have an open market is judgemental and at times contentious. For example, coming up with a DRC by valuing a theoretical modern equivalent asset with the same level of service potential to the actual underlying asset is very different to obtaining a sales price that would apply if an open market existed. Both would be true and fair, yet the modern equivalent asset’s valuation could be far removed from the value of the asset in its existing use and existing condition.
66. For this option to be a simplification over the current process, the preparer should not have to demonstrate to the auditors that the carrying value of the asset is materially the same as a current valuation. Therefore, the five-year periodic valuation would need to be deemed true and fair which may be seen as too radical by some.
67. We would also suggest that HM Treasury review the impairment standards because the methods to estimating value in use for non-cash generating assets could be quite onerous – they include DRC, restoration cost approach or service units approach.

Question 11

Do you agree with the assessment HM Treasury has presented for other options? If so, why? If not, why not and what alternatives do you propose?

68. The FReM permits departures from IFRS if there are public sector specific reasons for doing so. We would argue that diverting from IFRS requirements in how fair value is applied in the public sector for some assets is problematic and that overriding IFRS should be a last resort.

Question 12

Do you agree, in general, with HM Treasury's proposed changes, that will be reflected in FReM adaptations and interpretations to IAS 16 and adaptations to IAS 38, in respect of the measurement of assets? If so, why? If not, why not and what alternatives do you propose?

69. Yes, on balance, we agree with HM Treasury's preference for Option 3. By reviewing the measurement basis for individual asset classes, it is possible to target specific problem areas whilst leaving the measurement basis for those assets that are not causing any issues unchanged.
70. However, we have some reservations regarding the proposed new measurement basis for some of the asset classes, see below for detail.

Question 13

Do you agree with the proposed measurement basis for networked assets? If so, why? If not, what not and what alternative do you propose?

71. No, as we have several reservations about the use of DRC as a method for measuring network assets on an ongoing basis (ie for subsequent measurement).
    - There are benefits to using DRC in the context of public sector assets, particularly where there is no external market that can be referenced to calculate a current value. This is especially the case for assets that do not generate any income or that require significant public subsidy, where DRC provides a method for calculating a value where other methods are not seen to be practical. This is echoed by RICS guidance, which suggests that if there is no market-based evidence to work out existing-use value (EUV), then the valuer can use DRC.
    - DRC can be an acceptable valuation technique that can provide useful information of relevance to users. For example, it is sometimes used in accounting for business combinations in the private sector, albeit typically where it is lower than the income-generating ability of an asset. The DRC calculated amount then becomes the deemed historical cost for measuring the asset subsequently.
    - The use of DRC is also helpful in minimising the differences between the amounts recorded in public sector financial statements and the National Accounts.
72. However, there are significant challenges in using DRC as an ongoing measurement basis for network assets, especially where it results in values that are significantly higher than a fair value that might be reasonable in equivalent circumstances.
    - For example, the DRC for the national railway network is substantially higher than the value ascribed by Network Rail prior to its consolidation in the WGA. DRC in this case provides a theoretical value that may be significantly higher than a government might choose to incur if it were hypothetically called on to replace the rail network given how service requirements have changed over time and how the rail network might be configured if starting from a blank sheet of paper.
    - DRC can give rise to an asset value that would be significantly higher than would be supportable if that asset was owned by a private sector entity operating on a concession basis on behalf of government. The perceived overvaluation in these circumstances may detract from the usefulness of the financial statements by giving a misleading impression of the value of the assets concerned.

- DRC calculations are also subject to a high degree of subjectivity, particularly for large and complex network assets that have been constructed (in some cases) over centuries. Reasonable but very different assumptions can lead to significant variability in the amounts calculated between assets and in some cases between different calculations for the same asset.

73. Another very significant problem with measuring assets at DRC on an ongoing basis (as opposed to a one-off deemed historical cost that isn't revised subsequently) is the impairments that often result from newly constructed additions to existing networks.
    - Such improvement is likely to provide incremental economic value in excess of their cost but may result in significant impairment charges because the increase in the calculated replacement cost of the entire network, including the newly added component, will almost always be less that the cost of the addition. This is because it will almost always be more cost effective to build a network in its entirety rather than on a component-by-component basis and this will be reflected in the DRC calculation.
    - For example, expanding a three-lane motorway with a current DRC of £1bn to a four-lane motorway with a DRC of £1.2bn would result in an accounting impairment of £300m if (say) the cost of building the fourth lane was £500m. This reflects the lower cost of building a four-lane motorway in one go rather than in two stages, even though the £500m cost of enhancing the asset would be more than justified by a positive economic return on this investment.
    - Such impairments, which arise as a consequence of a technical accounting choice rather than reflecting economic reality, distort the financial statements and make it difficult for Parliament and other stakeholders to distinguish from genuine economic impairments in the value of assets that they should seek to hold management teams accountable. A reasonable user might be forgiven in our example for overlooking a (say) £100m write-down in the value of a different asset that reflected genuine economic loss when it is obscured by such significant technical accounting impairments arising from the use of DRC.
74. We agree with the characteristics of networked assets as listed in paragraph 4.12 which are very similar to specialised assets, the key difference being (unsurprisingly) that networked assets need to be part of a system or network. It will not always be obvious if an asset is part of a wider network yet the proposed accounting for networked assets is very different compared to specialised assets that are not part of a network, with the former measured at DRC and the latter at historical (deemed) cost. This may create incentives for preparers to classify assets as not being part of a network to avoid the more costly DRC approach.
75. We believe there is a case for using DRC to calculate an initial historical deemed cost at a particular point in time, followed by historical cost accounting subsequently. The capitalisation of replacement expenditure using the component accounting approach should limit the gap between the amounts recorded and their current values compared with a non-deemed historical cost approach, especially given the level of ongoing new capital, replacement capital and renewals expenditure that is required for many network assets in practice. Such an approach would significantly reduce technical accounting impairments, while also providing a sounder basis for componentising assets to permit the capitalisation of renewals expenditure.
76. An alternative approach would be to continue to revalue network assets using a 'deemed income' approach to calculate an asset value equivalent to that the state would be willing to pay for that asset if it was owned by a private sector entity operating on a concessionary basis, including an appropriate margin. This is likely to provide a better value in terms of the economics of the asset, although it might still (albeit to a lesser extent) give rise to technical asset impairments as seen with DRC if used for ongoing subsequent measurement.
77. One of the benefits of the proposal in the consultation paper is the implication that it would align the accounting treatment of network assets between central and local government.
    - Unfortunately, there are significant concerns about the potential adverse implications for local authorities of adopting DRC for their network assets, including local road networks.

- Not only would the issues we highlight above apply (including technical accounting impairments) potentially distort the useability and understandability of local authority accounts, but weaknesses in asset records identified in some local authorities may be exacerbated if carried forward into DRC calculations.
- The adoption of DRC by local government would also place a significant additional burden on finance teams and auditors at a time when the system is already in crisis.

78. There is an argument for local authorities being asked to revalue their assets using DRC on a one-off basis as part of a transition to a deemed historical cost approach for network assets in both local and central government.
    - This would align the accounting treatment between central and local government, with a consequent benefit to the Whole of Government Accounts, without imposing an ongoing burden of annual valuations or the other downsides of using DRC on an ongoing basis.
    - A one-off exercise of this nature might also provide an opportunity for local authorities to address weaknesses in their asset records, for example by calculating deemed values for componentised assets to form the basis for subsequent historical cost accounting.

Question 14

Do you agree HM Treasury definition of specialised assets (PPE) If so, why? If not, what not and what alternatives do you propose?

79. Yes, we agree with the definition which is based on RICS guidance.

Question 15

Do you agree with the proposed measurement basis for specialised assets (PPE)? If so, why? If not, what not and what alternatives do you propose?

80. We agree with the proposed change from DRC, which we believe is inappropriate and does not provide sufficiently better information in most cases compared with a historical (deemed) cost approach for most specialised.
81. We concur with the arguments made in paragraph 4.22 as to why DRC is not appropriate but suggest that these also hold true as to why DRC may be inappropriate for networked assets. We agree with the point made in the consultation about the limited connection of DRC valuations to the practical spending implications of replacing an asset.
82. DRC can inflate asset values when modern equivalent asset is used to work out what the hypothetical replacement cost might be. There are several assumptions the valuer needs to consider such as location and obsolescence adjustments. These are highly judgemental and can lead to inconsistency in valuations since judgements will differ from one valuer to another. The estimation uncertainty inherent in DRC means auditor and preparer attention is often focussed on valuations that are perceived to be of limited risk.
83. There will need to be safeguards put in place to ensure that assets with significantly higher current values than their book values are appropriately managed.

Question 16

Do you agree it could be suitable for the starting point for valuation of specialised assets to be initial historical cost, but if this information is not available, then measure at historical deemed cost? If so, why? If not, why not?

84. We agree that if historical costs are not available, and in many cases they may not be given the age of some of the assets, then a pragmatic way to proceed is to use a current valuation as deemed historical cost.
85. This principle is in line with IPSAS which state that assets whose transactional or historical cost is not known (such as at first time adoption or as part of a non-exchange transaction)

are initially valued at deemed cost which is the fair value in these instances. The deemed cost definition is likely to be updated to also include Current Operational Value.

86. There is a potential argument for adopting a consistent approach of using deemed cost at a specific date for all assets to encourage comparability and consistency.

Question 17

Do you agree with the HM Treasury definition of non-specialised assets (PPE)? If so, why? If not, why not and what alternatives do you propose?

87. In our view the definition needs to be more principles based since there is an argument, for example, that museums or libraries could be classified as operational assets held for their service potential given that many could be converted to alternative uses quite easily. More work and guidance will be required around what is meant by 'non-specialised in nature' in paragraph 4.25 of the consultation paper.

88. In some cases, the difference between an asset being classified as specialised or not may be negligible. Sound judgement will be required to make consistent decisions that result in the most decision useful outputs for users. There is a risk that assets will be classified as specialised if deemed historical cost can be applied as opposed to fair value for non-specialised assets.

89. Having three very different valuations methods for networked assets, specialised and non-specialised assets could cause practical issues, especially when it is not clear cut to which category an asset is most suited. In the private sector, most assets that are not held for their financial capacity are measured at historical cost, something HM Treasury could also consider as a radical solution.

Question 18

Do you agree with the proposed measurement basis for non-specialised assets (PPE)? If so, why? If not, why not and what alternatives do you propose?

90. We broadly agree with applying IFRS 13 Fair Value to non-specialised assets since most of these should have observable fair value inputs by definition.

91. However, there may be instances where operational assets held for their service potential will not be utilised to their full potential. Applying fair value may then over-value the assets based on a highest and best usage as opposed to the cost of replacing the asset's service potential. Consideration should be given to IPSASB's proposed approach of measuring non-specialised assets held for operational rather than financial purposes based on their actual use and location, rather than at their highest and best use per IFRS 13.

92. IPSASB's new measurement standard differentiates between assets held for their operational capacity and assets held for their financial capacity. Assets held for their operational capacity are measured using current operational value (similar to RICS's expected use value approach) which permits a market-based measuring technique but without the requirement of highest and best use as viewed by market participants.

Question 19

Do you agree with the proposed measurement basis for operational and non-operational heritage assets? If so why? If not, why not and what alternatives do you propose?

93. We agree with leaving the measurement basis unchanged for heritage assets. We have not come across any significant issues with the reporting of heritage assets in the UK and thus the current basis remains reasonable.

Question 20

Do you agree with the proposed measurement basis for social housing assets? If so why? If not, why not and what alternatives do you propose?

94. We agree with leaving the current measurement basis as EUV.

95. EUV for social housing can be extrapolated from market data given that comparative market information is provided by property income streams and sale transactions. In our view EUV is more suitable for social housing assets than fair value as it disregards potential alternative uses and any other characteristic of the asset that would cause its market value to differ from that needed to replace the remaining service potential.

96. The disregard of potential alternative uses is important in this context given the need to provide social housing and the higher economic costs that might be incurred (for example in housing benefits) if that social housing were withdrawn.

97. For older housing stock, the market value may be based on re-development rather than existing use as a rational private sector market participant might knock old properties down and start again. We believe EUV provides a more relevant measurement in such circumstances.

Question 21

Do you agree with the proposed measurement basis for surplus assets? If so why? If not, why not and what alternatives do you propose?

98. Yes, we agree with retaining a fair value measurement basis for surplus assets.

Question 22

Do you agree with the proposed measurement basis for intangible assets? If so why? If not, why not and what alternatives do you propose?

99. Yes, we agree with the proposals.

100. We believe a consistent approach of recording all intangible assets at historical deemed cost would be better than the current approach of fair value for most intangibles but cost for low value or short-life intangibles.

101. However, HM Treasury may wish to consider measuring intangible assets such as commercial patents that are held for their income generating capacity at fair value. This would arguably provide more relevant and decision useful information for users.

Question 23

Do you think the proposed changes of the preferred new option will improve the financial reporting for users of the accounts? If so, why? If not, why not and what alternatives do you propose?

102. Yes, we do. Option 3 should benefit users by providing more reliable, more understandable, and more timely financial information.

103. A deemed historical cost approach for specialised assets should have the added benefit of improving the timeliness of reporting. This should also help enhance the ability of annual reports support those responsible for holding public bodies to account.

104. We stress the importance of having high quality and relevant data to support decision making process. The year-end financial reporting process is just one part of the overall PFM process and applying historical cost to assets doesn’t mean that management will not have oversight of dilapidation rates (impairments), maintenance requirements, capital expenditure and depreciation. For example, detailed asset information should be contained within asset registers which should be reported back to management via monthly management reports.

105. Of concern is the continued application of DRC for networked assets. Not only will judgement be required to ensure such assets are correctly classified (network vs specialised assets) but the current challenges of applying DRC will continue and be amplified if local authorities apply this basis to their assets from 2025. Applying deemed historical cost to networked assets would remove complexity and cost and could improve reliability of the information reported.

106. We do not accept poor record keeping as a reason for not adopting a particular measurement basis. If anything, applying a current value measurement basis for an asset

that does not have a market is not appropriate, which is a point made in paragraph 4.32 of the consultation paper.

107. And finally, the Review makes an interesting point on the limited application of EUV in general. Knowledge and practical experience are only likely to diminish in the years and decades ahead and is something that should be considered. There is also a risk that EUV itself may change given that RICS is currently consulting on it.

Question 24

Overall, do you agree with the sub-classes of assets HM Treasury has identified in scope of IAS 16 for the purposes of the differential regime proposed? If so, why? If not, why not and what alternatives do you propose?

108. We agree with the sub-classes identified, with the primary exception of separable land, where there may be a case for classifying land separately from the buildings, facilities and other asset that sit on that land.

109. We have also suggested considering whether intangible assets such as commercial patents held for their income generating ability might be classified separately from other intangible assets.

110. We are concerned about the risk of inconsistency in the way assets are categorised, potentially including users trying to ‘game’ the system’. It is important that there is sufficient guidance to support users in classifying assets between sub-classes, and to support auditors in assessing their compliance with the accounting policies adopted.

Question 25

Are there any areas of ambiguity in the proposal that you think will require further guidance? If so, what areas would require further guidance?

111. We concur with the consultation paper’s suggestion that additional guidance on impairment would be helpful given this is an existing area of concern and there will a greater need to consider impairment if the proposals are adopted.

112. We also believe there will be a need for regularly updated guidance to support preparers in distinguishing between specialised, non-specialised and network assets. Practical guidance on how to apply the fair value guidance of IFRS 13 to non-specialised operational assets would also be helpful.

Question 26

Do you agree with the proposed effective date of financial year 2025-26 for the changes? If so, why? If not, do you think the proposed effective date should be accelerated to financial year 2024-25? If so, why?

Question 27

Do you agree with the proposed timeline for implementation? If so, why? If not, why not and what alternatives do you propose?

113. There are advantages to the proposed effective date of 2025/26 because the override for local authority infrastructure assets expires on 31 March 2025. However, should the current proposals for networked assets remain in place, there is a need to ensure sufficient funding for local authorities to enable them to rectify weaknesses in asset records and obtain DRC valuations by the effective date.

114. We concur with the need to get away from having different measurement bases for the same asset depending whether it is owned or controlled by central or local government. This hampers comparability as well as hindering the preparation of WGA. It is preferable that the same implementation date is applied across government.

115. We would encourage the government to set a realistic date that does not change rather than an unrealistic date that is continually deferred.

Question 28

Do you agree with the transition approach for the proposed amendments to the FReM? If so, why? If not, why not and what alternatives do you propose?

116. Yes, we agree with the transition approach.

Question 29

Are there any areas of guidance required for transition? If so, what areas would require further guidance?

117. We believe local government will need support and guidance on implementing DRC for the first time (or for a single occasion if our alternate proposal were to be adopted).

Question 30

Are there any other areas not covered by the questions which you would like to comment on? Please explain any comments, including providing alternatives HM Treasury should consider.

118. Changes to the valuation basis of assets will have an impact on areas where asset values are used to evaluate performance, monitor entities or set charges. For example, the valuation of assets is currently used as the basis of the calculation of capital charges for NHS trusts.
119. ICAEW believes this presents an opportunity to review this mechanism as we are concerned that the current approach of a flat percentage of total assets may create perverse incentives. For example, a NHS trust may be discouraged from necessary investment in essential new infrastructure as they are concerned that the capital charges will be unaffordable. In addition, it creates pressure on accounts preparers to seek to minimise the valuation of hospitals. We are aware of at least one case where a NHS trust hired consultants to advise them on how to reduce the value of property whilst remaining within the applicable accounting and valuation guidelines.
120. HM Treasury will also need to consider the impact of changes in the valuation of property on budgeting in central government. If the switch from current value to deemed historical cost for specialised assets results in an overall reduction in asset values, this could result in lower depreciation and therefore impact budgets.
121. In local government, a reduction in the value of operational property could affect the calculation of prudential indicators and other measures of financial sustainability. It is important that DLUHC takes this into account as part of its oversight of local government and the decisions it makes.
122. In addition to proportionate reporting requirements relating to non-investment assets in the public sector, we also want to see proportionate audit requirements. We welcome recent additional guidance in Practice Note 10 (Statement of Recommend Practice for Audits in the Public Sector) on setting materiality but call for the Public Audit Forum to consider further interpretations to auditing standards that enable a more proportionate audit approach.