David Heald's Response to the HM Treasury Consultation on Non-investment Asset Valuation Thematic Review

1. I am Emeritus Professor at the Adam Smith Business School, University of Glasgow. I was a member of the Financial Reporting Advisory Board to HM Treasury (2004-09) and specialist adviser on government accounting and public expenditure to the Treasury Committee (1989-2010). Those roles meant I had a ringside seat during the Treasury's conversion of UK central government accounting from cash to accruals on a current value basis. I am a member of HM Treasury's User and Preparer Advisory Group on government financial reporting. This submission only engages my own responsibility.

2. There is currently a chronic problem of audit delays in English local government, the reasons for which I explore below. I am opposed to all the options in the Consultation Paper (Treasury, 2023) which I believe are a misjudged response. I supported the Treasury's accounting reforms that began in the 1990s (Treasury, 1995) and I believe that reversing important elements of those because of the local audit crisis in England is a policy mistake that will later be seen as damaging.

3. I am concerned by what seems to be a panic in which accounting changes are proposed without full consideration of their long-term effects. I am not convinced that the proposed changes will address the underlying causes of audit delays. I do not understand why the Treasury has launched this consultation with a closing date before the publication of the Thematic Review on which the consultation is based. Respondents who have not seen the Thematic Review are placed at a serious disadvantage as the evidence in support of the Consultation Paper options is not fully in the public domain. There is no information about the methods or detailed results of the survey of 828 public sector entities conducted as part of the Thematic Review (Treasury, 2023, para 3.7). I have seen the Valuation Office Agency's (2023) response to the Consultation Paper, which I found helpful in understanding the background.

4. One of the Treasury's objectives in the 1990s was to secure consistent accounting across the UK public sector. Although there remain imperfections (for example, regarding local authority roads), this has been a creditable achievement. Consistent accounting across the public sector is an important contribution to fiscal transparency, making possible the Whole of Government Accounts (WGA) and facilitating the reconciliation of financial reporting numbers (WGA) and statistical accounting numbers (national accounts on the basis of ESA10) (Eurostat, 2013).

5. There are two separate issues:
   a) I am strongly committed to government accounting being performed on the basis of international accounting standards. In the UK's case, this has been on International Financial

Reporting Standards (IFRS) interpreted for public sector use by the Treasury with the consent of the Financial Reporting Advisory Board. I have long been aware that there remains substantial anti-IFRS feeling in the local government sector which is unlikely to be satisfied by piecemeal changes to the valuation of non-investment assets. Internationally, there is increasing use of International Public Sector Accounting Standards (IPSASs). Even though the UK does not use IPSASs, it is one of the countries that conforms closely to them

b) I am strongly committed to the use of current values in the public sector, which the Treasury promoted in the 1990s, even though IFRS allows for historical costs. I summarise below why current values should be the basis of financial reporting in the UK public sector.

6. It is striking that the audit crisis is in English local government. There is no crisis in local audit in Scotland, Wales and Northern Ireland, and no crisis in central government audit (Bradley et al, 2023; Heald, 2023). There are some delays in audits due to Covid-19, though these are being recovered. I reject the view that the accounting basis for public sector asset valuation should be changed because of what has been a self-inflicted injury in part of the UK public sector:
   a) Were it not for the abolition of the Audit Commission, and particularly of District Audit, there would now not be a local audit crisis in England
   b) Were it not for the obsession in the early 2010s with reducing local audit costs without regard for the consequences, there would not now be a local audit crisis in England. If local audit is going to be totally outsourced to the private sector, it is imperative that it is profitable for private audit firms and that their risk exposure is contained
   c) Were it not for the way that local authorities suffered a disproportionate share of austerity in the 2010s, there would not now be a local audit crisis in England. This has contributed to the deterioration of financial reporting capacity in local authorities at a time when the demands of accounting standards have increased and when some local authorities have engaged in complex and risky activities
   d) Were it not for reductions in central government oversight of English local authorities during a period of unprecedented expenditure cuts, there would not have been reckless behaviour by some local authorities which has damaged the reputation of the whole sector. Early warning systems in England were dismantled
   e) Were it not for audit failures in the private sector, in particular Carillion plc which collapsed in January 2018, it is unlikely that private audit firms with local audit engagements would have become so nervous of Financial Reporting Council (FRC) inspections. The FRC fining of Mazars (Financial Reporting Council, 2022) for the audit of an unnamed local authority sent shock waves through the audit firms with local audits subject to FRC review.

The local audit crisis in England does not derive from the use of current values but from policy and implementation mistakes and bad luck. Covid-19 and spillovers from corporate audit have aggravated an already desperate situation.

7. If one asks organisations or individuals whether they want less regulation and lower costs, they will usually say ‘Yes’. After 2010, there was local authority enthusiasm for cheaper audit and the elimination of centrally-run performance review. As the Redmond Review (2020) recognised, the core problem in the absence of a system leader has been fragmented authority. Capable and well-intentioned actors could not overcome system weaknesses (Bradley et al, 2023).

8. I have seen no evidence that the local audit crisis in England is caused by accounting standards, but the proposed amending of accounting standards across the public sector to reduce workload will shift the audit problem elsewhere. I am concerned about the impact on the WGA. I want to see the WGA published more quickly and with those audit qualifications which do not result from fundamental disagreements between the National Audit Office and the Treasury eliminated as soon as possible. However, two remedial measures worry me. First, for the 2020-21 WGA, the Treasury has increased the threshold for auditor review of local authority WGA submissions from £500 million to £2 billion, the same as for central government. This reduces the number of WGA returns subject to local auditor verification from a number not in the public domain to 10 (Public Accounts Committee, 2022, para 3) out of 383 (excluding parish councils). Whereas central government departments undertake different activities, local authorities undertake similar activities so that what might not be regarded as material at the entity level might be material at the aggregate level. Second, although the Consultation Paper proposals might be thought to make audit less demanding at entity level (though I have doubts), mixed measurements by asset categories might accentuate audit problems at the WGA level.

9. The principled reasons why the UK public sector should use current values are as follows:
   a) Public sector entities are not subject to capital markets. Corporate firms listed on markets are disciplined by the capitalisation of their future profit streams, which provides information supplementary to valuations in financial reports
   b) Public sector entities often have assets with very long lives and which sometimes are very expensive. Current values indicate how much depreciation is attributable to the current year and provide some protection against assets wearing out more quickly because of inadequate maintenance. Current values focus on service potential. Neglect of existing fixed assets was one of the drivers for adoption of accrual accounting in the UK public sector. Current values are helpful in terms of both fiscal sustainability (can the existing operating capacity be

sustained over time?) and inter-generational equity (are present citizens being privileged at the expense of future citizens through the running down of infrastructure assets?). Professional asset valuations perform an important public function and are not discardable overhead

c) Historical costs are irrelevant for decision making and accountability. Comparability between similar organisations is damaged when historical costs are used because those values will depend heavily on when assets were acquired. The local government sector is one of the parts of the UK public sector where comparability is possible and desirable because, unlike in central government, these entities undertake broadly comparable activities. The newly-established Office for Local Government seems likely to produce comparative statistics and financial comparisons will be much less informative without current values.

10. The pragmatic reasons why the public sector should not use historical costs are as follows:

a) Because many assets are long-lived, and may have been inherited from now abolished entities, records of historical costs may not be available

b) The assumption of the Consultation Paper is that using historical deemed cost will reduce the scope for disagreements between the audited entity and the auditor. In the present climate, where the private audit firms are nervous of FRC inspections, I doubt if this will be the case. I do not understand the claim that "As per the Conceptual Framework, using the deemed cost as a starting point for subsequent measurement at historical cost will help provide relevant information about the asset." (Treasury 2023, para 4.6).

11. For convenience, I have copied Table 1.A which summarises the Treasury's chosen Option 3. By shading out those asset categories which do not have changed accounting treatment, this presentation focuses attention on what valuation changes are proposed.

Table 1.A: Proposed Changes (Option 3)

Asset Category (using existing FReM categories)	Current Measurement	Proposed Measurement
Networked assets	Depreciated replacement cost, with the exception of English, Welsh and Scottish Local Authorities which depart from the FReM, and measure networked assets at historical cost	Depreciated replacement cost
Specialised assets (PPE)	Depreciated replacement cost	Historical (deemed) cost
Non-specialised assets (PPE)	Market value in existing use	Fair value
Heritage assets	Current value like other IAS 16 assets, but where not practicable to value, non-operational heritage assets reported at historical cost	No change proposed
Social housing assets	Existing use value	No change proposed
Surplus assets	Fair value	No change proposed
Intangible assets	Market value in existing use or historical cost for low value assets or assets with short useful lives	Historical (deemed) cost

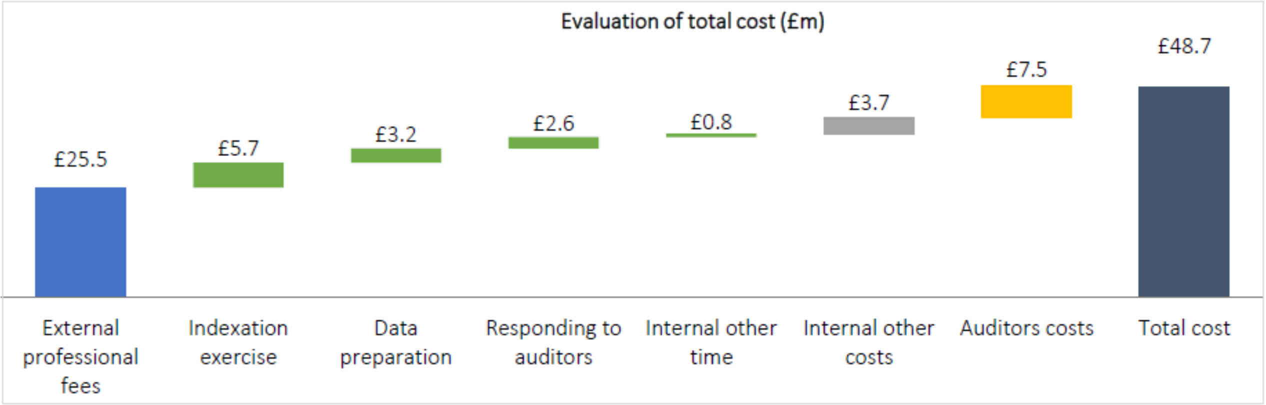
12. The asset categories in the first column of Table 1.A are already included in the FReM (Treasury, 2022b). This categorisation only has practical effects where the measurement basis (third column) diverges. Currently, networked assets (except for English, Welsh and Scottish local authorities) and specialised assets are measured at Depreciated Replacement Cost (DRC). Under Option 3, all networked assets would be measured at DRC but specialised assets would be measured at historical deemed cost. Drawing a line between these could become contentious. Rail and road networks are examples of physical infrastructure. However, other assets are parts of organisational networks, meaning that valuations are interdependent. For example, primary schools are part of a system of provision which can be affected by rapid demographic change: some schools might be operating well under capacity while other schools are under population pressure. Although I support local authority networked assets being moved from historical cost to DRC, I observe that this element in Option 3 is unlikely to satisfy the clamour for 'simplification' which largely comes from the local authority sector.

13. Under Option 3, with specialised assets moving from DRC to historical deemed cost, non-specialised assets would move from market value in existing use to fair value. Although these were not previously on the same basis, changes to the measurement basis might attract more

auditor attention. The Valuation Office Agency (2023, para 3.14) makes the important point that assets whose character looks non-specialist can become specialist because of their location. For example, office blocks can be on hospital or defence sites, thus limiting alternative use. The driving purpose of the Thematic Review Consultation Paper is to speed up audits and to reduce valuation costs, but I am doubtful whether that would be the outcome.

14. Proposed changes should be considered in comparison with the base of existing practice. 'Table 3.A: Evaluation of total cost of Current Regime' of the Consultation Paper (reproduced below) provides a decomposition of the costs of the Current Regime, which comes from the still-unpublished Thematic Review. What it is essential to consider is an estimate of the total cost of the Proposed Regime (Option 3), but this is not available. External professional fees are shown as more than 50% of the total cost of the Current Regime which has been in place for many years. It is noted in the Consultation Paper (Treasury 2023, para 3.10) that there has been an increase in external professional fees in recent years. This is probably because of the regulatory pressure on audit firms and the increased vulnerability of those firms. No quantification of those increases is provided.

Table 3.A: Evaluation of total cost of Current Regime



15. Almost everything in connection with public expenditure involves big numbers. The total cost of the Current Regime is given in Table 3.A as £48.7 million whereas total expenditure on public services in 2021-22 was £1,060.3 billion (Treasury, 2022a, Table 4.1). I reject the implication I hear that expenditure on operating the accounting and auditing system is wasteful, just as I rejected the post-2010 desire to reduce local audit costs. What should be investigated is why the external professional fees have been increasing (likely to be the consequence of increased auditor nervousness) and whether application guidance on implementation, particularly in relation to DRC, would lead to auditors usually being satisfied with the valuations done by the local authority's accredited external valuers.

16. Neither am I persuaded by the argument that the information provided by the current regime is not much used. Rather, the question should be why, contrary to the Treasury's (1995) intentions, this happens. My interpretation is that the system has been so stressed since 2010 that the purposes have been lost sight of. The accountability benefits of fiscal transparency and the challenges of fiscal unsustainability should motivate greater use.

17. The above text sets out my response to the Consultation Paper. I am opposed to all the Options (I support continuation of the Current Regime), so I am only responding to Question 3 on the Treasury's preferred Option 3.

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?

I have set out in the text above why I support continuation of the Current Regime. I fall into the group cited in the Consultation Paper (Treasury, 2023, para 3.24) as always favouring current values wherever practicable. Moreover, the present crisis about timeliness in the English local authority sector is mostly attributable to audit issues, not to accounting standards. Option 3 is intended to assist in the recovery of timeliness but I doubt that, and fear that audit problems may be shifted to other arenas, particularly in relation to the WGA.

References

Bradley, L., Heald, D. and Hodges, R. (2023) 'Causes, consequences and possible resolution of the local authority audit crisis in England', *Public Money & Management*, 43(3), 259-267.

Committee of Public Accounts (2022) *Whole of Government Accounts 2019–20*, Twentieth Report of Session 2022–23, HC 31 of Session 2022-23. London, Controller of Her Majesty's Stationery Office.

Eurostat (2013) *European System of Accounts: ESA 2010*. Luxembourg, Eurostat for the European Commission.

Financial Reporting Council (2022) *Sanctions against Mazars - January 2022*, London, Financial Reporting Council.

Heald, D. (2023) *Written evidence submitted by David Heald [FRA 012]*, Inquiry into Financial Reporting and Audit in Local Authorities, Levelling Up, Housing and Communities Committee, available at https://committees.parliament.uk/writtenevidence/120246/pdf/ (accessed 18 May 2023).

Redmond, T. (2020) *Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting*. London, Ministry of Housing, Communities and Local Government.

Treasury (1995) *Better Accounting for the Taxpayer's Money: The Government's Proposals*, Cm 2929, London, HMSO.

Treasury (2023) *Thematic Review of Non-investment Asset Valuation for Financial Reporting Purposes: Consultation Paper*, London, HM Treasury.

Treasury (2022a) *Public Expenditure: Statistical Analyses 2022*, CP 735, London, Controller of Her Majesty's Stationery Office.

Treasury (2022b) *The Government Financial Reporting Manual*: 2022-23, London, HM Treasury.

Treasury (2023) *Thematic Review of Non-investment Asset Valuation for Financial Reporting Purposes*, London, HM Treasury.

Valuation Office Agency (2023) *HM Treasury Thematic Review of Non-investment Asset Valuation for Financial Reporting Purposes*: *VOA Response to Consultation Paper*, London, Valuation Office Agency.

Glasgow, 18 May 2023