Impact of revaluations

Rising property market values will have a knock-on impact on the NHS through the revaluation process. Jill Boggan provides a basic guide to revaluations and the key implications for financial reporting

Despite a difficult economic period, property values in general have continued to increase, underpinned in more recent times by a broader increase in confidence in the economy in general.

The performance of the property market will clearly have an impact on future capital projects and purchases, but it will also be an influencing factor on the existing estate – and current finances – through the revaluation process.

The basis of valuation for all operational NHS assets is fair value, which equates to their market value – albeit a market value that assumes the assets continue to be used for their existing purpose. Accounting standard IAS 16 (paragraph 31) states that 'revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date'. For most major assets in the NHS, this means a full revaluation (using professional valuers) every five years, interspersed with annual desk-based adjustments or three yearly interim valuations. However, significant fluctuations in market prices or changes to the estate could warrant more regular full revaluations.

The impact of revaluations of NHS assets will depend on the method of valuation adopted. And this in turn will depend on whether the asset to be valued is specialised or non-specialised in nature. Most of the NHS estate – including virtually all hospital buildings – falls into the specialised asset category (certainly by value if not by number). For revaluation purposes, a specialised asset is one where there is a lack of reliable transactional sales evidence of comparable assets that the valuer can use to determine a fair or market value.

Specialised approach

Without easily available market values, an alternative method of assessing fair value is needed. Specialised assets are therefore valued using the depreciated replacement cost (DRC) approach. This establishes the cost of a modern equivalent asset that has the same service potential as the existing asset and then adjusts this value to take account of age and obsolescence. This obsolescence includes physical obsolescence (the wearing out of the asset over time) and functional obsolescence (the design and layout make it less fit for purpose than a more modern asset).

When revaluing an asset adopting the DRC approach, all the construction and building material costs of providing a modern equivalent asset have to be assessed using prices at the date of valuation, before allowing for depreciation of the asset. In general terms, building costs are increasing due to increased activity and demands placed on the construction industry. These increased costs will tend to result in an increase in the value of the asset at revaluation, although this is, to some extent, offset by the depreciation element (the asset has less useful life

and more wear and tear than at the last valuation). Any improvements made to the specialist asset by way of capital expenditure, such as renewal or replacement of some of the building's components, will tend to offset the impact of depreciation.

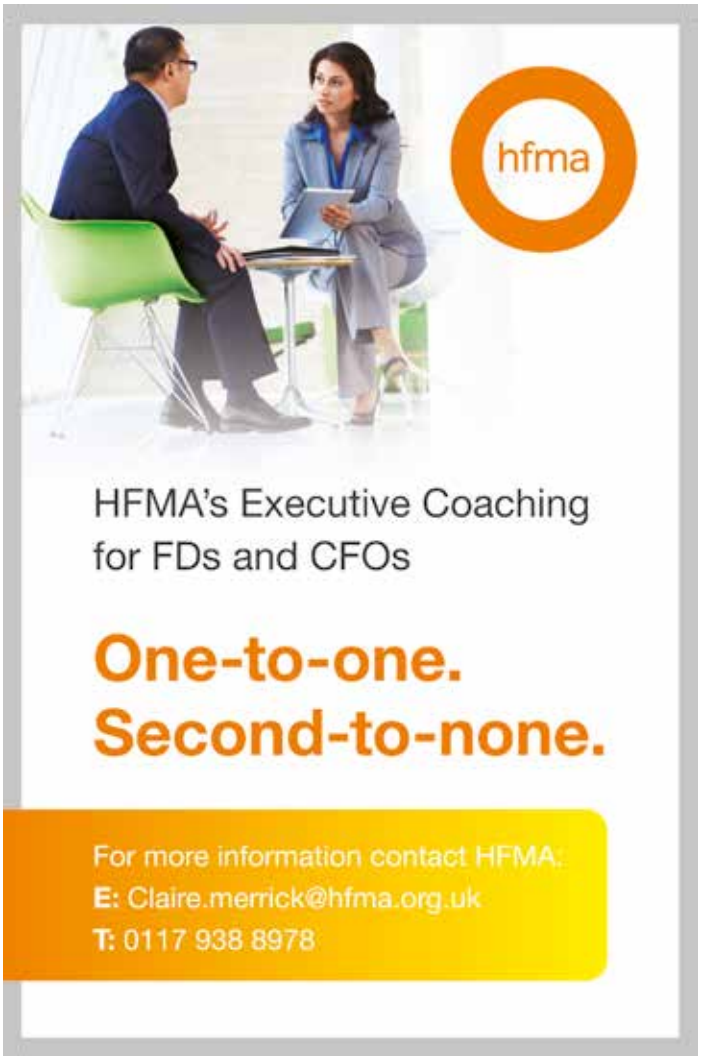
Non-specialised assets

Non-specialised operational assets, such as office buildings, are valued using market comparables. While activity in the housing sector is widely reported as having increased in some parts of the country, with corresponding increases in market value, it is important to note that this will not necessarily be the case within the health sector. Again the revaluation should be on the basis that the asset would continue to be used for the same purpose and so market comparables should be relevant to this continued use.

Non-operational assets

In contrast, the revaluation of non-operational assets should reflect potential alternative uses. The assumption for this is that the property is no longer required for existing operations and operations have ceased.

Typically assets become non-operational as the properties have become functionally obsolete or require significant refurbishment that is uneconomical. As such, the most likely alternative use is often redevelopment – with this quite likely to be for residential housing. This means that if residential land is increasing in value, this should be reflected when the non-operational asset is revalued.



Land

In a formal revaluation, the separate values of an asset and the land it is built on will be identified. In subsequent revisions to the value, separate consideration will need to be given to these two elements. For a non-specialised operational asset, the land element will be an apportionment of the asset's total fair value taking account of market values for comparable land. For a specialised asset, the land will reflect the cost of a site suitable for a modern equivalent facility. This will also be based on market evidence and may mean a rise in the land value assessed for the asset. Since land is not subject to depreciation for financial reporting purposes, this increase in value is not offset by depreciation. The key implications of the revaluation of NHS assets are discussed below.

Depreciation

The accounting policies adopted by NHS bodies follow the Treasury's *Financial reporting manual* and significant variation would require discussion with and authorisation from the Department of Health. NHS bodies recognise depreciation as an expense based on the cost or valuation of the asset at the outset, less any residual value, spread over the estimated useful life of the asset. If land and building values increase, and there are no changes in the estimated useful life of the asset, the annual depreciation charge recognised in operating expenses will rise.

Example: impact of revaluation on depreciation (£000)

Building value 31 Mar 13 (pre-valuation)	1,000
Estimated life	25 years
Annual depreciation charge	40
Building value 31 Mar 13 (revalued)	1,100
Estimated life	25 years
Annual depreciation charge (revalued amount)	44

Impairment

When an asset value decreases as a result of a change in market values, the impairment is charged to the revaluation reserve up to the level of any balance held for that asset in the reserve. If the impairment exceeds

Example: reporting impairments (£000)

Building value 31 Mar 12	2,000
Building revalued 31 Mar 12	1,600
Impairment (as a result of changes in market values)	400
Revaluation reserve balance for building 31 Mar 12 before impairment	300
Impairment charged to revaluation reserve	300
Revaluation reserve balance for building 31 Mar 12 after impairment	Nil
Impairment taken to operating statement 31 Mar 12	100
Building value 31 Mar 13 (brought forward from 1 Apr 12)	1,600
Building revalued 31 Mar 13	2,200
Increase in value as a result of changes in market values	600
Reversal of previous impairment credited to operating expenses 31 Mar 13	100
Balance of increase in value taken to revaluation reserve for the building 31 Mar 13	500

this balance, the excess must be charged to operating expenses. If there is a subsequent increase in the value of the asset due to changes in market values, the increase in value can be credited to operating expenses up to the amount previously charged. Any excess is then taken to the revaluation reserve for the asset.

PDC dividend payment

Rises in asset values will increase the value of net relevant assets used to calculate public dividend capital (PDC) dividend payments. The current rate of dividend payments is 3.5% of average net relevant assets. In the first year of an increased asset value, the impact on the dividend payments will only be 1.75% of the rise in the asset value. In subsequent years, the PDC will feel the full impact of the increased asset value.

Example: impact of revaluation on PDC dividend (£000)

Opening net relevant assets 31 Mar 13	10,000
Closing net relevant assets 31 Mar 14	12,000
Average 31 Mar 14	11,000
Less: average GBS balances 2013/14	(2,000)
Average net relevant assets 31 Mar 14	9,000
PDC dividend 2013/14	315

Opening net relevant assets 31 Mar 13	10,000
Closing net relevant assets 31 Mar 14 (revalued property assets)	13,000
Average 31 Mar 14	11,500
Less: average GBS balances during 2013/14	(2,000)
Average net relevant assets 31 Mar 14	9,500
PDC dividend	332.5
Increase in PDC div payable 2013/14 (revalued property assets)	17.5

Assuming all else remains the same and no impact of surplus in 2014/15	
Opening net relevant assets 31 Mar 14	13,000
Closing net relevant assets 31 Mar 15	13,000
Average 31 Mar 15	13,000
Less: average GBS balances 2014/15	(2,000)
Average net relevant assets 31 Mar 15	11,000
PDC dividend 2014/15	385

Continuity of services ratios

Increased PDC dividend as a result of increased average net relevant assets will also have an adverse impact on the continuity of services – annual debt service cover ratio.

Example: impact of PDC dividend rise (as a result of revaluation) on continuity of services rating

Using PDC in above example and assuming no other debt service

	Pre revaluation PDC £000	Post revaluation PDC £000
Operating surplus	2,000	2,000
PDC dividend	(315)	(332.5)
Comprehensive income and expenditure for the year	1,685	1,667.5
Continuity of services, annual debt service cover		
Comprehensive income and expenditure for the year	1,685	1,667.5
Add PDC dividend	315	332.5
Revenue available for debt service	2,000	2,000
Debt service cover	6.35 x	6.01 x

Residual value

NHS bodies will have a process for assessing indicators of impairment, value and the estimated remaining useful life of assets on an annual basis. An area that may not have received attention is residual value of assets. It may be worth reviewing the assumption that most building assets will be used until the end of their useful life. The need to factor in residual value may increasingly be an issue as the NHS works towards greater integration and transformation of services. This could impact on the calculation of depreciation for both buildings and equipment assets.

Example: impact of residual value on depreciation

An NHS trust is awarded a five-year contract to deliver a service after competitive tender. The trust has to buy a scanner for £1m. The scanner will be used by the trust for five years with residual value assessed at £250,000 after five years. The trust intends to dispose of the scanner at the end of the contract

Depreciation calc using residual value of £250,000	**£**
Scanner at cost – assessed as being fair value	1,000,000
Less: residual value	(250,000)
Economic benefits to be consumed by the trust	750,000
Annual depreciation charge	150,000
Depreciation calc not recognising value of £250,000	**£**
Scanner at cost – assessed as being fair value	1,000,000
Annual depreciation charge	200,000

The above examples and scenarios look at the most typical impact of upward revaluations in NHS assets and there will be alternative scenarios that give a different result.

While there is an overriding question around whether upward revaluations are ever good news for NHS bodies, the impact of cost pressures from increased depreciation and PDC dividend will focus attention on the wider issues around NHS estate management as part of the transformation agenda.

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