Briefing Paper

Housing Revenue Account – Valuations, Depreciation and Impairment

June 2015

Lambeth Town Hall at Brixton. Like many local authorities, Lambeth Borough Council has ambitious regeneration and new build schemes. These may be adversely affected by the methods of accounting for valuations, depreciation and impairment.

Introduction

Ever since self-financing was introduced in 2012 I have been warning that the system includes a well concealed 'time-bomb' in the form of the arrangements for valuation, depreciation and impairment that it is envisaged will come into being when the transitional period comes to an end in 2017.

Now some councils are beginning to realise the threat to their finances and to their development programmes.

This is a rather technical accounting issue but it could cost councils and their tenants millions so I will try to explain it in relatively simple terms. The problem is that when councils reduce the value of their housing stock on the balance sheet either to reflect depreciation (the planned write down of asset values over time) or impairment (the immediate write down of asset values when something happens) they make an equivalent charge to the housing revenue account. However, before self-financing was introduced, and during the transitional period until 2017, councils are able to 'reverse' this charge so that it is not a real cost to the housing revenue account and to tenants. After 2017 they will not be able to do this and the depreciation and impairment charges will become real costs.

Furthermore, problems already exist with the treatment of non-dwelling assets, and problems are already looming for authorities that are building new housing where the schemes may complete after March 2017.

Definitions

Councils value their council housing using a method called 'existing use value for social housing'. This is less than open market value, reflecting the fact that council houses are let at rents that are below market rent and therefore can be expected to generate less income than dwellings that are let at open market rates. There has recently been a move to 'component accounting' which requires councils to identify different components within a dwelling (for example, the roof, the kitchen and the windows) and to value each separately.

Because council houses are treated as operational assets (assets that are used to provide a service) rather than as investment assets (assets that are held to generate a financial return), it is considered appropriate for the housing revenue account to be charged with depreciation to reflect the cost of the 'capital' that is used in providing council housing. Depreciation is calculated by looking at the value of each component in the dwelling and its useful life. For example, if a house is valued at £60,000 and has a useful life of sixty years the depreciation charge would be £1,000 a year. Each year the value of the house would be written down by £1,000 and the housing revenue account would be charged £1,000 as depreciation.

Impairment also arises when the value of a dwelling is reduced but it arises as a result of a specific change of circumstances rather than as part of a long-term plan as with depreciation. For example, a council may reduce the valuation of its council houses if it discovers contamination or subsidence. Impairment charges also arise when a council buys a dwelling on the open market and then decides to use it as social housing because the value will reduce from open market value to existing use value for social housing. When impairment occurs a council reduces the value of its assets and makes an equivalent charge to the housing revenue account.

Before self-financing, depreciation and impairment were regarded as 'notional' costs so were ignored when calculating the balance on the housing revenue account reserves. However, when self-financing was introduced it was decided that, after a five year transitional period that comes to an end in March 2017, depreciation and impairment would be treated as 'real' costs in the housing revenue account.

Background

Before self-financing started in April 2012 any entries in the income & expenditure account for valuation and impairment losses were fully reversed out in the housing revenue account statutory adjustments (the same also applied to annual depreciation). The move to self-financing changed this and created different approaches to the treatment of non-dwellings, investment properties and dwellings.

The current arrangement for non-dwellings is that any valuation and impairment losses are charged to the income & expenditure account where there is no revaluation reserve available. There is no reversal of this entry under the housing revenue account statutory adjustments. Consequently if values reduce, the housing revenue account will have a lower balance for the year. This means that the working balance for the year end is reduced. If there is an increase in the value of a council's assets this is credited to the income & expenditure account and reversed out under the statutory adjustments so there is no net impact on the housing revenue account. This is because the 'Item 8 determination' (a determination that is issued annually by the Department for Communities & Local Government that determines the treatment of capital-related transactions in the housing revenue account) does not allow upward valuations to be posted to the housing revenue account. However, councils are obliged to post downward revaluations to the housing revenue account and if they subsequently have upward revaluations they cannot post these to the income & expenditure account to offset the costs in previous years (even though this would accord with proper accounting practice). This does not appear to be rational or to be fair to councils or their tenants.

Investment property is not specifically mentioned in the current arrangements. The term is also not specifically included in the definition of impairment in the 'Item 8 debit and credit determinations' that refer to 'land houses or other property' and 'proper accounting practices'. It is assumed by most practitioners that the reference to 'other property' can be taken to include investment property but it could be argued that the basis for this is unclear.

The Housing Act 1985 (Clause 12, Part2) allows the 'Provision of shops, recreation grounds etc.' to be accounted for within the housing revenue account (subject to the approval of the Secretary of State). The presumption here is that the facilities are provided 'in connection with the provision of housing accommodation' and 'will serve a beneficial purpose (to) the persons for whom the housing accommodation is provided'. So it is possible to have non-dwelling assets in the housing revenue account which, if they are generating market income, would meet the definition of Investment Property.

There is therefore a need to be clear about how changes in the value of investment property are shown in the accounts. Accounting practice requires any gains or losses to be accounted for in the housing revenue account in the year in which they arise as there is no revaluation reserve for this class of asset. The change in value is technically determined as a change in 'fair value'. This term does not appear in the 'item 8 debit and credit determinations' that refer to revaluation and impairment. The Accounting Code also has this distinction in terminology. It could therefore be concluded that changes in fair value are not required by the item 8 determinations but debits and credits of equal value can be posted to the housing revenue account to comply with proper accounting practice.

The current arrangement for dwellings is that any valuation and impairment losses are charged to the income & expenditure account where there is no revaluation reserve available. For the five year period ending on 31st March 2017 (the transitional period) this entry can be reversed under the housing revenue account statutory adjustments. After this no reversal is possible. Currently therefore, changes in the valuation of dwellings or any impairment losses do not have any impact on the housing revenue account, which in turn means that the working balance for the year end is unchanged. This was the position before self-financing was introduced.

Once the transitional period ends, there is no reversal under the housing revenue account statutory adjustments. Consequently, if values reduce, the housing revenue account will have

a lower balance for the year, which in turn means that the working balance for the year end is reduced (the same position that currently exists for non-dwellings). In practice many local authorities have reported revaluation losses during the transitional period and if this were to be repeated after the end of the transitional period significant 'real' costs would be charged to the housing revenue account.

New build has particular issues as evidenced by the following example. A council has just finished a scheme for the construction of five dwellings. This scheme shows a positive net present value when assessed over thirty years and meets all other financial appraisal criteria. However, this scheme is funded from revenue so there is a charge to the housing revenue account statutory adjustments for the capital expenditure (£750,000). The market value of the dwellings is £1,185,000. The dwellings are valued on the basis of 'existing use value for social housing' at 32% of market value, giving a balance sheet value of £379,200 and a loss on revaluation of £370,800. During the transitional period such a loss is 'reversed out' but in future, the £370,800 would be an extra charge to the housing revenue account. This would require equivalent expenditure reductions as the housing revenue account business plan uses all available resources and is at its minimum working balance. In addition to this there is an annual depreciation charge to the income & expenditure account even though the scheme was fully charged to revenue at the time it was built.

The analysis above generates an irrational position in that it cannot make any sense for a viable scheme to generate an immediate revaluation loss. While this can be 'reversed out' during the transitional period it will become a major issue for local authority new build for schemes finishing after March 2017. As this is less than two years away, authorities planning new build schemes at the time of writing will be likely to be considering schemes that would not be completed until April 2017 or later and which would therefore be affected by the end of the transitional period.

The housing revenue account working balance is treated as a useable reserve while the revaluation reserve is treated as an unusable reserve. In practice a Council's Chief Financial Officer recommends a minimum acceptable level below which the housing revenue account balances should not fall. Section 76(3) of the Local Government and Housing Act 1989 requires a Council to make 'the best estimates that they are able to make at that time of the amounts which… will fall to be… credited or debited (to the housing revenue account to) secure that the account… does not show a debit balance'.

The Act stipulates which items are to be debited or credited to the housing revenue account. The housing revenue account working balance is the net balance after these entries and is therefore the key figure that determines whether the account is in surplus or deficit. The legislation requires that housing revenue account balances should always be positive but recognises that unforeseen events may lead to unexpected deficits, in which case it is expected that steps would be taken to correct the situation.

It is therefore possible for a revaluation or impairment loss to push the housing revenue account working balance into a negative situation, requiring an immediate reduction in spending plans to correct the situation. In effect a usable reserve is reduced due to a change in asset valuation, which in most cases is an unusable reserve. In addition, a revaluation or impairment loss does not reduce the level of cash available to the business to meet its obligations but any reduction in spending plans would generate cash savings.

Gains or losses on right to buy disposals could still be neutralised against the capital adjustment account through the movement on housing revenue account balances so this would have no overall impact on housing revenue account resources. In calculating the gain or loss, it is necessary to regard the discount given to tenants as a cost of sale and therefore the sale proceeds are 'grossed up' to the open market value.

One authority has classified garages, community centres and shops on estates as non-dwellings. Some Councils have transferred garages to the general fund or even treated them as investment properties to avoid problems with accounting for depreciation and impairment.

Councils incur impairment losses on dwellings that they buy back (dwellings that were previously council houses that the council buys back from their private owners at open market value). In these cases, the Council would value the bought-back dwelling at existing use value for social housing after paying the market value with the difference being accounted for as impairment. During the transitional period this is not an issue as these valuation losses continue to be 'reversed out'. However, after the transitional period these losses would become a genuine charge against housing revenue account resources.

Department for Communities & Local Government Determinations

What can and cannot be charged to the housing revenue account is governed by statute. The Local Government and Housing Act 1989 provides the basis for the current rules. Schedule 4 to this Act lists all debits and credits. The most relevant for the purposes of this paper are the Item eight Debit and Credit determinations. The last such determinations were issued in February 2012 just prior to the introduction of self-financing. In terms of impairment they specify:

- Debits – Impairment Charges means any revaluation and impairment decreases in respect of land, houses and other property within the authority's housing revenue account calculated in accordance with proper accounting practice.
- Credits – Impairment Adjustments allows local authorities to reverse valuation and impairment decreases on dwellings out of the housing revenue account. Revaluation and impairment decreases are calculated in accordance with proper accounting practices. This applies for a transitional period for the 2012/13 financial year and the four subsequent financial years.

It should be noted that the current Determinations only relate to decreases. In other words, it is not possible to follow the procedure currently set out for non-dwellings and credit back to the housing revenue account increases in valuation where losses have previously been charged there as they were not covered by a revaluation reserve. Such a situation will also apply to dwellings at the end of the transitional period.

So for example, if a non-dwelling asset is valued at £1million today with no revaluation reserve and over a five year period, had revaluation losses totalling £250,000 and increases in valuation of £300,000, leaving a net increase in value of £50,000; current rules would require the £250,000 to be debited to the housing revenue account. The credits could be posted to the income & expenditure account but would have to be reversed under the statutory adjustments. The overall effect is that the housing revenue account working balance would be reduced by the valuation decreases but is would not be able to gain from the revaluation increases, leaving a net reduction in working balance of £250,000 despite an overall increase in value of £50,000. This could hardly be claimed to be a reasonable position.

I understand that the Chartered Institute of Public Finance & Accountancy have an understanding with the Department for Communities & Local Government that additional entries not covered by the determinations can be made to the housing revenue account to comply with proper accounting practice as long as there is no net impact on the housing revenue account working balance. All debits and credits that are not specified in the determinations must be reversed.

The Problems

It appears that the combination of the current Chartered Institute of Public Finance & Accountancy arrangements and the Department for Communities & Local Government determinations creates difficulties. In particular:

- The determinations do not allow the housing revenue account to be credited with revaluation gains that reverse previous losses charged to revenue in accordance with proper accounting practice. This position exists now for non-dwellings assets. It will exist at the end of the transitional period for dwellings.
- The requirement to make non-reversible charges to the housing revenue account for valuation and impairment losses means that it is not possible to treat the full working balance on the housing revenue account as a usable reserve as it is being reduced by non-cash entries that relate to unusable reserves.

This is an urgent issue. Councils are being encouraged to build new dwellings. Right to buy retention agreements allow councils to retain ‘extra’ Right to buy receipts. It is possible to bid for increases in the debt cap to support new build schemes. Councils will shortly reach the point where they will be taking decisions on new build schemes where completion will take place after March 2017. If such schemes would result in impairment losses that could not be ‘reversed out’ it would be questionable whether such schemes would remain economic.

One solution would be for the determinations to be amended so that revaluation losses and gains and all impairments would be shown in the housing revenue account in accordance with proper accounting practice. All such entries would then be ‘reversed out’ including those relating to dwellings and non-dwellings. This would leave the housing revenue account working balance unaffected by such entries and to continue to be treated as a usable reserve. The revised determinations would allow local authorities to implement these changes with immediate effect. Retrospective adjustments may be appropriate in some cases.

An alternative would be to split the housing revenue account working balance between a usable and unusable reserve. The calculation of whether the housing revenue account is in surplus or deficit would need to be based on a calculation using the usable reserves and confirmation would be required that this would meet the requirement of Section 76 of the Local Government & Housing Act 1989.

Urgent action is needed to address these issues. Without it, there is a real risk that housing revenue account working balances will be reduced by revaluation and impairment losses that would lead to requirements to curtail spending plans.

The Potential Impact on New Build

One of our concerned local authority clients has well developed plans for the construction of new dwellings in the housing revenue account but is getting increasingly concerned about the potential impact of valuation losses arising from new build and buy backs. They have identified two examples as follows:

New build accounted for within housing revenue account
Cost of new build £10,000,000
(The actual cost of building the homes).
Existing use value for social housing £2,500,000
(The valuation on the balance sheet to reflect the fact that the homes are provided at social or affordable rents rather than market rents).
Valuation loss therefore £7,500,000
(The amount that would have to be charged to the housing revenue account and covered by savings in other budgets such as management or maintenance).

Buy backs
Cost of buy back £200,000
(The actual costs of buying back former council homes)
Existing use value for social housing £50,000
(The valuation on the balance sheet to reflect the fact that the homes are provided at social or affordable rents rather than market rents).
Valuation loss £150,000
(The amount that would have to be charged to the housing revenue account and covered by savings in other budgets such as management or maintenance).

In both cases, assuming the dwellings are for Social Housing, Existing use value for social housing would result in valuation losses and if the Council had inadequate revaluation reserves in the housing revenue account, these would be charged to housing revenue account balances.

A unitary authority is planning to demolish and rebuild about 1,500 properties over a period of years and are seeking a strategic partner with whom to work. When these properties are demolished they will be written out of the asset base incurring an impairment charge of about £50million (based on an average book value of £33,600). When the new homes are built at a cost of about £120,000 each they will initially be added to the assets on the balance sheet at open market value at about £180million (1,500 properties at £120,000 each) and then revalued to existing use value for social housing at about £58million (32% of open market value). The difference of £122million would be accounted for as impairment. The total impairment would therefore be £172million. If the Council completes the scheme before 31st March 2017, this impairment would be ‘reversed out’. However, if the scheme takes place after 1st April 2017, the housing revenue account would be put into a significant deficit position. If the scheme straddles the two periods the impairment would be partly ‘reversed out’. However, the extent of any impairment charge in 2017/18 or subsequent years would probably ‘bankrupt’ the housing revenue account.

A district council purchases new build properties at cost price and then revalues them to existing use value for social housing resulting in a large impairment charge. While this charge is currently ‘reversed out’ it would not be from 2017/18 and this would significantly affect their ability to provide new social housing.

This situation appears to be a contradiction of the principles of the Local Authority Accounting Code that states that Impairment losses and reversals of impairment loss charged to a surplus or deficit on the provision of services 'are not proper charges to the general fund' (and the housing revenue account is technically a ring-fenced part of the general fund). The current situation leaves the housing revenue account being charged with non-dwelling valuation losses but not credited from valuation gains reversing those losses - which appears to be unfair to tenants and not in accordance with good accounting practice.

This is a significant issue and councils clearly require clarity on what mitigations (if any) they can expect after April 2017 when the transition ends. If it is the Government's policy to encourage new build the current rules provide a major disincentive.

Department of Communities & Local Government Reaction

In April 2013 the Chartered Institute of Public Finance & Accountancy's Finance Advisory Network issued a briefing entitled 'Housing Revenue Account Depreciation, Impairment and Valuation Losses (England)' that said that the Institute was in discussions with the Department for Communities & Local Government on possible solutions to the potential problem of impairments that cannot be met from the revaluation reserve hitting the housing revenue account balance after the five year transitional period. However, progress on addressing the matter appears to have been slow. I understand that it was discussed at the Chartered Institute of Public Finance & Accountancy's Housing Panel in November 2014 where panel members were assured that the Department for Communities & Local Government was aware of the issues.

However, as one local authority practitioner pointed out:

"If the Department for Communities & Local Government are aware of the urgency… why the continuing silence? Although the effects of the impairment issue won't be felt for a couple of years, we're having to make decisions now about the provision of new housing - partly because of the… conditions around 1-4-1 receipts. Delays in resolving this issue may mean that housing won't get built, since local authorities may not be willing to accept the risk to the viability of their housing revenue accounts that the impairment issue presents."

In April 2015 it was reported that civil servants were drawing up plans to ensure that these technical accountancy rules do not prevent councils building new homes.

Milan Joshi, service accountant at Harrow Borough Council, was reported as saying that local authorities were exposed to serious financial risk over the issue and that before self-financing, impairment charges were written off as a 'technical anomaly'.

The Department for Communities & Local Government said that it does not want councils to be put off building new homes because of accountancy rules and has told sources it will publish a consultation to ensure housing revenue accounts do not take the hit for depreciation and impairment losses after 2017. This consultation is still awaited.

Conclusions

The Chartered Institute of Public Finance & Accountancy do not expect any immediate mitigation for valuation losses relating to non-dwellings as there are still no clear messages of intent regarding the non-dwelling side of things. However, I understand that Department for Communities & Local Government representatives have indicated that the accounting issues should not become a barrier to councils engaging in the Government's social housing policies. They have indicated that this would mean changing the determinations to ensure losses are reversed beyond the five-year transition period, however there is no draft legislation in place to effect this.

We understand that the Department for Communities & Local Government will be going out to consultation on amended determinations now that the 2015 general election has been held. As the transitional period runs out in March 2017 there is still some time to address this but the existing accounting position remains for 2014/15. Doubtless, local authorities will wish to respond to any consultation that emerges.

The move could encourage councils to continue to build more homes as it would mean they would not have to take more financial risk. Housing Minister Brandon Lewis has said that:

"Subject to the need to pay off (the) deficit, we will continue to remove Whitehall barriers and encourage long-term investment in affordable house building."

My personal view is that is it remarkable that these issues were not identified before self-financing was introduced in 2012 and surprising that we are still awaiting the government's proposals within two years of the ending of the transitional period.

This matter will be among those that will be considered at our seminar and workshop: 'Developments in Local Authority Housing Finance' that will be held in London on 9th June 2015. Details are shown below.

Adrian Waite
June 2015

Developments in Local Authority Housing Finance in England 2015

June 2015

We are holding a seminar and workshop on 'Developments in Local Authority Housing Finance in England' in London on 9th June 2015. This seminar is designed to look in depth at current developments in local authority housing finance in England – especially the implications of the policies of the new government, ongoing austerity, welfare reform, sale of high value properties to fund the extension of 'right to buy', self-financing and new development.

If you want to be up to date with the world of local authority housing finance, this is the seminar and workshop for you!

Seaview House, a Canterbury Council Sheltered Scheme in Herne Bay, Kent.

The seminar and workshop will address the following questions:

- What is the Political, Economic, Social and Technical Context?
- What are the implications for local authority housing finance of the new government's policies on housing and welfare?
- How can we develop effective self-financed business plans?
- How can we invest in existing and new housing including regeneration in the light of the 'borrowing cap'?
- How can we get 'value for money' and excellent customer service?

The day also includes a Participatory Case Study – Business Planning for a Local Authority Housing Revenue Account.

Who should attend?

All those with an interest in developments in local authority housing finance in England, including Managers in Local Authorities and Arm's Length Management Organisations, Elected Members, ALMO Board Members, Housing Accountants and Tenant Representatives. The session will assume a basic knowledge of local authority housing finance but will not assume that delegates are experts. Attending this seminar and workshop is a good way of keeping up to date with developments in local authority housing finance.

The session is accompanied by a very useful book entitled:
"Developments in Local Authority Housing Finance in England 2015"

Venue and Date:

London: Novotel Hotel, Waterloo – Tuesday 9th June 2015

For further information or to make a booking, please visit our website at: http://www.awics.co.uk/devts15.asp

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Future Seminars and Workshops:

All You Want to Know about Local Authority Housing Finance:
- Oldham - 7th July 2015
- London - 10th November 2015

All You Want to Know about Housing Association Finance
- Oldham - 29th September 2015

All You Want to know about Service Charges in Social Housing
- London - 10th June 2015

Developments in Local Authority Housing Finance in England
- London - 9th June 2015

All You Want to Know about Scottish Social Housing Finance
- Falkirk - 15th September 2015

For further information please see http://www.awics.co.uk/seminars2015.asp or contact Adrian Waite at Adrian.waite@awics.co.uk or 017683-52165.