Existing use value valuations for UK public sector financial statements

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Document definitions

Document type	Definition
RICS professional standards	Set requirements or expectations for RICS members and regulated firms about how they provide services or the outcomes of their actions. RICS professional standards are principles-based and focused on outcomes and good practice. Any requirements included set a baseline expectation for competent delivery or ethical behaviour. They include practices and behaviours intended to protect clients and other stakeholders, as well as ensuring their reasonable expectations of ethics, integrity, technical competence and diligence are met. Members must comply with an RICS professional standard. They may include: • mandatory requirements, which use the word 'must' and must be complied with, and/or • recommended best practice, which uses the word 'should'. It is recognised that there may be acceptable alternatives to best practice that achieve the same or a better outcome. In regulatory or disciplinary proceedings, RICS will take into account relevant professional standards when deciding whether an RICS member or regulated firm acted appropriately and with reasonable competence. It is also likely

Document type	Definition
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1 Introduction

This document applies to RICS members in the UK when applying existing use value (EUV) valuations of owner-occupied operational properties in public sector valuations. The content is intended to assist members by explaining and reaffirming the principles of EUV when used in the public sector financial reporting context and to enable a more consistent approach. While the geographic scope of this standard is the UK, many of the principles are globally applicable and may support RICS members outside these jurisdictions.

This professional standard addresses the valuation for financial reporting purposes of UK public sector owner-occupied operational properties that are classified as non-specialised. Their prescribed valuation basis is *existing use value* (EUV) as defined in UK VPGA 6 of the RICS Valuation – Global Standards: UK national supplement (Red Book: UK).

Please note: The cross references in this standard relate to the updated Red Book: UK, which went to consultation in November 2022 and is due to be published later in 2023.

It does not address any other use to which the term '*existing use value*' is put, such as in development viability, where *existing use value* is the first component of the benchmark land value within a viability assessment.

The current definition of EUV dates from its inclusion from 1 May 2003 in the RICS *Appraisal and Valuation Standards,* 5th edition. There have been two previous RICS publications providing guidance on its principles and application, these *being Valuation Information Paper 01* in 2002 and the guidance note *Valuations for financial statements under UK GAAP* in 2011, both subsequently archived as the use of *fair value* became predominant for financial reporting purposes.

Use of the UK VPGA 6 EUV basis has continued in the public sector for the valuation of property classified as property, plant and equipment (PP&E) under IAS 16 for financial reporting purposes. RICS has become aware that the continued use of EUV by UK public sector bodies in what is otherwise an International Financial Reporting Standards (IFRS) reporting environment, and in the absence of the previously available RICS guidance, can give rise uncertainty and inconsistencies in how valuers and other stakeholders are sometimes interpreting and applying the EUV definition and its conceptual framework.

This professional standard explores the underpinning measurement principles of the adapted accounting standards, unpacks the EUV definition and considers its practical application and issues that may be encountered by valuers. Case studies in appendix A provide best practice guidance on the application of EUV in a range of real-life scenarios.

As a market-based assessment of value, EUV relies on the availability of comparable market evidence that is capable of analysis and appropriate application by the valuer, using the required assumptions embodied within EUV, to reliably inform the asset valuation being undertaken. Where there is an absence of such market evidence, the valuer may have to resort to the use of depreciated replacement cost (DRC) as a measurement basis (see section 8).

This professional standard will be effective three months after publication.

2 UK public sector measurement principles

2.1 Accounting standards

International Financial Reporting Standards (IFRS) are the accounting standards followed for financial reporting purposes by most UK public sector bodies, including central government, local authorities and the NHS. However, the adoption of IFRS by these bodies is subject to the application of certain adaptations and interpretations approved by the Financial Reporting Advisory Board.

For the valuer, the most important adaptation is that the IFRS 13 standard and its fair value basis of valuation does not apply to the measurement of public sector operational assets, whether specialised or non-specialised. These are assets classified as PP&E under IAS 16. They are usually occupied (or treated as being occupied) by the owners of the interest being valued for the purposes of delivering their operational functions.

This adaptation was made because the primary driver of public sector financial reporting is the service potential (operational capacity) of these assets for ongoing delivery of existing services within a specific location, rather than a measurement of the opportunity cost of holding them in terms of the cash flows that could be generated through disposal. As a result, operational assets are valued having regard to the amount required to replace at least cost their service potential for the ongoing purpose to which they are being put by the entity at the valuation date. The RICS valuation basis used to deliver this principle for non-specialised assets is existing use value (EUV).

EUV is defined in UK VPGA 6 of the RICS Valuation – Global Standards: UK national supplement (commonly referred to as the Red Book: UK) as follows:

> 'The estimated amount for which a property should exchange on the *valuation date* between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had acted knowledgeably, prudently and without compulsion, assuming that the buyer is granted vacant possession of all parts of the asset required by the business, and disregarding potential alternative uses and any other characteristics of the asset that would cause its *market value* to differ from that needed to replace the remaining service potential at least cost.'

2.2 Public sector bodies' guidance

The measurement principle for operational public sector assets is captured in the following documents:

Central government bodies	HM Treasury Financial Reporting Manual (FReM) – Chapter 10
Local government bodies	CIPFA/LASAAC Code of Practice – Chapter 4
NHS bodies	DHSC Group Accounting Manual – Chapter 4

There are minor variations in the wording used by each document but the underlying measurement principles and the requirement to use EUV for operational non-specialised assets is identical. FReM, for example, states:

> 'Assets which are held for their service potential (i.e. operational assets used to deliver either front line services or back office functions) should be measured at their current value in existing use. For non-specialised assets current value in existing use should be interpreted as market value in existing use which is defined in the RICS Red Book as Existing Use Value (EUV). For specialised assets current value in existing use should be interpreted as the present value of the asset's remaining service potential, which can be assumed to be at least equal to the cost of replacing that service potential.'

The distinction that these documents make between specialised and non-specialised assets is unnecessary, given that EUV and DRC both require the assessment at the valuation date of the value of an asset's remaining service potential for the existing purpose for which it is being used.

The CIPFA/LASAAC Code of Practice identifies DRC as being a separate valuation basis for specialised operational assets that sits alongside EUV. However, RICS recognises depreciated replacement cost (DRC) as being a method rather than a basis of value, and as a method to arrive at EUV. This distinction has no material impact on the practical

steps that the valuer is required to undertake when valuing public sector operational assets for financial reporting purposes.

EUV is often described as applying to owner-occupied operational property, i.e. property occupied by the owner for the purpose of delivering their functions. However, where a property leased to a third party does not meet the test for an investment asset, it will be treated as PP&E under IAS 16 and valued to EUV as if owner-occupied. IPSAS 16 provides a public sector interpretation of the definition of investment property, this being a property that is used solely to earn rentals or for capital appreciation or both. This definition is used by UK public sector bodies, although FReM substitutes the word 'only' in place of 'solely'. The CIPFA/LASAAC Code of Practice, for example, states that a local authority can classify as PP&E under IAS 16 property that it holds as a lessor where the local authority considers that the purpose of the lease is to facilitate the delivery of a service that supports or complements the public sector entity's wider policy objectives (e.g. social/community/economic), rather than the property being 'solely' held to earn rentals or for capital appreciation. Such lease arrangements may often also involve leasing to a tenant at a concessionary rent.

Where a property is so classified, the interest is valued to EUV as if owner-occupied rather than it being subject to the lease terms and conditions. While this means that any concessionary rent is to be disregarded, the rent passing may on occasion have been set at a market level and this may provide useful comparable evidence to help inform the EUV assessment (See case study 1).

3 The EUV concept and service potential

Market transaction information forms the basis for a valuation to EUV. However, EUV is not the same as market value. EUV is an assessment of what constitutes replacement at least cost of the asset's remaining service potential for continued delivery of the current functions that are being provided by use of the property at the valuation date. This figure may be lower, higher or equal to the asset's *market value* as the EUV assessment, as per the EUV definition, requires the disregarding of any 'characteristics of the asset that would cause its *market value* to differ from that needed to replace the remaining service potential at least cost'.

EUV measures the value that a property has for the operational business function being delivered from it at the valuation date. There is an underlying assumption in EUV that the current operational business function will continue to be delivered from the premises for the foreseeable future, without interruption, although not necessarily by the current owner-occupier. The characteristics of the current owner-occupier are disregarded, ensuring that EUV is not an assessment of worth, but the ongoing requirement for continued delivery of the current business functions is not disregarded.

EUV is applied to assets held for their service potential, i.e. operational assets that are used to deliver either front line services or back office functions. The service potential of property is a tangible concept, capable of being factually identified and appropriately substantiated by the valuer through discussion with the client.

Service potential refers to the amount of a property's physical and economic potential that is available at the valuation date and required for continued provision of the business functions currently being delivered from the premises. The underlying intent is to establish what a potential owner-occupier would pay in the market for an asset with the characteristics of the actual asset, if deprived of the asset, to replace at least cost that existing service potential to enable continued provision of the current business function. For the avoidance of doubt, this does not involve the valuation of a hypothetical asset to replace the current asset but, rather, an assessment applying available market evidence of the actual asset's value reflecting the embodied EUV assumptions.

Service potential for EUV purposes excludes any value attributable to alternative uses, including other uses within the same planning class and any development or redevelopment potential that is incompatible with uninterrupted continued delivery of the business function. It also excludes any parts of the property that are not required for the current business delivery function as such parts would not be replaced.

When valuing a property to EUV, the assumption is that an owner-occupier tasked with continuing the same business delivery function will seek a replacement property identical in all respects to the actual property in location, size, specification, configuration, age, state of repair, etc. The starting point is therefore to assume that the EUV (least cost replacement) will be the same as the *market value* of the actual property, evidenced by market transactions of similar properties.

The valuer **must** then address in what respect, if any, property characteristics and marketplace considerations cause that *market value* to differ from the amount required to replace at least cost the remaining service potential for the current business function. For example, a least cost replacement would not:

- have its value inflated by alternative uses that raise its price above that needed to replace the service potential required by the current business function
- have its value inflated by development potential that is irrelevant to the needs of the current business function or that cannot be realised without interfering with the occupation of the property for the purposes of the current business function
- seek to replace any parts of the actual property whose use is not required for delivery of the current business function
- have its value depressed by existing contamination, where such contamination does not impact on the current use of the asset
- have its value depressed by there being a planning permission personal to the existing owner-occupier and hence not transferable.

This illustrative list is not exhaustive but demonstrates that, dependent on the factual circumstances in each case, EUV may be equal to, higher or lower than *market value*.

4 Basis of valuation

4.1 EUV definition

Section 2.1 of this professional standard reproduces the UK VPGA 6 definition of EUV. UK VPGA 6, paragraph 3 explains that the EUV definition is taken from the wording of the *market value* definition with one additional assumption and a further requirement to disregard certain matters. In practical terms, the definition of EUV generally accords with the conceptual framework of VPS 4. However, it is subject to the supplementary commentary provided in UK VPGA 6, which provides further insight into the definition and in particular its disregards that can result in a property's EUV differing from its *market value*.

The importance of the final part of the definition cannot be overstated. It is the requirement to disregard any alternative uses to the current operational use, and to similarly disregard any other characteristics of the asset that cause its *market value* to differ from the figure needed to replace the existing remaining service potential at least cost, which combine to differentiate EUV from *market value*.

EUV is also a different basis from that provided by '*market value* subject to the special assumption of restriction to existing planning use'. EUV captures the present value of the existing asset's remaining service potential for continuing delivery of the current actual business function being delivered from the property, rather than for other potential planning uses, including those within the same planning use class. Planning uses are, therefore, not relevant when considering EUV. For operational properties classified as PP&E under IAS 16, the EUV conceptual framework envisages the existing service delivery function to which the land and its in-situ building is being put continuing for the foreseeable future, their remaining physical and economic life for this purpose being reflected in the EUV.

4.2 What is meant by 'vacant possession'?

The reference in the EUV definition to vacant possession does not mean that the property being valued is physically vacant at the valuation date. A property valued to EUV is in operational use rather being empty. The current operational use to which the property is being put has not ceased and there is an assumption for EUV purposes that delivery of the current business function will seamlessly continue without interruption.

UK VPGA 6, paragraphs 9 and 10 explain that the assumption that:

> 'vacant possession would be provided on acquisition of all parts of the property occupied by the incumbent entity does not imply that the property is to be regarded as empty, but simply that physical and legal possession would pass on completion of the sale at the valuation date to an incoming entity.'

As the property being valued is not empty but in operational use both at the valuation date and thereafter without interruption, no deductions should be made in its EUV assessment for any costs or other losses that would arise were it non-operational and exposed to the market for sale. For example, it would be inappropriate for the valuer to

apply a reduction to EUV for any potential holding costs, marketing costs, potential break-up costs and void periods, etc., because they anticipate that sale difficulties and delays would be experienced were the property to be vacant.

EUV is, therefore, not an assessment of what the property could be sold for were the current operational use to cease and the property be vacant, awaiting a potential occupier. Where a property is vacant because its use for operational purposes has permanently ceased, it will instead be classified by the client as either 'held for sale' and valued to *fair value*, or 'surplus' and valued, provided there are no restrictions on sale, to *fair value.*

4.3 Actual owner-occupier versus hypothetical owner-occupier

EUV's definition is based on the core definition of *market value* whose conceptual framework states in its explanation of a 'willing buyer' that the present owner is included among those who constitute the market. Therefore, for EUV, the current owner-occupier is also considered to be part of the market.

Valuation standards stipulate that *market value*, and by extension EUV, exclude the additional bid of a 'purchaser with a special interest'. To address this, the specific characteristics of the current owner including any value attributable to goodwill and to the impact of their reputation are to be disregarded. EUV is not an assessment of 'worth'.

EUV is nevertheless based on the premise that the operational purpose for which the premises are being used by the existing owner-occupier will continue. This ongoing demand is to be reflected in the valuation. EUV is not to be approached as if the current occupier's service delivery function has ceased.

The above paragraphs are not contradictory. The EUV measurement principle requires the valuer to have regard to the service potential that the asset is providing for the occupying entity's functions. The concept is that the EUV is the price that is required to be paid in the market by a potential owner-occupier who is tasked with the responsibility of continuing to deliver the same service function from the property and in the same way.

The valuer **must** disregard the fact that the actual occupier is 'comfortable' in the property and may out-bid the competition to avoid being displaced. However, the valuer does not have to disregard the fact that the property may be especially suitable for a particular purpose – this will be relevant to ascertaining the least cost of replacing its service potential. That suitability should not be ignored. An operational property, appropriate for the needs of the current business function, should **not** be recorded in the balance sheet as having a low value due to there being a low demand for it in the open market.

The valuer **must** avoid reflecting any additional bid that may be made by the actual owner-occupier because of their particular characteristics but **must** reflect the value of the asset for the continuing service function that is delivered from the property. An

effective means of accomplishing this is to envisage that there is a hypothetical purchaser in the market with the same objectives and operational requirements, who is seeking to purchase the property and use it for the same or similar purposes as the actual owner-occupier. Consider what they would pay for the property to enable that.

Conceptualising such a buyer may seem difficult, particularly as the public sector authority may be the sole provider of the specific service in the area, but it is a necessary step to imagine that such a hypothetical purchaser does exist.

As EUV is a market-based measurement, it is important that the opinion of value is supported by market-based evidence. If such market-based evidence is either unavailable or not capable of reasonable adjustment to reflect the actual asset, the valuer may need to utilise depreciated replacement cost (DRC) as an alternative measurement approach (see section 8).

5 Application of EUV

5.1 Process

There is an initial presumption that EUV will be the same as *market value.*

The valuation process begins with the valuer seeking to identify, analyse and apply appropriate available market transaction evidence, which is relevant to the property, reflecting its age, condition and other physical characteristics. The reasonable starting assumption is that an owner-occupier tasked with continuing the same business delivery function, if deprived of the current property, will seek to replace it with a property identical in all respects such as location, size, specification, configuration, age, state of repair, etc. As explained in section 3, this does not involve the valuation of a hypothetical asset.

The valuer next considers the impact on the *market value* of the disregards in the EUV definition. These are:

- the disregarding of potential alternative uses
- the disregarding of any other characteristics of the asset that cause its *market value* to differ from that needed to replace the remaining service potential at least cost.

The impact of each of these disregards is considered in detail below.

Circumstances may be encountered where there little or no market transaction evidence available that is truly comparable to the actual property, particularly if it has atypical characteristics. Where it is not possible to reliably extrapolate EUV from market evidence, the valuer may require to use the depreciated replacement cost (DRC) method of valuation instead. This is explored in detail in sections 5.2, 5.3 and 5.4.

5.2 Disregarding potential alternative uses

UK VPGA 6, paragraph 17 addresses this disregard. This is the requirement to ignore potential alternative uses that result in the asset having a higher *market value* than that for its existing use.

This disregard is required because to reflect alternative uses may increase the value above that needed to replace at least cost the service potential provided by the property for continuance of its existing operational purpose.

For EUV purposes, what constitutes an alternative use is not restricted to a different planning class use. Uses or redevelopment within the same planning use can be just as incompatible with the continuation of the existing service delivery. An alternative use or redevelopment is to be disregarded if it is not required for the entity’s existing service delivery functions from the property or could not be undertaken without extinguishing or causing major interruption to operational provision of these services. The valuer is assessing what the market would pay to purchase the existing property, comprising both its land and building, for the purpose of continuing to deliver the same service in the same way for the foreseeable future with no expectation of being able to realise any redevelopment value (see case study 2).

However, UK VPGA 6, paragraph 18 states that provided certain specific conditions are met, EUV can reflect any value attributable to the possibility of extensions or further buildings on undeveloped land forming part of the property, or redevelopment or refurbishment of existing buildings. The conditions which **must** each be met are as follows:

- there is an operational requirement for this at the valuation date on the part of an entity tasked with the responsibility of continuing provision of the existing service delivery function from the premises
- the additional buildings or extensions will be occupied by the entity responsible for provision of the current service delivery function
- the additional construction can be undertaken legally, and without major interruption to the current operation being conducted at the property (see case study 3).

Where such land exists, it is the client’s responsibility to confirm whether or not each of the conditions are met. Applying appropriate professional scepticism, the valuer **must** establish the factual position through discussions with the client and record the outcome in the case file. The client in turn will be required to justify to their auditor their decision and instruction to the valuer.

In the absence of these specific conditions being met, the valuer should not add ‘hope value’.

5.3 Disregarding parts not required by the business

Commonly, provision of the current business function entails use of the full accommodation and site area available to the occupying entity. However, UK VPGA 6, paragraphs 13 to 16 note that situations will exist where a part, or parts, of a property are permanently unused and are not required for delivery of the current business function being provided from the asset. Such parts may be land or building accommodation or both.

The underlying principle is that if there are parts that are not contributing to the service potential required for the ongoing operational delivery and there are no plans for parts not being used to be replaced, they will not feature in a 'replacement at least cost'. As the entity does not require to replace these parts, the economic potential offered by these areas does not contribute to EUV.

It is, therefore, important that the valuer establishes in discussion at the outset with the client the extent of the actual property, both building accommodation and land, required to provide the current business function delivery. The inspection can provide a useful insight but may not be sufficient to establish the position. While the client should advise on this, the valuer should always be prepared to appropriately challenge the information received. The outcome **must** be recorded in the valuer's case file and appropriately referenced in the report.

Any requirement for less than the whole property is a factual issue that should be straightforward to establish after appropriate discussions. The outcome **must** be recorded in the valuer's case file. Ultimately, it is a matter for the client to determine and, in due course, defend to its auditor the position adopted and instruction given to the valuer.

The valuation treatment of any such parts not required to maintain the current service potential, depends on whether they can be separately sold or leased, and subsequently separately occupied, without adverse material impact on the continued use of the remaining operational property for its existing purpose (see case studies 4, 5, 6 and 7).

If these parts are capable of being sold or leased separately at the valuation date without detriment to the existing owner-occupier's functions, they will usually be separately classified by the entity and treated as a separate asset (or assets) to be valued to *fair value*. The valuer should, therefore, establish with the client at an early stage whether it has classified any parts as being surplus property under IAS 16, 'held for sale' under IFRS 5, or investment property under IAS 40.

When assessing *fair value*, the valuer will consider the uses to which the parts not being used for operational purposes may be put, separation and other incidentals costs, physical characteristics, planning position and market demand. The uses envisaged should be compatible with the ongoing operational functions of the remainder during both the construction phase and subsequent occupation.

For avoidance of doubt, the operational parts will continue to be valued to EUV.

If such separate disposal and occupation is not possible, the parts that are not being used for operational purposes will not be separately classified and valued. They will continue to be valued together with the operational parts of the property to EUV but will usually contribute no more than a nominal amount to that EUV. This is because they are contributing nothing to the service potential required for delivery of the continuing function and would not feature in a replacement at least cost.

5.4 Other disregards

It is the interpretation and practical application of the principle of 'disregarding … any other characteristics of the property that would cause its market value to differ from that needed to replace the remaining service potential at least cost' that can give valuers the most difficulty. The principle establishes that replacement of remaining service potential at least cost acts as a level below which EUV cannot fall. To assist understanding, UK VPGA 6, paragraph 19 provides examples of property characteristics that may adversely impact the level of market value but do not similarly impact EUV.

These examples demonstrate that what is being measured when applying the EUV basis as the value that the operational asset has for the continued delivery of the current business function being undertaken from the property rather than the sales price that might be achieved on a market disposal or transfer on cessation of that service requirement – although the two figures may sometimes coincide.

The illustrative examples provided at UK VPGA 6, paragraph 19 are:

- Where an occupier is operating with a **personal planning consent**. The 'personal' nature of that consent is disregarded in EUV. The valuer assumes that the incoming hypothetical willing buyer has the same planning consent as that held by the current owner-occupier.
- Disregarding of contamination where a property is known to be **contaminated**, provided the continued occupation for the existing use is not inhibited or adversely affected, and provided there is no current duty to remedy such contamination during the continued occupation (see case study 8).
- Circumstances may occasionally be encountered where a site is **overdeveloped**. The presence of the extra accommodation on the operational site and the service potential which it provides is required for continued delivery of the current business function (unless the client advises otherwise) and so would require to be replaced if deprived of the property. However, if the existing use ceases and the property is exposed to the market, there potentially may be little or no market demand for the excessive accommodation on the overdeveloped site. The resulting *market value* may attribute little or no value to the additional buildings and may be net of the cost of demolishing them. When weighting and applying market transaction evidence for EUV, the valuer will have regard to the value which

the whole facility has for the continuance of the current business function, while also reflecting in the valuation its disadvantages compared to comparable premises offering the same amount of accommodation but on a site that is not overdeveloped (see case study 9).

- Similarly, circumstances may occasionally be encountered where the **existing buildings are old** and if delivery of the current business function ceases and the property is exposed to the market, lack of market demand for the buildings means *market value* will be restricted to site value. However, the property remains operational and capable of continued use for its existing service delivery purpose. The property therefore continues to be of value for its existing use while it remains operational. It will be valued to EUV having regard to market transaction evidence of comparable properties, albeit likely less old, with the analysed evidence appropriately weighted to reflect the age, physical condition and other characteristics of the subject property (see case study 10).
- Circumstances where the property is in an **unusual location, or oversized for its location**, resulting in it potentially having a low *market value*, but where the cost of replacing the service potential for the continuing use is significantly greater. The detrimental impact which these characteristics have on *market value* is to be disregarded for EUV. It is considered that in these circumstances, relevant market transaction evidence is likely to either be unavailable or incapable of reliable application to inform EUV, necessitating the use of the depreciated replacement cost method by the valuer. This is discussed at section 8 on this professional standard (see also case studies 11 and 12).
- Where the market comprises predominately investors, resulting in the *market value*, but the valuer can evidence and substantiate that the replacement cost (the price agreed between a willing vendor and willing purchaser for owner-occupation for the purposes of the existing service delivery function) may be higher. This is explored at section 6.

Each of the examples in UK VPGA 6, paragraph 19 involves the characteristics of the existing asset and the current purpose of occupation and use being transposed onto an incoming hypothetical willing buyer for owner-occupier purposes with the same operational delivery requirements. They entail a measured and reasoned departure from a specific marketplace consideration and, therefore, from the potential *market value* which might otherwise result. It is essential that where the valuer establishes that any of these property characteristic disregards exist and adjusts their opinion of value accordingly, the valuer's reasoning, judgements and the adjustments applied are fully captured and recorded in the case file and appropriately referenced in the report.

Where market transaction evidence to reliably support such property characteristic adjustments is lacking, use of the DRC valuation method may be necessary (see section 8).

If the valuer considers that EUV may be materially higher or lower than the potential *market value* achievable (should the current operational requirement cease) this possibility **must** be brought to the attention of the client. This action will assist the client's strategic asset management planning and parallels the advice given at UK VPGA 1.5 in respect of properties whose valuations for financial reporting purposes are based on depreciated replacement cost. However, there is no requirement or expectation that the valuer will additionally report a *market value figure* in the absence of separate instruction to do so.

5.5 Client dialogue and capturing of outcomes

When undertaking a valuation for financial reporting purposes, dialogue with the client is important throughout the valuation process as there are a range of issues that require clarification and for which their input is vital. Each of these has an important bearing on value and the valuer **must** be prepared to appropriately question and challenge all information supplied, applying appropriate professional scepticism.

Two of the key issues that **must** be discussed are:

Asset classification: This is ultimately a matter for the client to determine, although advice may be requested from the valuer occasionally. The valuer **must** always be prepared to sensitively query and challenge a client's classification if it is considered potentially inappropriate, explaining their reasoning and affording the client an opportunity to reconsider the matter and either confirm or revise their classifications. Asset classification is important because it determines the valuation basis to be applied. The choice of valuation method to be employed to arrive at that basis is a matter for the valuer to decide.

Service potential: The service potential provided by the property that is required for the current business function **must** be established with the client. The whole property may often be confirmed as being required for the business function but if any parts are identified as not being required, it **must** then be established whether they are capable of disposal without detriment to the ongoing delivery functions of the remainder.

Similarly, where undeveloped land is part of the property it **must** be established with the client whether the conditions listed at UK VPGA 6, paragraph 18 are met, enabling EUV to reflect any value attributable to the possibility of extensions or further buildings on that undeveloped land.

The outcome of all such discussions with the client that have a bearing on the valuation **must** be recorded in the case file and be appropriately referenced in the report.

Where possible, valuers should seek to obtain information from the client about a property's previous valuation for financial reporting purposes. Useful information will

include the value, its apportionment, remaining lives and any componentisation. This is for awareness purposes only and does not imply that the previous figures are to simply be replicated. The availability of previous figures **must** not constrain the current valuer's judgement nor impair the requirement to value accurately at the new valuation date. However, any unexpected or abnormal fluctuation in the respective figures, for example, as a result of a change of approach, may have a significant financial impact for the client and early identification and highlighting of this to the client by the valuer will be beneficial.

6 Extrapolating EUV from investment market evidence

6.1 Use of investment transaction evidence

EUV envisages an exchange between a willing seller and buyer, with there being demand at the valuation date from a hypothetical owner-occupier for the operational premises to continue delivery of the same business function from the property in a similar manner. This hypothetical owner-occupier purchaser is assumed to be in the market at the valuation date.

In assessing what that party would pay for this purpose, capital transactions between owner-occupiers in the market will provide the best comparable evidence. Care **must** be taken to identify capital transactions for similar purposes rather than transactions where higher alternative uses may be reflected in the prices achieved.

Where there is little or no evidence of relevant owner-occupier capital transactions but lettings and investment transactions evidence for similar properties is available, the valuer will seek to extrapolate from these the price that will be paid by a hypothetical owner-occupier purchaser in the market on the valuation date who has the same objectives as the existing occupier. Use of such evidence presents challenges. When analysing and applying rents and yields derived from occupational and investment market transactions, the valuer **must** be conscious of the different factors that may be at play for the investor compared to an owner-occupier, impacting on value (see case study 13).

Where there is little or no relevant market transaction evidence available of either capital, lettings or investment that is capable of reliable adjustment and application, the property may be categorised as specialised and valued using the depreciated replacement cost method (see section 8).

6.2 Rents and yields

The yield to use in these circumstances will depend on a range of factors, including:

- market conditions
- location and type of property
- condition and characteristics of the building and

- the nature of the continuing service delivery function being undertaken from the property.

The strength of the reputation of the existing occupier **must** be disregarded. This raises the issue of what strength of covenant can be envisaged when applying an investment approach to arrive at the *market value* to an investor, from which the valuer will then seek to extrapolate what a hypothetical owner-occupier purchaser would pay. The EUV premise envisages an owner-occupier charged with the same operational delivery responsibilities as the incumbent owner-occupier. However, that hypothetical purchaser cannot be assumed to be a public body, notwithstanding the nature of the service being delivered.

It is reasonable to assume nevertheless, unless there is evidence to the contrary, that investors will consider an entity charged with such responsibilities and ongoing service delivery obligations to be one that offers a reasonable degree of income security and to have regard to this, among other factors, when considering the appropriate yield to use.

Additionally, service provision may be sensitive to location. The incumbent occupier may have chosen to provide the existing service in the locality for practical operational or policy reasons. The hypothetical owner-occupier will be in competition with other potential purchasers in the area, which may include public bodies, and will need to at least match their bids in order to secure the property.

Another issue to consider when weighting investment transaction evidence is that yields achieved on single-let buildings may more closely approximate those pertaining to owner-occupation than yields achieved on buildings that are multi-let.

It is appropriate to draw on yields that are quoted net of purchasers' costs where that reflects the reality of the market transactions in which the hypothetical exchange is deemed to occur and, consequently, the transactional price that will be paid. See section 6.4 for more detail.

6.3 Investment value versus value to an owner-occupier

Having assessed the *market value* that an investor may pay for the property, the valuer needs to consider how that figure relates to the EUV for owner-occupation purposes (see UK VPGA 6, paragraph 19, bullet point 6). To what extent, if any, may the price agreed between a willing vendor and willing purchaser for owner-occupation for the purposes of the existing service delivery function be higher?

In markets where owner-occupation is rare or absent, and investment transactions predominate, the *market value* will reflect the motivations and risk perceptions of investors. The amount that an investor speculator will offer for a property takes into account a range of costs and risks applicable to the investor but not necessarily to the willing hypothetical owner-occupier purchaser. An investor will reflect in their *market value* bid the time and costs associated with the securing of a tenant or tenants for the property. The possibility of void periods and future rental payment default will be factored into their investment valuation, together with allowances for the range of

marketing, management and non-recoverable holding costs that may be incurred, including any rental incentives offered to attract tenants such as rent-free fit-out periods.

None of these allowances or incentives are required for the envisaged hypothetical owner-occupier in EUV. The EUV premise is that there is a hypothetical owner-occupier purchaser in the market ready to replace the current occupier on the valuation date, taking immediate occupation to continue delivery of the same business function. This involves a number of assumptions, including that such a purchaser exists, that there has been a proper marketing period leading up to the sale on the valuation date, and that the purchaser will seamlessly continue the existing service delivery. The certainty of occupation and purpose in EUV contrasts markedly with the uncertainties and additional costs present for investors.

This suggests that where owner-occupation is common, with owner-occupiers competing with each other, they will out-bid investor speculators because they do not need to make allowance for these deductions, giving rise to higher values.

In a marketplace dominated by investors where there is no competition from other potential owner-occupier purchasers, a hypothetical owner-occupier will be similarly able to outbid investors because they do not need to make the same deductions and risk allowances. However, such an owner-occupier will not seek to pay more than is required, and it **must** be remembered that the purpose when applying EUV is to establish what an owner-occupier would have to pay in the market to replace the existing property's service potential for the current business function at least cost.

It is, therefore, sometimes argued that the hypothetical owner-occupier purchaser need only pay £1 more than the investor price to secure the property. While that in theory may be all that is needed to secure the property, the valuer will rarely have perfect comparable transactional evidence available to them and its quality and the extent to which it is directly applicable will vary. It may also be rare for there to be a complete absence of owner-occupier transaction evidence. A willing and knowledgeable vendor will also be aware of the potential ability of an owner-occupier to out-bid investors and can be expected in negotiations to seek to secure a higher figure, the outcome in practice being influenced by the respective parties negotiating strengths and willingness to conclude an agreement.

In summary, each case and its circumstances **must** be judged on its individual merits in accordance with these principles. In markets where owner-occupation is rare or absent, it may be that an owner-occupier will on occasion be prepared to pay more than an investor (although not necessarily materially more) in order to secure the property, while being mindful at all times of the requirement to secure replacement of the service potential at least cost. In each case, it is essential that the valuer fully records and captures the analysis and reasoning which evidences and substantiates their opinion of EUV in the case file and report.

Having arrived at a valuation figure for EUV purposes, regardless of whether this has drawn on investment or capital transaction evidence, valuers should not then treat the property as if it is vacant and reduce their valuation to reflect any sale difficulties and delays envisaged were the property's current use to have actually ceased and it be placed on the market. To do so would artificially reduce the asset's deprival value; i.e. the value of its remaining service potential for the current business purpose (see section 4.2).

6.4 Treatment of acquisition and disposal costs and taxation

EUV is the estimated amount that would be paid in a hypothetical exchange between willing buyer and seller. The valuation figure stated in the report is to reflect the valuer's opinion of the amount that would appear in the hypothetical sale and purchase contract. Any directly attributable acquisition costs (such as legal costs and stamp duty land tax) should therefore not be added to the valuation figure reported as that figure is to be the actual estimated exchange price that is paid between the parties for the asset. Similarly, while an owner would incur costs if selling a property, the valuer in such circumstances should not reduce the valuation figure that they report by deducting such costs.

Should a valuer be asked for any purpose to advise on the potential acquisition or disposal costs, these **must** be reported separately and should not be amalgamated with the reported transaction figure.

There is a distinction to be made between the basis of value being applied and the treatment of the transactional evidence used to arrive at the valuation. The need to disregard transaction costs only applies to the hypothetical transaction on which the EUV is based. The comparable evidence that is used in the support of the valuation will reflect the realities of the relevant market and the impact of applicable costs and taxes on agreed prices. For example, property investment yields are often quoted 'net of purchaser's costs'. If this is the metric used to analyse other market prices, it should be the one used to estimate the price agreed in the transaction, see UK VPGA 1.7, paragraph 3.

7 Depreciation

7.1 Apportionment between land and non-land parts

IAS 16, paragraph 58 requires land and buildings to be accounted for separately, whether or not they were purchased separately. The non-land (buildings/improvements) element is known as the depreciable amount and will be subject to accounting depreciation. The EUV figure, therefore, needs to be apportioned between its land and non-land parts.

The land and building apportionment figures are hypothetical in nature as the individual parts of such an operational property are either incapable of being, or are not normally, separately valued and marketed. Therefore, the valuer should state in their

valuation report that these apportionment figures are derived solely for accounting purposes and do not represent formal valuations of the individual elements.

There are three prevailing methods used by valuers to arrive at the apportionment, as explained at UK VPGA 1.11, paragraph 28:

- Assessing the land value based on market evidence and/or a residual appraisal. The valuer then deducts this land value from the property valuation to calculate the building value.
- Calculating the building value using DRC. The valuer then deducts this building DRC from the property's valuation to arrive at the land value.
- Applying a percentage approach to the property valuation based on experience, backed up by sound analysis of relevant evidence.

Care is required because the valuer is not undertaking a fresh valuation but rather is apportioning the already assessed EUV of the existing operational asset. EUV reflects the service potential being provided by the property for continued delivery of the existing operational purpose. Therefore, whichever of the methods set out at section 5.3 of this professional standard is used, it **must** reflect that current operational use rather than any alternative uses.

When considering the amount of the total EUV figure to be apportioned to the land, the valuer should reflect the actuality of it being a site 'encumbered' by a building that may not be the optimum development for the site, even within the same planning use class. Any available market evidence for vacant land is, however, likely to reflect its 'highest and best value' for development. In the apportionment, the assessment of service potential for the current business function that is being reflected in the valuation of the property **must** also feed into the value attributed to the land.

IAS 16, paragraph 58 states that an increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building. While such an increase in the value of the land may influence the entity's view of how long it intends to continue using the premises for its operational purposes, it is irrelevant at the valuation date to the EUV assessment of the operational asset and to the apportionment of that EUV.

Where a percentage method is used for the apportionment, it is important to recognise that what is an appropriate percentage will change over time as a building ages and advances towards the end of its economic life. Change can also result from the positive impact of new capital expenditure. Percentages may differ between different types of asset and should be derived from a sound analysis of evidence relevant to the property type.

Valuers are advised to avoid reliance on an over-mathematical approach to the land and buildings apportionment as, whichever method is applied, there is a risk of producing a disproportionate split that understates or overstates either part. It is recommended

that a 'stand back and look' sense check is always applied after undertaking the apportionment. The valuer should consider whether the figures appear fair, reasonable and appropriate for financial reporting purposes.

7.2 Componentisation of the depreciable amount (i.e. the non-land parts)

Under IAS 16, componentisation of the amount apportioned to the non-land part (the depreciable amount) of a non-specialised asset may be required (see UK VPGA 1).

Componentisation is cost based, which presents a challenge as an asset's EUV is usually derived from market-based evidence. Equating cost and value invariably requires a degree of approximation and artificiality, which impacts on the degree of accuracy achievable and, therefore, the usefulness of componentisation. The depreciable amount itself is already the result of a hypothetical apportionment of the asset's total EUV.

It is for the client to determine its policy regarding the extent to which componentisation is required, if at all, and the valuer should be prepared to offer advice to assist their decision. Generally, the higher the number of components or component groupings, the greater the degree of subjectivity involved and consequently the higher the potential for inaccuracy, particularly for non-specialised operational assets valued to EUV.

If the client's policy requires the application of componentisation, it is recommended that the form it takes, and the resources devoted to it, should have regard to both the materiality impact on accuracy of the overall depreciation assessment and on the cost to the public purse.

Valuers are advised to use their professional expertise and judgement, combined with a 'stand back and look' sense check, when estimating a fair apportionment of the depreciable amount between the components or component groupings which are to be separately recognised.

In all circumstances, the sum of the individual values of components or component groupings (together with any 'remainder' not separately componentised) **must** be equal to the overall value of the depreciable amount figure already assessed by the valuer.

8 Use of depreciated replacement cost

UK VPGA 6, paragraph 20 states that:

> 'Where market evidence is absent or EUV cannot be reliably extrapolated from that which is available, the depreciated replacement cost (DRC) method may be used to ascertain EUV.'

This provision applies to properties used for conventional purposes as well as to properties used for more specialised functions. The test is neither use nor form of construction but the availability of suitable comparable market transaction evidence.

The valuer may encounter property that is used for a conventional purpose, for example, as office accommodation or a depot, but which is unusual in terms of where it is sited and/or its size for the location. It is not uncommon in the public sector for properties to sometimes be situated for economic, social or political reasons in geographic areas that would not be the choice of the market.

The Red Book Global Standards glossary defines a specialised property as

> *'A property that is rarely, if ever, sold in the market, except by way of a sale of the business or entity of which it is part, due to the uniqueness arising from its specialised nature and design, its configuration, size, location or otherwise.'*

RICS' Depreciated replacement cost method of valuation for financial reporting, at paragraph 3.2, explains that:

> 'This definition [of specialised property] is broad and can apply to properties or assets that may be of conventional construction, but become specialised by virtue of being of a size or in a location where there is no relevant or reliable evidence of sales involving similar property.'

An operational property, appropriate for the needs of that service delivery function, should **not** be recorded in the balance sheet as having a low value due to there being little or no demand for it in the open market, should the current occupier's need cease. That would result in a value below which the occupying entity would consider unrepresentative of the deprival value of the asset; i.e. less than its remaining service potential for the current business function. The EUV premise envisages a hypothetical owner-occupier exists in the market, tasked with the same service delivery functions as the incumbent entity and requiring the existing service potential of the property to enable continued delivery of the current operational functions in the same way.

Consider a situation where an entity incurs significant capital expenditure constructing a purpose-built facility to deliver its functions in a desired way. Anticipated absence of demand from others for the premises should not result in the operational property being down-valued to the level of a *market value* reflecting that lack of market demand.

The first step for the valuer is to establish whether there is adequate comparable market transaction evidence available that can be analysed and applied to produce a reliable EUV.

Where a property is atypical in its characteristics, the valuer may need to consider the suitability of evidence from across a wider area than usual. There are limits, however, to the extent to which market information and market behaviours can be adapted to fit a property's atypical characteristics and reliably produce a figure reflecting the premise of remaining service potential for current business function that can be substantiated. In the absence of appropriately applicable market transaction evidence, the valuer should resort to use of the DRC method (see case studies 11 and 12).

The requirement to disregard the impacts of 'unusual location' and being 'oversized for location' is a good example of circumstances where such a situation may arise and result in the valuer concluding that, notwithstanding a conventional use, the property requires to be treated as a specialised asset and the depreciated replacement cost method (DRC) applied.

See RICS' Depreciated replacement cost method of valuation for financial reporting for more information about the application of the DRC method.

It is recommended that any decision to use DRC in these circumstances is first discussed with the client and the reasoning explained. The valuation method applied and reasoning for its use **must** also be recorded in the report.

When reporting, the valuer **must** additionally draw the client's attention to the property likely having a lower *market value* should the existing operational requirement cease. This will assist the entity's strategic asset management planning. However, there is no requirement for the valuer to research or report an actual additional *market value*-based figure unless the client has commissioned that as an additional task.

Appendix A: EUV case studies

Use of the EUV basis is restricted to the valuation for financial reporting purposes of UK public sector operational property that have been classified as PP&E under IAS 16. The mandated use of EUV instead of *fair value* is the result of an adaptation made to IAS 16 when IFRS was first adopted. The incumbent entity in each of the following case studies is therefore a public sector body.

These case studies demonstrate application of the EUV principles described in the main text of this professional standard. It is not possible to cover every scenario that valuers may encounter and valuers **must** always have regard to the particular circumstances of each property when applying the principles.

The following indicative case studies are provided for illustrative purposes only, not to be formally relied on, and should not be construed as providing formal advice.

Case study 1: Potential PP&E classification of certain leased assets

Main text: see section 2.2

A local authority owns a terrace of six light industrial units and has let them on flexible terms for starter and micro business tenants. The entity has classified them as operational PP&E assets under IAS 16, to be valued to EUV. How should the valuer proceed?

Analysis

This case study considers the ability under certain circumstances to classify an asset as PP&E under IAS 16 rather than as an investment asset under IAS 40.

The public sector definition of investment property is a property that is used solely to earn rentals or for capital appreciation or both. Where a leased property does not meet the test for an investment asset, it will be treated as PP&E under IAS 16 and valued to EUV as if owner-occupied.

In this instance, a local authority has classified as PP&E several industrial units, which it lets out. Under the CIPFA/LAASAC Code of Practice, local authorities can classify a property as PP&E under IAS 16 on the grounds that it is used to facilitate the delivery of services that support or complement the entity's wider policy objectives (social/community/economic, etc.) rather than 'solely' for the purpose of earning rentals or for capital appreciation.

The local authority has made an interesting classification decision in this case study. Had these units been classified as investment assets, the valuer would assess them to *fair value*, having full regard to the lease terms and rent, reflecting what someone will pay to step into the lessor's shoes.

Solution

The valuer should confirm and document with the client its classification decision. The valuer should be alert to the possibility of mistaken classification of an asset and be prepared to enquire and appropriately challenge, applying professional scepticism. Ultimately however, the decision on classification rests with the entity.

If, after discussion, the assets' classification as PP&E is confirmed, the valuer will value the units as if they are owner-occupied rather than held by a lessor following the granting of leases. The terms of the occupational leases are to be disregarded.

The relevance of the rents passing under the leases will depend on whether they reflect current market rental levels. Unless aligned with the valuer's opinion of market rent, the valuer should not capitalise the lease rent as part of their valuation of the PP&E. For example, the valuer may identify that the rents under the lease are concessionary or over-rented. Such rents **must** be disregarded in the EUV assessment as they reflect the leased nature of the premises and to use them would not align with the PP&E 'owner-occupation' premise.

If the passing rent is at a level that represents the market rent of the accommodation, the valuer may find this rental information to be relevant and of assistance to their EUV valuation, supplemented by market transaction evidence drawn from other comparable properties.

Fair value reflects what someone would pay in the market to acquire the lessor's interest and has full regard to existing leases and rents passing. Where the valuer considers that

fair value would materially differ from EUV, whether higher or lower, this **must** be brought to the entity's attention separately in the report. However, there is no requirement to research and report an actual *fair value* figure unless instructed otherwise.

Case study 2: Disregarding alternative uses including development value

Main text: see section 5.2

A local authority is owner-occupier of town centre freehold office premises from which it delivers its functions. The property has planning permission for the development of an office tower to replace the existing building. *Market value* of the site reflecting that development potential is £30 million. In the absence of the development potential, *market value* of the existing office property is estimated to be £15 million. What is the EUV?

Analysis

This case study considers the requirement when assessing EUV to disregard potential alternative uses, including other uses within the same planning class. The underpinning principle is that EUV is a measurement of the in-situ property's remaining service potential for continued delivery of its existing operational function without material interruption.

In this case, the £30 million *market value* is driven by the site's potential for redevelopment for what would likely be its optimum use within the same planning use class. However, that potential is not relevant to the determination of EUV. The additional redevelopment potential is not required for the existing function that is being delivered. UK VPGA 6, paragraph 17 confirms that the valuer is required to disregard any element of hope value for alternative uses, including those within the same planning use class, that would drive the value above that needed to replace the existing service potential provided by the property for the existing function. It is assumed that function will continue to be delivered from the current property for the foreseeable future.

EUV therefore reflects how the asset is being used by the incumbent entity at the valuation date in the context of its continuing operations, taking into account factors such as its age, condition and facilities, etc., i.e. the economic benefit being derived from the occupation and use of the asset.

Redevelopment within the same planning use can be just as incompatible with the continuation of the existing service delivery as redevelopment for an alternative planning use. The redevelopment potential is to be disregarded if it is not required by the entity and could not be undertaken without major interruption to the current ongoing service delivery operation, as is the position in this case study.

An entity seeking to replace at least cost the service delivery required for their existing operational purpose will not buy a property whose value is inflated by bids from other potential occupiers for whom the property has greater value because of alternative uses or development potential that is irrelevant to their own requirements.

In assessing the EUV for continuance of the existing service delivery function, it is always useful to envisage what a hypothetical owner-occupier purchaser in the market is prepared to pay for the property to replace the existing owner-occupier on the valuation date and carry on using it for the same purpose, and in a similar manner, to the actual owner-occupier.

Market evidence for similar local office properties, albeit ones that do not have redevelopment planning permission, will provide a useful guide to the value of the actual property. This is because their purchase represents a means by which an entity could achieve, at least cost, the replacement of the existing service potential required for continued delivery of their functions. In this case, the comparable evidence for such properties indicates a value of around £15 million.

Solution

The EUV in the example will be around £15 million. To adopt £30 million, which is the *market value*, values the asset at a considerably greater figure than the required economic benefit being derived from the asset for delivery of the existing service function.

Where the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise. This will assist the entity's strategic asset management planning and parallels the advice given at UK VPGA 1.6 in respect of properties whose valuations for financial reporting purposes are based on depreciated replacement cost.

Case study 3: Treatment of compatible development potential at the property

Main text: see section 5.2

A public sector body is the owner-occupier of a multi-building site and has recently obtained planning permission to erect an additional office building within the site boundary on an undeveloped area of land. Use of the existing buildings will continue while the construction is undertaken. Once completed, the public sector entity will occupy the new building for its own purposes. Should the EUV reflect any additional value attributable to this planning permission?

Analysis

This case study explores further the treatment of development potential when assessing EUV. The situation outlined differs from that described in case study 2 in that the proposed development concerns a currently undeveloped part of the site and appears to be compatible with uninterrupted continuation of the property's existing service delivery function.

UK VPGA 6, paragraph 18 states that the disregard that valuers should ignore redevelopment potential and any element of 'hope value' for alternative uses will not apply if the following conditions are met:

- the proposed works are required for the entity's continuing operations
- the construction can be legally undertaken and without major interruption to the property's current service delivery operation
- the additional accommodation will be occupied after completion by the entity

Only where these strict conditions are met will it be appropriate to consider any value attributable to the possibility of extensions or further buildings on undeveloped land.

Solution

Discussion with the entity will be required to establish that each of the conditions from UK VPGA 6, paragraph 18 are met. The valuer should be prepared to appropriately challenge any information provided but ultimately the decision lies with the client. The outcome **must** be appropriately recorded in the case file and in the report. Only if the conditions detailed at paragraph 18 are met should any additional value attributable to the planning permission be reflected in the EUV.

Development value of part of an operational site is not reflected in EUV if that development will cause major interruption to the site's continuing operations. From the case study synopsis, it appears likely that any added value that the land has as a result of the planning permission can in this instance be reflected in the EUV.

As in all cases, where the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise.

Case study 4: Approach where not all parts are required by the business

Main text: see section 5.3

A public sector body is owner-occupier of a four storey 1980s office building which offers 40,000 sq. ft. accommodation. It is situated in a prosperous market town with an active office market for similar properties. The building is not oversized for the area. At

the valuation date, the upper floor, comprising 25% of the available floorspace, is vacant due to workforce downsizing. The entity has no plans to re-use the vacant space. How should assessment of the EUV be approached?

Analysis

This case study examines the practical application of the reference in the EUV definition to 'all parts of the property required by the business'. 25% of the office space in an owner-occupied building is no longer required by the entity for its operational purposes (see UK VPGA 6, paragraphs 13 to 16).

EUV is a measurement of the service potential provided by the property that is required for continued delivery of the incumbent entity's current functions. Where parts of a property are unused and have been identified by the client as being surplus to their service delivery requirements, their service potential does not feature in a replacement at least cost.

This contrasts with the *market value* position. If the existing operational requirement ended and the property was marketed, the additional service potential offered by the vacant space is of value to a purchaser requiring the whole property for their own purposes. The value of all four floors is, therefore, reflected in the *market value*.

For EUV, the valuation treatment of the vacated floor will depend on whether it is capable of being separately sold or leased without detriment to the continuing service delivery functions of the operational remainder. This will require to be established through discussion with the client, who will also advise how they have classified the vacant parts.

Classification drives the valuation basis to be adopted for the vacant parts. While classification is ultimately the decision of the entity, the valuer should always be prepared to query a classification with the client if necessary.

Solution

The valuer should first confirm with the client that the vacant floor is not required by it for their operational purposes and that they have no intention of reusing it. Then, it is necessary to establish with the client whether the vacant floor can be sold or leased for separate occupation without detriment to the ongoing operational use of the remainder.

The valuer should be prepared to appropriately challenge any information but ultimately the decision lies with the client. The outcome of the discussions **must** be appropriately recorded in the case file and in the report.

In this instance, the office building is situated in a town with an active office market. This suggests that there should be good comparable market evidence available to both help inform EUV and, if required for the vacant floor, *fair value*.

As in all cases where the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise.

Approach where the vacant space is no longer required by the entity for its operations and is capable of being let (or sold) to third parties without impediment to their ongoing use of the other floors.

In these circumstances, the entity will classify the three floors required for ongoing operational delivery as PP&E under IAS 16, with this part of the property being valued to EUV, informed by local market transaction evidence.

The vacant floor, as it is no longer required and is capable of separate market letting, is expected to be classified as either surplus under IAS 16 or as an investment asset under IAS 40. In both circumstances, the basis of value applied will be *fair value*.

100% of the property is, therefore, valued for balance sheet purposes but separate valuations are required of the in-use and vacant parts, these being to EUV and *fair value* respectively. The figures should be separately stated in the report.

When assessing the *fair value* of the vacant part, due allowance should be made for factors such as letting voids, holding and management costs. No such allowance should be applied in the EUV assessment of the operational parts.

Approach where the vacant space is no longer required by the entity for its operations but is NOT capable of being released

In some circumstances, the vacant space will not be able to be released for separate occupation. There may, for example, be security concerns or the building configuration may be unsuitable. Where that is the case, all four floors will be valued together to EUV. However, the unused floor will contribute only a nominal amount to the property's EUV as its service potential is not required for the ongoing service delivery function.

Case study 5: Approach where not all parts are required by the business

Main text: see section 5.3

A freehold local authority council depot dating from the 1970s is situated on an industrial estate. It comprises a 20,000 sq ft workshop with a 5,000 sq ft open sided canopy, and 6,000 sq yds of concrete vehicle hardstanding on a total site area of 3 acres. 1.6 acres of the site is not in use. The rental value of the depot is £250,000 pa and its capital value is £2.75 million, based on available evidence of other operational depots. Value of site with planning permission for a new industrial development is estimated to be £4.5 million, less cost of demolition and clearance. What will the EUV be?

Analysis

This case study further examines the practical application of the reference in the EUV definition to 'all parts of the property required by the business' by considering the scenario of an operational depot where part of the site is not being used. It also examines treatment of the site's development value.

The *market value* of the site, reflecting redevelopment potential for its optimum industrial use, is £4.5 million, less the costs of demolition and site clearance. However, this 'whole site' redevelopment potential appears to be incompatible with the depot's current service delivery operation continuing without major interruption. The development potential would not feature in a least cost replacement of the service potential required by the entity for its purpose. Therefore, as in case study 2, the development value will not be reflected in EUV.

The 1.6 acres of the 3-acres site that are not in use raises a question over how that area should be treated for financial reporting purposes. The valuer should establish whether this non-use for the entity's purposes will be permanent and whether the entity has classified it differently from the operational area. As always, the valuer should be prepared to appropriately question and challenge the information supplied, applying appropriate professional scepticism.

Solution

If the entity retains an operational requirement for the parts even though they are currently unused, they will be valued as PP&E to EUV, together with the remainder of the property.

Where the entity has no plans to bring the 1.6 acres into operational use, UK VPGA 6, paragraphs 13 to 16 provide that if parts of a property are unused and are surplus to the operational requirements of the business, their treatment will depend on whether they can be sold or leased separately at the valuation date without having an adverse impact on the continuing operational functions of the remainder of the site.

If the unused part is not going to be brought back into operational use and can be disposed of for separate occupation, it will be separately classified by the entity as being surplus property under IAS 16 or 'held for sale' under IFRS 5 and will be separately valued to *fair value*. In these circumstances, the valuer needs to consider the alternative uses to which the unused area may be put, having regard to its physical characteristics, the planning position and market demand. The use will require to be one that does not materially interfere, both during construction and subsequent occupation, with the ongoing operational functions of the remainder. The rest of the property, being in operational use and required for continuing service delivery, will be valued to EUV.

If such separate occupation is not possible, any surplus parts will have no more than a nominal EUV, as they do not contribute anything to the service potential of the property and will not feature in a replacement at least cost.

The EUV will not be £4.5 million as that development value is only realisable if the current operational requirement ceases.

The provision of rental and capital valuation information in this case study suggests that there is adequate comparable market evidence available of similar operational depot facilities to assist the EUV assessment. The best evidence will be that for similar older depot type properties. Such transactions should provide a good indication of what will constitute replacement of service potential at least cost.

In other instances, appropriate market evidence may not be available and use of the DRC method may be necessary; for example, where a depot is a purpose built facility of a specialised nature not normally traded on the market and the valuer considers it impossible to reliably extrapolate the EUV from any available evidence of other different facilities.

Drawing on market evidence of other depots, the case study synopsis suggests that the EUV of the whole property may be £2.75 million, but that figure assumes the service potential of the whole property is required for the functions being delivered from it. The case study states that 1.6 acres is not in use.

If the part not in use is confirmed by the entity as being permanently not required for the existing service function, and it would be capable of disposal for separate occupation without detriment to the continued current use of the remainder, it can be separately valued to *fair value.* The entity can be expected to classify it as either 'surplus' or 'held for sale'. The remaining operational parts classified as PP&E will be valued to EUV. Given the reduced area, their EUV will be lower than the £2.75 million estimate were the whole site operational. These *fair value* and EUV figures will each be assessed and stated separately in the report.

However, if the part not in use and not required for future use is incapable of separate disposal, it will continue to be valued together with the other parts as PP&E to EUV, but will contribute only a nominal amount to the property's EUV.

As in all cases, if the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise.

Case study 6: Whether to reflect the potential for part to become 'not required'

Main text: see section 5.3

A public body is owner-occupier of a four-storey office building in a prosperous market town where there is an active office market, similar to case study 4. In this instance, there are no vacant floors. However, the valuer considers as a result of their inspection that, in their opinion, the number of staff/workstations in the building could comfortably fit into only three floors by reorganising the existing layout. The client has classified the whole building as an operational asset under IAS 16. Can the valuer treat any part of the accommodation as vacant for financial reporting purposes?

Analysis

This case study further examines the application of the reference in the EUV definition to 'all parts of the property required by the business', focusing on the issue of whether or not a valuer should reflect circumstances that do not physically exist at the valuation date.

The scenario is one where each floor is in operational use but the existing layout appears to be inefficient in its use of space, with a markedly low desk to floor ratio. The valuer considers that there is potentially an opportunity for rationalisation, which would free up one floor of the accommodation for disposal by way of sale or letting. As EUV is a measurement of the service potential required for continued delivery from the property of the current operational function, the issue is whether the valuer should value three or four floors as being necessary for this purpose.

Solution

It is not appropriate for the valuer on their own cognisance to assume space rationalisation is appropriate and to treat part of the property as unused when the entity is still using all of the floorspace. The position is that the full accommodation is in use by the entity at the valuation date and this is reflected in its classification. It has not been declared surplus to requirements and no information has been supplied by the entity regarding any future intention to rationalise space by, for example, vacating one of the floors.

Knowledge and awareness of how much space is needed for its existing operational delivery function, both now and in the future, rests with the client. Whether the entity's operational needs can be provided by a reduced floor area is not an issue that can be determined by the valuer.

The inspection may provide some insights but it will be necessary for the valuer to have an early discussion with the entity to ascertain their views on their accommodation requirements and any plans that they may have for it. The valuer should be prepared to

appropriately question and challenge the information supplied, applying professional scepticism. Ultimately however, the valuer will be guided by the client regarding this.

Unless instructed otherwise by the entity after appropriate discussion, the position is that the service potential offered by all four floors in operational use at the valuation date are required to enable continued delivery of the function in the same way. The valuer should reflect the reality of the occupancy position at the valuation date and assume that the whole of the property currently in use will continue to be required for that use.

If the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise.

Case study 7: Partly vacant property held for future redevelopment

Main text: see section 5.3

A local authority owns a 20,000 sq ft freehold town centre office building nearing the end of its economic life. The authority intends it to form part of a future larger site assembly regeneration project. The building is 40% let to a council entity with two years remaining and is otherwise vacant. The valuer is informed that the whole asset has been classified as PP&E under IAS 16.

Analysis

This case study addresses issues of classification, what is meant by 'all parts required by the business' and regeneration intentions.

Before a valuation can be produced, it is essential that the valuer obtain a clearer understanding about the current use of the property, the client's intentions for it and their reasoning for the PP&E classification. While classification decisions are ultimately for the client to determine, the valuer in their discussions should be prepared to challenge a classification, applying appropriate professional scepticism. The valuation basis and approach to be adopted by the valuer depends on the outcome of these discussions and the facts established.

The local authority has classified the whole property as being held for operational service delivery purposes although part is vacant and part is let. What is the client's reasoning for not treating the let part as subject to a finance lease or held as an investment asset? The lessee is 'a council entity', potentially suggesting a related party, and the possibility that the local authority is effectively in owner-occupation. Discussions will establish whether there is a formal lease in place and what the terms and conditions are, for example, whether any rent passing is concessionary or at a full

rental level, and whether there are provisions for early termination by the local authority at a time of its choosing.

For a property to qualify for classification as an investment asset, it **must** be used solely to earn rentals or for capital appreciation or both. It may be that in treating the let part of the property as PP&E, the client has concluded that it is not holding the property solely for these purposes but also for its wider policy objective of delivering future regeneration.

With regard to the 60% of the office building that is currently vacant, its classification as PP&E under IAS 16 also requires to be explored in more depth. Assets classified as PP&E that are held for their service potential (i.e. operational assets used to deliver either front line services or back office functions) are valued to EUV. However, the PP&E classification also accommodates two forms of non-operational asset, these being assets in course of construction and surplus assets. Surplus assets are assets that are not being used to deliver services, but which do not meet the criteria to be classified as either investment property or non-current assets held for sale. The valuer, therefore, needs to clarify the precise nature of the PP&E classification.

In determining whether an asset that is not in use is surplus, the client should assess whether there is a clear plan to bring the asset back into future use as an operational asset. Where there is such a clear plan, the asset is not surplus and EUV will apply. Assets that are surplus are valued to *fair value* if the client could access the market but if there are restrictions on the client or the asset that would prevent access to the market at the valuation date, the asset is valued to EUV.

The valuer also requires a clearer understanding of the client's future intentions for the building and the reference in the case study synopsis to a future larger site assembly regeneration project:

- How firm is this prospect?
- What is the timing?
- Does sufficient information exist to ascertain the subject property's potential contribution to the value of the project?

The age and condition of the property may inform the potential certainty of regeneration and whether this will involve demolition or major refurbishment. What, for example, does the client consider is likely to happen with the property after the lease of 40% of the accommodation expires in two years? What is the potential for redeveloping the property on its own in the absence of any wider scheme? In short, is there a clear plan for the asset?

Solution

There is no single solution to this case study as how the valuer will proceed depends on the valuer's investigations and the outcome of their discussions with the client.

Assuming the PP&E classification under IAS 16 is unchanged, and if no part of the asset qualifies as surplus within that PP&E classification, the whole property is valued to EUV as by definition it is being held for its service potential to deliver the entity's operational functions. The underlying principle is that if deprived of the asset, the entity would require to replace the service potential being provided by the existing property for the current business function.

Under this scenario, the occupied let part is treated as if an owner-occupied operational asset and valued to EUV, disregarding the lease. The rent passing may provide useful information for valuation purposes if set at a full rental value rather than being at a concessionary level or not representative of an arms-length transaction. The valuer will seek comparable local evidence of the market price for aged office space for ongoing office use, excluding redevelopment value, to assist their valuation.

The contribution to EUV of the vacant accommodation in this scenario is more challenging. As it is not being used to deliver the current business function provided from the property at the valuation date, it will not form part of the service potential requiring to be replaced under the EUV premise and therefore will contribute only a nominal amount to the property's EUV.

However, were the vacant accommodation to instead be treated as surplus within the PP&E classification, and then also considered to be capable of being separately leased without detriment to the continuing business function being delivered from the remainder, the vacant part would be excluded from the EUV assessment and separately valued to *fair value*. However, the age and condition of the accommodation, and the possibility of its requirement for an early redevelopment, may significantly depress market interest. Additionally, the vacant space's *fair value* in these circumstances will not reflect redevelopment value as it is probable that any redevelopment could not be undertaken without interfering with the occupied part and the business function being delivered from it.

An argument may be put forward that the EUV of the vacant area should reflect redevelopment value as it is being put to an operational delivery use in fulfilment of its duties at the valuation date, that use being retention for future delivery of the entity's wider policy objective of regeneration. However, interpreting future regeneration intentions as current operational use is at best tenuous. Further, for EUV the valuer is required to ignore potential alternative uses that result in an asset having a higher value than for its existing use. This includes other uses within the same planning class and redevelopment that cannot be undertaken without extinguishing or causing major interruption to operational delivery provision of the existing service being provided from the let area.

An important issue to consider is whether the classification as EUV and operational property to be valued to EUV is correct in the first place, or whether it is not in operational use and is an asset held purely for development purposes. Discussions with the client may conclude, for example, that the ageing building is not being held for delivery of business functions at the valuation date but rather is held in its entirety for the primary purpose of an imminent redevelopment scheme, with the current leasing of 40% of the space being only an incidental short term arrangement of convenience with a related party that has provisions enabling termination at will by the local authority. In these circumstances, the appropriate stance may be for the entirety to be valued to *fair value*, either for redevelopment in its own right in isolation of any wider scheme or, if sufficient information exists, in terms of its potential contribution to the value of a wider regeneration project.

The outcome of the valuer's investigations and any client discussions **must** be recorded in the valuer's case file and appropriately referenced in the report.

When a valuer is reporting EUV and considers that figure differs materially from the property's *market value* (or *fair value*), this **must** be brought to the client's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise.

Case study 8: Potential disregarding of contamination

Main text: see section 5.4 (bullet point 2)

A local authority is in owner-occupation of a maintenance depot that has been subject to ground contamination from historic land uses, prior to it becoming a depot. How should the contamination be reflected in the EUV assessment?

Analysis

This case study explores the disregard that applies when assessing the EUV of a property known to be contaminated (see UK VPGA 6, paragraph 19 (bullet point 2)).

Provided that the continued occupation for the existing purpose is not inhibited or adversely affected by the contamination, and provided that there is no current duty to remedy such contamination during the continued occupation, the presence of the contamination is to be disregarded in the EUV.

Solution

Establish whether or not the contamination interferes with the existing and continuing operational use to which the asset is being put, and the incidence of remediation costs. How, for example, would the market for the existing operational purpose reflect the presence of the contamination?

Should the current operational requirement for the depot cease and the property be exposed for sale on the market, the impact of any contamination and the incidence of remediation costs would be reflected in the *market value.*

Provided the contamination is not impacting the ongoing occupation for the existing use, and there is no current duty on the owner-occupier to remedy the contamination during the continued occupation, the presence of the contamination will not be reflected in the EUV. Discussion with the client is necessary to help establish the position regarding the contamination.

If the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise.

Case study 9: Treatment of overdeveloped site

Main text: see section 5.4 (third paragraph, bullet point 3)

A public sector body is owner-occupier of a multi-building site on which additional buildings have been erected over the years to meet the operational needs of the business function being delivered from the premises. This has resulted in an overdeveloped site with restricted space available for access, loading and the parking of vehicles. The complex currently provides some 200,000 sq. ft. of accommodation. If the current requirement ceased and the then vacant property was exposed to the market for sale, the resultant *market value* would attribute no value to the additional buildings and would additionally take into account the cost of their demolition to provide an improved site layout. It is considered that some 40,000 sq. ft. of accommodation would be cleared. After allowing for the cost of demolition and reinstatement of the access roads and loading/parking areas (say £500,000), market evidence indicates that the *market value* would be around £7.5 million.

The valuer is aware from transactional evidence that other industrial units in the area offering a similar level of accommodation to that currently existing, but with superior access, loading and vehicle parking facilities as their sites are not overdeveloped, have a *market value* of £10 million (£50 sq. ft.).

How should the assessment of EUV be approached?

Analysis

This case study explores the *market value* disregard at UK VPGA 6, paragraph 19 (bullet point 3), which applies when assessing the EUV of a facility/multi-building site which is overdeveloped. It presents a scenario where the extra buildings present on the site either limit or detract from the *market value* but are needed under the EUV premise to

fulfil the service potential provided by the property for the existing service delivery function.

Although the extra buildings add nothing to the *market value* achievable should the current operational use cease and the property be exposed to the market, and indeed detract from it, all the buildings have a value to the incumbent entity for the operational functions being delivered from the site. EUV, which is a measure of the least cost replacement of that service potential, will reflect the service potential provided by all of the accommodation, meaning that EUV is likely to exceed the £7.5 million *market value* figure.

However, the property is of an inferior standard to other industrial units in the area that offer similar levels of accommodation because of the site being overdeveloped, (200,000 sq. ft. in a site more suitable for 160,000 sq. ft.) with detrimental consequences. It would be inappropriate to ignore this and simply adopt without adjustment the £50 per sq. ft. rate which has been evidenced for ideally laid-out accommodation.

Solution

The valuer **must** reflect the service potential offered by the additional accommodation for the continuing business function being delivered from the property, also considering the impact of the consequential disadvantages flowing from the manner of its provision. While the EUV will exceed the *market value*, the detrimental impact of the restricted space for access, loading and parking, etc. is likely to restrict the EUV from matching the £50 sq. ft. *Market value* of industrial units offering similar-sized accommodation but without the site disadvantages.

The valuer will reflect these considerations in their analysis and weighting of available market transactions to arrive at EUV. It is essential that this analysis and the valuer’s reasoning to support their EUV assessment is recorded in the case file and appropriately captured in the report.

When the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity’s attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise.

Case study 10: Treatment of an old property whose service potential for existing purpose exceeds market value

Main text: see section 5.4 (third paragraph, bullet point 4)

A public sector client is owner-occupier of a number of old large buildings, comprising approximately 300,000 sq. ft. of accommodation. If the existing business function being

delivered from the properties were to cease, there would be no market for the existing buildings and the property would be sold for demolition and redevelopment. Market evidence indicates that *market value* is estimated to be £3.5 million, based on site value for redevelopment and after adjustment for the costs of demolishing the existing buildings.

However, despite their age, the buildings remain fit for the incumbent entity's purpose, still providing the service potential required for the effective and ongoing provision of the current operational delivery function. Market evidence for other comparable buildings, albeit not quite as old or big, sell for around £25 per sq. ft. capital value, suggesting that the EUV for continued use may be greater than the market value. How should assessment of the EUV be approached?

Analysis

UK VPGA 6, paragraph 19 (bullet point 4) states that one of the circumstances where it may be appropriate for the valuer to ignore a factor that will adversely affect *market value* but not EUV is:

> 'where the existing buildings are old and, despite their age and condition, remain suitable for the existing service delivery function, but in the absence of that requirement would have a limited *market value*, lower than the replacement cost to an entity for that existing service delivery function.'

This case study explores that disregard in the context of old buildings for which there is no market demand, save for redevelopment, but which are still providing the service potential required for the current operational business function being delivered by the incumbent entity. The underlying principle is similar to that discussed in case study 9, which featured a property whose *market value*, should the current business function cease, was impacted by it being overdeveloped rather than, as in this case, old.

There may be limited or no market demand for the existing accommodation were the current business requirement to cease, the property's *market value* being its value for redevelopment. However, the property retains a value for the business purpose for which it is currently used, and that will be reflected in EUV. EUV is a measure of what an owner-occupier will pay to replace, at least cost, the service potential provided by the subject property to enable the continued provision of their existing operational business function. If deprived of that service potential, it will require to be replaced.

Solution

Although old, the buildings are in operational use and, therefore, continue to be of value for the current business function. That there is no wider market demand for these particular buildings, and if exposed to the market place the site would be cleared for redevelopment, is not reflected in the EUV. As a starting point, the valuer will seek and analyse market transaction evidence for comparable older buildings that are also in

operational use, adjusting as necessary for differences in age, condition, size, etc. in the usual way.

It is essential that the valuer record in the case file and appropriately capture in their report their analysis and weighting of all the evidence used and the adjustments and reasoning that supports their assessment of EUV.

Where the valuer considers that EUV materially differs from the *market value* achievable were the operational requirement for the current service delivery function to cease, this **must** be brought to the entity's attention separately in the report. There is no requirement to research and report an actual *market value* figure unless instructed otherwise. This action ensures that the client is informed for potential future impairment purposes and will assist their strategic asset management planning.

From the limited information supplied in the case study synopsis, it may be that after a full consideration of available market evidence for similar properties, the cleared site *market value* of £3.5 million will be found in this instance to be less than the property's EUV, *market value* understating the amount required to replace the property's remaining service potential for the existing business function. Alternatively, if the EUV reflecting continued use of the buildings were to be exceeded by the *market value* for redevelopment, the scenario becomes that which is addressed by case study 2. The valuer is required to disregard any redevelopment value that will drive the value above the value of the remaining service potential for the current business purpose.

Although there is at the date of valuation a continuing requirement for the existing purpose to be delivered from the property, it is recognised that a point will be reached where a combination of factors such as age, condition and declining 'fitness for purpose' means that the ageing property is no longer capable of providing the function; its remaining service potential for the purpose will be exhausted. At that point, it is anticipated that the asset will become non-operational and be reclassified by the entity, at which time it will be measured to *fair value.*

Case study 11: Use of DRC for property oversized for its location

Main text: see section 5.4 (third paragraph, bullet point 5) and section 8

A government department is owner-occupier of a modern 350,000 sq. ft. building on the outskirts of a small town. Comparable evidence for similar large accommodation in the locality is lacking. The valuer also considers that there is little demand for the premises other than from the current occupier for their business function. Were the current use to cease and the property be marketed, its *market value* is estimated to be £10 million. This figure reflects valuer judgement that there is unlikely to be occupier demand beyond that of the incumbent body for accommodation of this size in the particular locality. However, it is considered that an investor may be attracted who will separate and let some parts of the building over time, incurring the costs of holding and

maintaining the whole while much of the space lies empty for potentially a considerable time. If the depreciated replacement cost method were applied, the building's value will be £40 million, inclusive of an amount for land value. What value should be reported for financial reporting purposes?

Analysis

UK VPGA 6, paragraph 19 identifies a need when assessing EUV to disregard certain characteristics of an asset that reduce its *market value*, but which are not to similarly affect the level of its EUV.

One of these disregards (UK VPGA 6, paragraph 19 (bullet point 5) is

> *'where the property is in an unusual location, or is oversized for its location, with the result that it would have a low market value were the existing business requirement to cease, but where the cost of replacing the service potential would be significantly greater'.*

This case study explores the practical application of that disregard and the potential for using DRC to provide the EUV/current value for financial reporting purposes.

The property in this case study is used for a conventional purpose – office accommodation – but is unusual in terms of where it is sited and its size for the location. It is not uncommon in the public sector for properties to sometimes be positioned for economic, social or political reasons in places which would not be the choice of the market.

The valuer should first establish whether there is sufficient comparable evidence available in the form of market transactions from which an EUV for this property can reliably be extrapolated. As the accommodation is atypical for its location, the valuer may need to consider the availability and suitability of evidence from across a wider area.

As EUV reflects replacement at least cost of the property's remaining service potential for the existing business delivery function, the valuer may also consider with the entity whether it is feasible for the function to be relocated. However, the public sector may have chosen for policy reasons to provide the delivery of the function from its present location and in the current manner, in which case there may be a reasonable presumption that remains the case.

Consideration may also be given to whether least cost replacement of the existing service potential might be achieved through delivery of the existing functions being split across a number of smaller buildings in the locality, for which there may be more abundant market evidence, rather than from one property. Discussion with the entity is needed to understand whether that is feasible and is not more costly, inefficient or detrimental to the ongoing delivery of their functions.

The case study states that were the requirement for the current use to cease and the property be exposed to the market, its *market value* is £10 million. This reflects the absence of a potential replacement owner-occupier for the whole premises and the likelihood of eventual purchase by a speculative investor, with only partial future lets, potentially lengthy void periods and the burden of ongoing management, security and marketing costs.

An operational property, appropriate for the needs of the current business function, should **not** be recorded in the balance sheet as having a low value due to there being a low demand for it in the open market, should the current occupier's need cease. The EUV premise envisages a hypothetical owner-occupier exists in the market, tasked with the same service delivery functions as the incumbent entity and requiring the existing service potential of the property to enable continued delivery of the current operational functions in the same way.

The valuer in this case is likely to conclude that an office building of this size will not have been developed in this location had there not been a specific requirement for the purpose; i.e. without a pre-let or an owner-occupier. If the owner has developed the building for their own occupation, it is also reasonable to assume that this was a sound business decision and that if deprived of the property the owner will rebuild it.

Notwithstanding the conventional property use, the absence of appropriate market transactions from which reliable adjustments and evidenced conclusions can be drawn for EUV purposes points towards the property being an asset requiring application of the depreciated replacement cost method.

The Red Book Global Standards glossary defines a specialised property as:

> 'A property that is rarely, if ever, sold in the market, except by way of a sale of the business or entity of which it is part, due to the uniqueness arising from its specialised nature and design, its configuration, size, location or otherwise.'

RICS' Depreciated replacement cost method of valuation for financial reporting at paragraph 3.2 explains:

> 'This definition is broad and can apply to properties or assets that may be of conventional construction, but become specialised by virtue of being of a size or in a location where there is no relevant or reliable evidence of sales involving similar property.'

Solution

EUV in this case study will not be the £10 million *market value* figure. That figure understates the amount required to replace at least cost the service potential provided by the asset for delivery of the current business function.

Because of the property's atypical size and unusual location, there is likely to be an absence of comparable market transaction to reliably compare EUV. There are limits to the extent to which available market information and market behaviours can be adapted and stretched to fit the specific owner-occupation service delivery requirement.

The property will, therefore, be treated as a specialised asset and valued using the DRC method. UK VPGA 6, paragraph 20 confirms that DRC is a recognised method for arriving at EUV/current value in appropriate circumstances.

The choice of valuation method to use ultimately rests with the valuer but there should be discussion with the client before proceeding. The valuation method and the reasoning for its selection **must** be recorded in the case file and appropriately recorded in the report.

When reporting, the valuer **must** additionally draw the client's attention to the likelihood of the property having a lower *market value* should the existing operational requirement cease. This will assist the entity's strategic asset management planning. However, there is no requirement for the valuer to research or report an actual additional *market value*-based figure unless the client has commissioned that as an additional task.

Case study 12: Application of market transaction evidence versus DRC

Main text: see section 8

A local authority owner-occupies a depot facility, which it constructed two years ago. To create this modern facility, the local authority acquired the three acre site for £4 million and spent £3.25 million on building construction and site improvements to deliver premises suitable for delivery of its business function. Market transaction evidence indicates that if the current operational requirement ceased and the depot was exposed to the market, its *market value* would be around £5 million. What is its value for financial reporting purposes?

Analysis

This case study further explores the relationship between build costs and market evidence and examines when use of the DRC method may be appropriate.

This is an operational property and as such will be classified as PP&E under IAS 16, the valuation basis for financial reporting purposes being EUV. EUV is the amount required to replace at least cost the service potential of the property for the continued delivery of the current business function.

The total build cost to the local authority of £7.25 million is higher than the valuer's estimate of *market value*, that being the figure that may be achieved if the local authority's existing requirement for the premises has ceased and the property is sold on the open market.

Where an owner has recently developed a property for its own occupation and in a location of its choice, it is reasonable to assume that this was a sound business decision and that if deprived of it the entity will either rebuild it or purchase a similar property. An operational property, appropriate for the needs of the current business function, should **not** be recorded in the balance sheet as having a low value due to there being a low demand for it in the open market, should the current occupier's need cease.

The valuer needs to carefully examine how the significantly lower *market value* has been arrived at. Are the market transactions used appropriate, reliable and truly comparable with the subject depot? Have they been appropriately analysed, weighted and adjusted to reflect the subject depot's characteristics and location?

Solution

If it is established that the market transactions used to arrive at the *market value* figure truly are representative, involving similar depots to the subject property that are used for a similar business function, then that market evidence will be used to inform EUV. This may result in the property's EUV being lower than the cost incurred in providing the facility, creating a revaluation loss against initial recognition.

It is likely in this instance that little or no market transaction evidence of similar depots will be identified from which EUV can be reliably extrapolated. Such properties may be purpose-built for their function and choice of location, as occurred in this instance, rather than delivered by the market, and there are limits to the extent to which other available market information and market behaviours can be adapted and stretched. In these circumstances, the property will be valued using the DRC method.

The choice of valuation method to use ultimately rests with the valuer but discussion with the client before proceeding is recommended. The valuation method and the reasoning for its selection **must** be recorded in the case file and appropriately recorded in the report.

When reporting, the valuer **must** additionally draw the client's attention to the likelihood of the property having a lower *market value* should the existing operational requirement cease. However, it is emphasised there is no requirement for the valuer to research or report an actual additional *market value*-based figure unless the client has commissioned that as an additional task.

Case study 13: Use of investment market transaction evidence

Main text: see section 5.4 (third paragraph, bullet point 6) and section 6

A city-centre office property is owner-occupied by a central government department for operational purposes, with 100% of the accommodation used. There are no capital transactions to assist assessment of the EUV but there are available investment

transactions for similar properties, providing market rental and yield evidence. How should the valuer approach the use of this evidence when assessing the EUV?

Analysis

Capital transactions for similar purposes between owner-occupiers in the market will provide the best comparable evidence for EUV. This case study considers the circumstances where evidence of such transactions is lacking and the valuer is reliant on occupational and investment market evidence from which to extrapolate an EUV (see UK VPGA 6, paragraph 19 (bullet point 6)).

The challenge when analysing and applying occupational and investment market evidence for EUV purposes is that the motivations and risk considerations of investors are not necessarily the same as those of an owner-occupier.

For EUV, the valuer is seeking to establish what price will be agreed in a purchase transaction for owner-occupation between two parties to secure an operational property's service potential for the current business function that it is providing and will continue to provide. The buyer is deemed to have the same business requirements of the property as the seller for the ongoing delivery of these functions. Beyond having responsibility for carrying on that service delivery, the buyer is not deemed to share any other characteristics of the incumbent occupier, thus excluding any value attributable to goodwill or to the incumbent's reputation and ensuring that EUV is not an expression of worth.

A means of accomplishing this for EUV is to envisage a hypothetical owner-occupier purchaser in the market who will buy the property on the valuation date for this purpose. Imagining the existence of such a buyer for a property can be difficult because the public body may be the sole provider of a specific service function in an area. However, it is a necessary step to imagine that a hypothetical buyer does exist who is charged with the same responsibilities but who is not necessarily a public body.

In a market dominated by investors, with capital transaction absent or rare, the valuer will begin by using the available occupational and investment transaction evidence to establish *market value*. The valuer will then seek to extrapolate from the price an investor would pay the EUV; i.e. the amount which a hypothetical owner-occupier purchaser charged with the same operational delivery responsibilities as the incumbent owner-occupier would pay.

Rental figures achieved for similar uses will be of assistance in establishing the *market value*. When considering what yield to apply, the valuer will have regard to the usual range of factors that impact on yield levels. This raises the issue of what strength of covenant can be envisaged when applying an investment approach to arrive at the *market value* to an investor. The hypothetical purchaser cannot be assumed to be a

public body, notwithstanding the nature of the service being delivered, and the strength of the reputation of the existing occupier **must** be disregarded.

However, the underlying EUV premise is that the existing business function will continue to be delivered from the property for the foreseeable future by the hypothetical purchaser. Any resultant security that continuance of function may be considered to provide can be appropriately reflected.

The service provision may also be sensitive to location. The incumbent occupier may have chosen to provide the existing service in the locality for practical operational or policy reasons. The hypothetical owner-occupier will be in competition with other potential purchasers in the area, which may include public bodies, and will need to at least match their bids in order to secure the property.

As a general rule of thumb, and assuming all other factors are neutral, the yields achieved on single-let buildings may be found to approximate more closely to those pertaining to owner-occupation than those achieved for buildings that are multi-let.

Having arrived at the *market value* that may be paid by an investor buying to let, the valuer **must** consider how that figure relates to what might be paid by a hypothetical purchaser to secure the whole property for owner-occupation.

A number of differences can be identified. The amount which an investor speculator will offer for a property takes into account a range of costs and risks applicable to the investor but not necessarily to the willing hypothetical owner-occupier purchaser. An investor will reflect in their *market value* bid the time and costs associated with the securing of a tenant or tenants for the property. The possibility of void periods and future rental payment default will be factored into their investment valuation, together with allowances for the range of marketing, management and non-recoverable holding costs that may be incurred, including any rental incentives offered to attract tenants such as rent free fit out periods.

None of these allowances or incentives are required for the envisaged hypothetical owner-occupier in EUV. The EUV premise is that there is a hypothetical owner-occupier purchaser in the market ready to step into the shoes of the current occupier on the valuation date, taking immediate occupation to continue delivery of the same business function. In the investor world, a potential tenant, or indeed a potential owner-occupier interested in the property, might not turn up for many months or even years. The certainty of occupation and purpose in the EUV premise contrasts markedly with the uncertainties and additional costs present for investors.

Solution

A hypothetical owner-occupier will in theory be able to outbid investors because they do not need to make the same deductions and risk allowances as potential investor

purchasers. However, that an owner-occupier may be able to pay materially more does not necessarily mean that they will be prepared or need to do so. An owner-occupier will not wish to pay more than is required to secure a property and it **must** also be borne in mind that the purpose of EUV is to establish what an owner-occupier would pay in the market to replace at least cost the existing property's service potential for the current business function.

It is therefore sometimes argued that the hypothetical owner-occupier purchaser need only pay £1 more than the investor price to secure the property. While again in theory may be all that is needed by the hypothetical purchaser to secure the property, the valuer will rarely have perfect comparable transactional evidence available to them and its quality and the extent to which it is directly applicable will vary. A willing and knowledgeable vendor will also be aware of the potential ability of an owner-occupier to out-bid investors and in negotiations will seek to secure a higher figure, the outcome in practice being influenced by the respective parties negotiating strengths and willingness to conclude an agreement.

The extent to which the various risks and costs associated with holding a property for occupational or investment purposes are present in the transaction evidence used will also vary. Where evidence has been drawn, for example, from single let buildings rather than multi-lets, and for tenants offering good security with little risk of default, that may be expected to materially reduce any perceived differential between the value to an investor and value to the envisaged owner-occupier.

In summary, each case and its circumstances **must** be judged on its individual merits in accordance with these principles. It may be that in markets where owner-occupation is rare or absent, an owner-occupier may on occasion be prepared to exercise their ability to pay more, although not necessarily materially more, than an investor to secure the property, while being mindful at all times of the requirement to secure replacement of the service potential at least cost.

In practice, between willing parties, a price will be negotiated at a figure that reflects the level of competition for the property, worth to the vendor and their level of desire to sell, and the value to the purchaser.

Having arrived at a valuation figure for EUV purposes, regardless of whether this has drawn on investment or capital transaction evidence, valuers are reminded that they should not treat the property as if it is vacant and reduce the valuation to reflect any perceived sale difficulties, delays or associated costs which might arise were the particular property to be vacant and exposed for sale on the market, its current use having ceased. To do so would artificially reduce the asset's deprival value; i.e. the value of its remaining service potential for the current business purpose. UK VPGA 6 confirms that the property for EUV purposes is not physically vacant at the valuation date but

instead remains in operational use. There is therefore no risk of void periods and the incurring of associated holding costs while seeking to secure a new owner or one or more potential new tenants, nor exposure to letting marketing costs, tenant management costs and the risk of rental default. The EUV premise of a hypothetical owner-occupier purchaser tasked with delivery of the same business function in the same way similarly means there is no to adjust the EUV to reflect an allowance for the fit-out period that a new occupier may seek when first occupying a property.

It is of particular importance in cases where EUV is being extrapolated from occupational or investment transaction evidence that the valuer records in the case file and appropriately references in the report their analysis of the evidence, capturing all adjustments applied and the reasoning which substantiates their opinion of value and also subsidiary judgements made such as the rent and yield applied.