GUIDANCE ON ASSET VALUATION

Introduction

This guidance should be read in conjunction with the text in the Government Financial Reporting Manual (FReM) about the application of FRS 15 by entities covered by the requirements of the FReM. It has been developed with the assistance of a Working Group[1] set up to consider issues around asset valuation and capital charging. Separate from, but critical to, the Working Group's deliberations was the review by the Royal Institution of Chartered Surveyors' (RICS) Public Sector Valuation Group (PSVG) of its guidance on preparing valuations using the depreciated replacement cost methodology. RICS has now published its Valuation Information Paper (No 10) *The Cost Approach for Financial Reporting*. This guidance interprets that Valuation Information Paper for the particular circumstances faced by the entities covered either directly by the FReM or by guidance derived from the FReM (for example, the NHS Manuals of Accounts).

This guidance does not address the valuation of Heritage Assets. Separate guidance on Heritage Asset Valuation is being developed.

This guidance covers two areas: Valuation Information Paper No 10; and valuation policy.

Valuation Information Paper No. 10: The depreciated replacement cost (DRC) method of valuation for Financial Statements

1.1. This section of the guidance supports Valuation Information Paper (VIP) No. 10 by interpreting for the central government sector those requirements of the VIP that need to be explained further so that valuers and accountants achieve consistency (but not uniformity) across the many types of entity in the sector.

1.2 VIP No. 10 provides supplementary information about the use of the cost approach for financial reporting as set out in IVSC Guidance Note 8 *The Cost Approach to Financial Reporting – (DRC) (Revised 2005)*. (Valuation standards are published by RICS in its 'Red Book' (RICS Appraisal and Valuation Standards)). The terms 'Cost Approach' and 'depreciated replacement cost' (DRC) are considered to be synonymous, since both are in common use world-wide to describe the same valuation technique. The VIP is available from RICS at 12 Great George Street, Parliament Square, London SW1P 3AD.

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[1] The Asset Valuation and Capital Charging Group, which was chaired by HM Treasury, comprised accountants and valuers from the following organisations: the Scottish Executive; the Department of Finance and Personnel, Northern Ireland; the Welsh Assembly Government; the Valuation Office Agency; the Ministry of Defence; the Foreign and Commonwealth Office; the Home Office; HM Prison Service; the Department for Constitutional Affairs; HM Courts Service; the Department for Communities and Local Government; the Department for Environment, Food and Rural Affairs; the Department of Health; and HM Land Registry.

1.3 This part of the guidance follows the order of the VIP for ease of access, although it does not comment on all the sections of the VIP. Paragraph references are to VIP paragraphs.

When is DRC used?

DRC is a valuation method of last resort

1.4 DRC should only be used as a last resort. It should be used only where there is no useful or relevant evidence of recent market transactions due to the specialised nature of the asset (paragraph 3.1). The specialised nature may be a result of the size or location of the asset, as well as the service provided. But it does not follow that, where DRC has been the valuation method in the past, it remains appropriate to use DRC for the latest valuation, since there might be sufficient evidence of an emerging market; the VIP gives the healthcare and leisure sectors as examples.

1.5 Some specialised assets in the central government sector may generate material cash flows and might be valued by the income or profits test approach.

Buildings of conventional appearance that have specialised features

1.6 VIP 10 notes that there will be some buildings that have a conventional basic design that is superficially similar to other buildings that are regularly bought and sold in the market, but on closer inspection have specialised features designed to meet the requirements of the actual occupier.

1.7 A typical example of this is a purpose-built embassy, which, although built to perform an office function, is situated on a site that includes extra stand-off land and includes designed-in security features such as thickened walls and toughened glazing. This type of building will often cost considerably more to develop and build than a normal office building, but provide extra service potential (in the form of security for its occupants) which cannot be replicated through the purchase of a normal office building.

1.8 In this instances, provided that the occupying entity continues to require the extra service potential, it is likely that the building should be treated as specialised and valued to DRC with full account taken of the extra cost of the specialised features and requirement for stand-off land.

Buildings that include specialised adaptations

1.9 Some buildings will comprise conventional structures that have been adapted to the requirement of the occupier. For example, a commercial office building may have been purchased by a government department and adapted by provision of enhanced security features such as perimeter barriers or toughened glazing. Where an entity has opted to treat the cost of such specialised adaptations as a separate item in its financial statements, the valuer will value the conventional building (paragraph 3.9). Where the entity has not accounted for the costs of adaptation separately, the valuer will need to consider whether the adaptations are such that the building meets the definition of a specialised property (paragraph 3.10).

1.10 Central government entities can choose whether or not to account for adaptations as a separate item in their financial statements. As a guide, while

specialised features designed-in to purpose-built buildings should normally be accounted for as part of the whole building, adaptations to existing buildings should normally be accounted for separately.

1.11 Where an entity opts to account for the costs of the adaptations as a separate item, those costs should be depreciated over a maximum of the useful economic life of the property to which they relate, subject to this not exceeding the useful economic life of the adaptations themselves. Where the costs are material, the entity should ensure that the net book value of the adaptations continues to give a true and fair view at the balance sheet date and make any necessary adjustments.

1.12 Where an entity opts to include the adaptation costs within the property interest, the entity will need to ensure that the valuer understands the general nature of the adaptations. It will not be appropriate, for example, for a valuer to value an embassy's additional stand-off land as surplus land: it is a necessary part of the property. Nor will it be appropriate for a valuer to value a newly built embassy building as a conventional office block.

Assessing replacement cost

1.13 Where DRC is being used to value specialised property (regardless of whether or not the property is historic or listed), it will rarely be appropriate to cost a modern reproduction of the asset (i.e. using an identical replacement or modified reconstruction approach). The value of the property should normally be based on the cost of a modern equivalent asset that has the same service potential as the existing asset and then adjusted to take account of obsolescence.

The Site value of a Specialised property

1.14 DRC should only be used as a last resort. It should be used only where there is no useful or relevant evidence of recent market transactions due to the specialised nature of the asset (paragraph 3.1). The specialised nature may be a result of the size or location of the asset, as well as the service provided. In selecting the site on which the modern equivalent asset would be situated, the valuer will consider whether the actual site remains appropriate (VIP section 7). For a central government entity, the choice of whether to value an alternative site will normally hinge on the locational requirements of the service that is being provided.

1.15 So it could be that buildings that serve the community in which they are located – for example, hospitals, and other buildings used to deliver front-line services – might need to be on expensive inner-city sites or in town and city centres rather than on the outskirts. In these cases, the valuers should value a site in a similar location to the actual site (VIP paragraph 7.1).

1.16 Other buildings might not need to be located on the actual site (or in the locality there they are currently situated). In these cases, valuers should value an alternative site. Where the alternative site forms part of an entity's relocation plans, this should be disclosed in the accounting policies note. The Management Commentary should also include a brief discussion of the relocation plans.

Calculating the cost of the buildings and site improvements of a specialised property

The buildings and site improvements

1.18 Guidance on enhancements to existing assets is given in the section on valuation policy.

Historic buildings

1.19 It is rarely appropriate to value historic buildings on the basis of costing a modern reproduction by use of an identical replacements or modified reconstruction approach.

1.20 Where the historic nature of the property itself contributes to the service provided, it would be appropriate to reflect the cost of reproducing the existing asset in the cost of the modern equivalent (paragraph 8.7). The example of a parliament building is given. However, where it would be impossible for a modern reproduction to recreate the original's historic significance, entities should not cost such a reproduction (paragraph 8.8).

1.21 Where an entity does cost on the basis of creating a modern reproduction using the identical replacement or modified reconstruction approach, it must be able to demonstrate that it is not valuing a mere facsimile of the existing asset and that the historic property itself is intrinsically part of the service potential. Before undertaking a valuation using a modern reproduction approach, an entity should discuss with the relevant authority (through the sponsoring department as necessary) whether such an approach is appropriate. Entities should start from the premise that it will not be.

1.22 Buildings of iconic status (which might or might not be historic or listed) that would be replaced by similarly iconic buildings, should be valued on the basis of a modern equivalent asset but including the costs of achieving that iconic status. That might mean, using the Royal Courts of Justice as an example, a modern court house that has either a façade in keeping with the surrounding buildings, or even a reproduction façade.

1.23 Further guidance on valuing heritage assets is being developed.

Sources of cost information

1.24 The VIP notes that the cost of a modern equivalent asset will reflect the cost that would be incurred if the works were commissioned on the date of valuation (paragraph 8.11). But it goes on to note (paragraph 8.12) that there are factors that may result in the cost of a notional replacement being different from that of creating the actual asset. These factors are:

- Site preparation. The VIP refers to works that may have been undertaken to prepare the actual site for occupation that would not need to be carried out on an assumed equivalent site. Entities should instruct the valuer to assume that the site being valued is level and serviced and ready for development.

- Phasing of work. The VIP notes that a large site may have been developed in phases and that the cost of a modern equivalent reflects a single phase development. Entities should instruct the valuer to assume a single phase development at the building cost

at the date of valuation. Entities should also instruct the valuer to assume that the construction has happened ‘instantly’. As a consequence, it follows that there will be no phasing of payments, and there will be no reflection of the cost of capital in the valuation.

- Optimal working conditions. Abnormal working conditions at the actual site are ignored if an alternative site is being valued.

- Additional costs arising from extending an existing property. These costs should be ignored, since the norm is that the valuation will be of a modern equivalent asset.

- Contract variations. Additional construction costs because of design or specification changes should be ignored. The modern equivalent asset being valued will have the same service potential as the existing asset.

- Planning changes. Entities should consider with the valuer whether planning consent would need to be obtained were the modern equivalent asset to be constructed on the actual site.

Assessing Depreciation

Functional obsolescence

1.25 Paragraphs 9.7 to 9.11 discuss functional obsolescence. One factor that might cause functional obsolescence is technological advances. This need not reflect only technological advances in, say, the delivery of healthcare. For example, the Ministry of Defence will need to consider whether the technological advances in military materiel mean that its hardened aircraft hangers would be replaced by different types of structures, and the effect this would have on the valuation of its existing hangers.

Economic obsolescence

1.26 References to the impact of changing demand for goods or services should be read to include, for non-revenue generating assets, references to future service potential.

Guidance on the valuation policy outlined in the FReM

2.1 Entities are reminded that their balance sheets must give a true and fair view of the value of the assets at the balance sheet date, but that, within the constraints imposed by the FReM, entities are free to adopt practices that are most appropriate to their circumstances.

Valuation of Property Assets

2.2 Entities have, within the confines of FRS 15, total discretion in how they determine the most appropriate valuation approach for their estates. When their valuers advise that DRC is the most appropriate valuation methodology, entities should refer to the guidance notes above when discussing the approach with their valuers.

2.3 Early and ongoing dialogue with the valuer is vital. Neither RICS guidance nor FRS 15 are tightly prescriptive regarding aspects of asset valuation methodology, particularly at the detail level of DRC. Within their confines, many subtle variations in approach or interpretation are possible and these can have a significant impact on the resulting figures produced. An instruction which simply asks for an asset valuation to be undertaken in accordance with RICS and FRS 15 will be insufficient to ensure that the entity receives a common result and consistency of approach over time, regardless of which valuer is used. Discussion between entity and valuer about the exact nature of the entity's bespoke requirements and how these can best be fulfilled is essential. Sufficient details about the exact approach employed must be captured for the benefit of future valuations, when it is likely that there will have been a change of valuer.

2.4 FRS 15 states that the objective of a revaluation is to reflect current values as at the balance sheet date. Full quinquennial valuations of properties, and an interim valuation every three years, will meet this objective. Additional valuations should only be carried out in the intervening years where it is likely that there has been a material change – and it is likely that the annual impairment review will give an indication of whether this is the case. Interim valuations are not the same as full valuations: paragraphs 47 and 49 of FRS 15 set out the differences: no need for a detailed inspection of the building or locality, unless the valuer feels it necessary; and no enquiries of the local planning and similar authorities nor of the entity or its solicitors The valuer will seek confirmation that the property has not been altered in any way, and that there are no significant changes to legal rights or planning considerations. See below for more guidance on what to do when a property has been altered.

2.5 Entities with large estates might consider carrying out a rolling programme of revaluations following the guidance in paragraph 46 of FRS 15. In addition, entities with large estates comprising homogeneous properties (such as hospitals or prisons) might consider using an approach that bases the gross valuations on standard models. For example, it might be hypothesised that, ideally, an entity would use one of three building models or beacons to deliver a service, depending on location – inner city, town and rural. The valuer will be able to discuss and advise on how many beacons may in practice be required, having regard to the nature of the estate. An entity could derive a standard gross replacement cost for each building beacon, and then assess depreciation in line with the VIP (section 9; and also see above) for each of

the individual property assets. Local land values would then be added to arrive at the DRC valuation.

2.6 Entities are permitted, but not required, to re-appraise the valuations of their properties using indices in the years between their quinquennial valuations. Interim valuations are not required where entities choose to use annual indexation. However, in the light of experience[2] shared by the Working Group, entities should consider carefully the appropriateness of annual indexation in their particular circumstances and make a careful judgement as to whether annual indexation will result in a true and fair view of the value of their estates at the balance sheet date.

Valuation of Non-Property Assets (other than infrastructure assets)

Depreciated historical cost basis as a proxy for current valuations

2.7 Entities may elect to adopt a depreciated historical cost basis as a proxy for current valuations for assets that have short useful economic lives or low values (or both). Examples where using depreciated historical cost as a proxy for current value might be appropriate are described below.

2.8 Motor vehicles: generally of relatively low value, and depreciated over a short useful economic life. The life should reflect established fleet management practice. Depreciation should be estimated in accordance with the expected reduction in vehicle values – which is not likely to be straight-line.

2.9 IT: the pace of technological change and reduction in values are generally reflected in a very short useful economic life. In some (more extreme) cases, IT might be expensed on purchase. Where IT is carried as an asset, depreciation should be estimated in accordance with the expected reduction in IT values – which might not be straight-line.

2.10 Furniture (and fixtures and fittings generally): normally of relatively low value in relation to other assets. In some cases, office fixtures and fittings are expensed on purchase. Where they are capitalised, depreciation should be estimated in accordance with the expected deterioration – which is likely to be straight-line.

Non-property tangible fixed assets with longer useful lives should be carried at current value

2.11 Indices or other appropriate information sources should be used to determine the gross valuation of non-property assets where depreciated historical cost is not a suitable proxy for current value (unless there are specific requirements set out in the FReM for specific asset classes).

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[2] The general experience shared by members of the Working Group was that indexation can cause volatility in asset values. There is some evidence to suggest that the application of indices where assets are valued to market value or to existing use value tends to lead to upward revaluations, and the quinquennial valuation tends to lead to a reversal of all or part of (or more than) the gain. (Indexation generally works well when applied to specialised assets valued to DRC.)

Enhancements

2.12 Enhancements to assets in the public sector invariably give rise to additional expenditure as a result of health and safety, security or operational requirements. Examples include the need to keep two lanes of a motorway operating, but at the same time ensuring the safety of the workers building a third lane; safeguarding prison's security while an additional wing is built within the curtilage; and the need to keep a hospital open, but at the same time safeguarding the health and safety of patients and visitors while a new wing is build, and additional costs associated with linking new infrastructure to old.

2.13 On the first valuation of the enhanced asset after it has been brought into use, the valuer will value it as a single asset, and will not take separate account of the additional costs arising from the above requirements. (This expenditure could be described as the immediate revenue consequence of a capital project.) The difference between the construction cost and the initial valuation of the new asset will be written off to the operating cost statement.