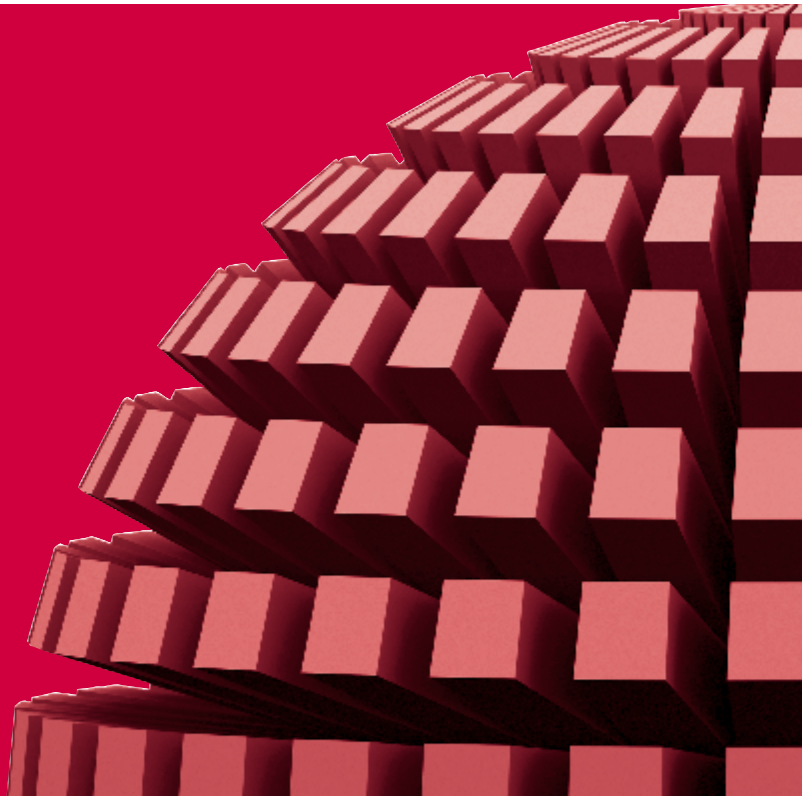
RICS professional standards, UK

RICS Valuation – Professional Standards UK

January 2014 (revised April 2015)



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RICS would like to thank Communities and Local Government for its help in revising UKGN 5, Local authority disposal of land for less than best consideration.

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The Institute of Revenues Rating and Valuation (IRRV) is the largest UK professional body operating in the field of revenues, benefits and valuation. IRRV valuer members usually have dual membership of RICS and IRRV.

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1 Introduction to the UK valuation standards

Overall purpose

1 Globally recognised, high-level valuation principles and definitions are now embodied in the International Valuation Standards (IVS) published by the International Valuation Standards Council (IVSC). The global edition of *RICS Valuation – Professional Standards 2014*, commonly referred to as the 'Red Book', formally recognises and adopts the IVS by requiring members to follow them. It also complements the IVS by providing detailed guidance and specific requirements concerning their practical implementation.

2 This approach is reinforced by the RICS professional standards regarding ethics, skills and conduct; and is assured by a well-established system of regulation and by progressive introduction of a system of practising valuer registration. The whole ensures the positioning of RICS *members* and regulated *firms* as the leading global providers of IVS-compliant valuations.

National standards

3 RICS publishes – separately from the global standards – a number of national standards (see PS 1 paragraph 5, RICS national association valuation standards) and national guidance material. They are designed to cover specific statutory or regulatory requirements in local jurisdictions, while being consistent with relevant international standards. This approach is fully in accord with United Nations voluntary guidelines encouraging jurisdictions to enhance transparency and overall consistency in valuation. National association valuation standards and guidance are available directly from RICS at www.rics.org/guidance

4 The RICS UK Valuation Standards January 2014 (revised April 2015) are national valuation standards and supporting guidance to be read in conjunction with the global *RICS Valuation – Professional Standards January 2014* (see PS 1 paragraph 5.1 thereof).

Coverage

From the valuation provider's perspective

5 For *members*, these national standards, appendices and guidance notes set out procedural rules and guidance which:

(a) include the principles set out in the IVSC *Code of Ethical Principles for Professional Valuers* and expressly comply with the RICS *Rules of Conduct*

(b) impose on individual valuers or firms registered for regulation by RICS certain mandatory obligations regarding competence, objectivity and transparency

(c) establish a framework for uniformity and best practice in the execution and delivery of valuations.

6 They do not:

(a) instruct members on how to value in individual cases

(b) prescribe a particular format for reports: provided the mandatory requirements in these standards are met, reports should always be appropriate and proportionate to the task.

From the valuation user's perspective

7 For clients and other valuation users these professional standards and valuation practice statements ensure:

(a) consistency in approach, aiding understanding of the valuation process and hence of the value reported

(b) credible and consistent valuation opinions by suitably trained valuers with appropriate qualification and adequate experience for the task

(c) independence, objectivity and transparency in the valuer's approach

(d) clarity regarding *terms of engagement*, including matters to be addressed and disclosures to be made

(e) clarity regarding the *basis of value*, including any *assumptions* or material considerations to be taken into account

(f) clarity in reporting, including proper and adequate disclosure of relevant matters where valuations may be relied on by a third party.

Arrangement of RICS global material

8 The RICS global material is grouped under three distinct headings, the first two covering matters relevant to valuation assignments generally, the third covering matters relating to particular applications. The intention is to make clear to members what is mandatory and what is advisory – thus collected together under the first two headings is the mandatory material and under the third the advisory material:

- RICS Professional Standards (PS) – mandatory
- RICS Global Valuation Practice Statements (VPS) – mandatory
- RICS Global Valuation Practice Guidance – Applications (VPGA) – advisory

9 Valuation practice guidance will be issued either in the form of Guidance Applications, covering specific asset types or situations that are closely linked to one or more practice statements, or in the form of Guidance Notes, in all other cases. Guidance Applications and Guidance Notes are of equal status – they contain advisory and not mandatory material. But for the convenience of users, the Guidance

Applications are reproduced in full in the *RICS Valuation – Professional Standards January 2014*, whereas appropriate cross-references are given in relation to Guidance Notes.

RICS Red Book glossary

10 The RICS Red Book glossary defines various terms used in the global *RICS Valuation – Professional Standards January 2014* (and this national standard) that have a special or restricted meaning. Terms not appearing in the glossary follow their common dictionary meaning. Where a term is used as defined in the RICS Red Book glossary, it is identified in both the global Red Book and this text with italic font. Where the glossary includes terms that are defined in the IVS, the IVS wording has been adopted.

Publication

11 The primary resource for accessing these standards is the Red Book section of the RICS website (www.rics.org/redbook). In addition it provides links to the national association valuation standards, guidance notes, exposure drafts, valuation alerts and other valuation material. It also includes all amendments and newly published material issued after the date from which this edition takes effect.

All versions of these standards, including translations, are available directly from RICS at www.rics.org/guidance

Other RICS publications that may have a relevance to valuation may be obtained from the RICS website (www.rics.org/guidance). They include practice statements, guidance notes and valuation information papers.

Amendments and exposure drafts

12 The content of these standards is under regular review, and amendments and additions will be issued from time to time, when required. These will be made to the web-based publication as required, but for the printed version they will be included only in the subsequent editions.

13 Where amendments may have a substantial effect, they may be published as an exposure draft. An exposure draft will contain the text authorised for public comment by the RICS Valuation Standards Board, see www.rics.org/redbook

14 The purpose of an exposure draft is to enable members to comment on the approved text, and possibly identify flaws, before incorporation into the Red Book global or national standards. The text of an exposure draft will, after consideration of any comments made and final approval of the RICS Valuation Standards Board, become mandatory/advisory on the effective date of the next Red Book update following its publication.

15 The RICS Valuation Standards Board would also be pleased to receive suggestions for inclusion of additional material or requests for clarification of the text.

Effective date

International Valuation Standards

16 The International Valuation Standards reproduced with kind permission from IVSC in the *RICS Valuation – Professional Standards January 2014* are those approved by the IVSC Standards Board on 1 July 2013 with an effective date of 1 January 2014 (although IVSC encouraged earlier adoption).

17 *Members* are reminded that IVSC reserves the right to make further amendments to IVS at any time. Any consequential amendments to the Red Book will be accessible on the RICS website (see under Publication above), but will not be incorporated into hard copy versions until the next edition.

RICS material

18 The RICS material included in this edition takes effect from **6 January 2014/1 January 2015 for UK GAAP changes/the date of publication 2015 for other changes – see Summary of changes on page 6** and applies to all valuations where the *valuation date* is on or after that day. Amendments to this UK Red Book edition will be accessible on the RICS website (see under Publication above), but will not be incorporated in hard copy versions until the next edition.

19 Copies of the RICS Red Book text current at any given date may be obtained through the RICS library.

Purpose of the UK standards

20 These standards are national association *valuation standards* that have mandatory status in the UK (see **PS 1.5, RICS national association valuation standards**). They supplement, expand or amend the global *valuation standards* so that they meet UK statutory or regulatory requirements.

Where a valuation is for a purpose that is not included in these standards the global *valuation standards* are to be applied, subject to any additional requirements that have been agreed with the client.

Since January 2015 the UK portion of the Red Book has been published separately from the global *RICS Valuation – Professional Standards*.

Arrangement of the UK standards

21 The same arrangement and format has been used for the UK material as in the previous (2012) edition, but with updated cross references to the global section as appropriate. The order of appearance is thus:

UK valuation standards

UK appendices

UK guidance notes.

Terms used in the UK standards

22 The terms used in these standards adopt the same definitions as set out in the International Valuation Standards (IVS) and in the RICS global standards. Where terms have a specific meaning in a particular context they will be defined in the standard, appendix or *guidance note* as required.

It is the member's responsibility to be aware of changes since the date of publication of this edition to legislation or to its interpretation through case law – and also to be aware of amendments to the International Valuation Standards or to any other valuation standards relevant to the particular valuation assignment. Valuers should refer to the RICS website for any updates regarding RICS material.

2 Summary of changes

1 Summary of changes from Red Book 2012

Reference	Changes made
UKVS 1	Rewritten to reflect the new UK GAAP (FRS 100–103 and FRSSE 2015). [**updated December 2014**] Paragraph 2 is revised to refer to the Financial Reporting Council as the accounting standard setting body.
UKVS 1.14	The reference in paragraph 7 has been revised to refer to the relevant section of the HMRC Business Income Manual.
UKVS 2 and UKVS 3	The Financial Services Authority (FSA) was superseded by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) in April 2013. All the cross references in these sections have been revised accordingly. Consequential amendments have also been made to UK Appendices 7 and 9.
UK appendix 1	Updated to reflect the new UK GAAP (FRS 100–103 and FRSSE 2015). [**updated December 2014**]
UK appendix 2	Updated to reflect the new UK GAAP (FRS 100–103 and FRSSE 2015). [**updated December 2014**]
UK appendix 3	The Companies Act schedules referred to in this appendix were repealed by the *Companies Act* 2006 and not directly replaced. Paragraph 3 (Director's responsibility) has been deleted. For more detailed information on the role of directors and auditors see www.frc.org.uk Text revised to reflect 1 January 2015 changes for UK GAAP and International Standards and Auditing (UK and Ireland). [**updated April 2015**]
UK appendix 4	Updated to reflect the new UK GAAP (FRS 100–103 and FRSSE 2015). [**updated December 2014**]
UK appendix 5	Text revised to reflect 1 January 2015 changes for UK GAAP and the *Code of Practice on Local Authority Accounting in the United Kingdom* published by the Chartered Institute of Public Finance and Accounting (CIPFA). [**updated April 2015**]
UK appendix 6	Updated to reflect the new UK GAAP (FRS 100–103 and FRSSE 2015). [**updated December 2014**]
UK appendix 7	The table to this appendix has been revised so that it matches to the list of terms set out in VPS 3, Valuation reports. Although some text has been moved into different categories, no alterations to the guidance have been made.

UK appendix 10	Paragraph 2.4 has been amended to refer to the revised list of minimum requirements in VPS 1, Minimum terms of engagement. Due to the merger of some of the original terms it is not possible to state that the specification relates to all the requirements of an individual term. Care should be taken to ensure that all the requirements of VPS 2, Inspections and investigations, are met. Unexpired lease term *assumption* adjusted from 70 years to 85 years (applies when it is not possible to inspect the lease). For an explanation see subsection 3 below. [**updated April 2015**]
UKGN 2	Published separately as EUGN 1: *European Union directives and regulations relevant to valuation* UKGN 2 is now *Depreciated replacement cost method of valuation for financial reporting* – it was formerly global GN 6 in the March 2012 edition of the Red Book. UKGN 2 *Depreciated replacement cost method of valuation for financial reporting*: references in subsections 10 and 12 have been revised to reflect 1 January 2015 changes for UK GAAP. [**updated April 2015**]
UKGN 7	The references to the *Charities Acts* have been revised to include the 2011 Act. Updated to reflect the new UK GAAP (FRS 100–103 and FRSSE 2015). [**updated April 2015**]
Red Book UK cross-references and references to RICS publications have been updated throughout.	

2 Changes to UK GAAP financial reporting standards effective from 1 January 2015

The updated UK GAAP (FRS 100–103 and FRSSE 2015) were published by the Financial Reporting Council (FRC) on 14 March 2013, and amended in July 2014. They introduced new Financial Reporting Standards (FRSs) for the United Kingdom and the Republic of Ireland (UK and ROI) effective on, and from, 1 January 2015, but with early adoption permitted for accounting periods ending on or after 31 December 2012 (although the existing regime continued until 31 December 2014).

UKVS 1 and UK appendices 1, 2, 4 and 6 were rewritten to reflect the changes and were reissued **on 17 December 2014**.

UK appendix 3 was revised **in April 2015** to reflect the changes to UK GAAP effective from 1 January 2015 and to the International Standards and Auditing (UK and Ireland).

UK appendix 5 was updated **in April 2015** to reflect the changes to UK GAAP and the *Code of Practice on Local Authority Accounting in the United Kingdom*, published by the Chartered Institute of Public Finance and Accounting (CIPFA).

A minor change was made **in April 2015** to UKGN 7 to reflect the new UK GAAP (FRS 100–103 and FRSSE 2015) application to the financial statements of charities.

3 Change to UK appendix 10

RICS Valuation – Professional Standards 2014 (Red Book), UK appendix 10, section 6.5(a) is being amended from **April 2015**. The chief amendment is an adjustment to the unexpired lease term *assumption* (applicable when it is not possible to inspect the lease); this will change from 70 years to 85 years.

RICS acknowledges that the change to the basis on which a valuation *assumption* is made may be of concern to both valuers and lenders. Note that this is merely a valuation *assumption* not a mortgage lender rule. Mortgage lenders will continue to set their own rules around what they consider to be suitable lease length on which to base lending.

However, the following points should be noted:

- The valuation of leases is set against the backdrop of the leasehold reform legislation. The *Commonhold and Leasehold Reform Act* 2002 introduced amending legislation that *marriage value* is to be ignored where at the *valuation date* to determine the enfranchisement price or new lease premium the existing lease term exceeds 80 years. Where the remaining term is 80 years or under, half (50%) of the *marriage value* is payable as a component to the price computation. The premium (or price) will increase as the remaining number of years to the lease diminishes.

  As the cost of extending the lease increases, the impact on its value will correspondingly increase. This impact will vary from property to property, but the potential for an impact on value exists for a remaining term of 80 years or less.

- To continue to value on an *assumption* of 70 years unexpired is a grey area for valuation as, by implication, it requires the valuer to reflect the costs associated with lease renewal. As time passes more and more leases for properties constructed in the 1980s and 1990s will begin to move into the category of fewer than 80 years unexpired and thus will require payment of *marriage value* on enfranchisement or grant of a new lease. Enfranchisement valuation is outside the remit of the valuation for mortgage lending purposes. It is important that, in any *assumptions*, the valuer can reflect the full value of the property and not be required to undertake a more complex enfranchisement calculation. It is the responsibility of the lender to decide on how to address this issue and its impact on their back book.

- RICS recognises that lender policies have reflected the existing Red Book *assumption* in the past, but from a valuation point of view it is necessary to ensure that any *assumption* of remaining lease term is at a level that enables a full and robust market value assessment to be completed.

- Lenders are free to issue specific instructions for valuation on an alternative basis, but must be aware that an *assumption* of 80 years or less may result in a lower valuation figure.

RICS understands and recognises that there may be a transition period for this change to become embedded, but feels that it is necessary to reflect the current market situation.

4 Forthcoming changes to UKVS 3.5

Changes to the RICS HomeBuyer service (HBS) are being considered at the time of publication of this revision to the UK standards. Any change to the HBS will be notified on the RICS website. See the Home Surveys section of the website: www.rics.org/homesurveys

5 Changes to legislation

Members are reminded of their responsibility to be aware of changes since the date of publication of this edition to legislation and/or to its interpretation through case law.

3 RICS UK valuation standards

UKVS 1 Valuation of real property, plant and equipment for financial statements under UK GAAP

UK Generally Accepted Accounting Principles (UK GAAP, FRS 100–103)

Scope

1 Valuations for inclusion in *financial statements* require particular care as they must comply strictly with the applicable financial reporting standards adopted by the reporting entity. Valuers are strongly advised to clarify at the outset with their clients (and ideally also with the client's auditors) which accounting regime they have adopted and the level and degree of valuation work and later disclosure required to accompany the valuation in order to ensure that their client's precise accounting prerequisites are addressed.

2 Although the International Financial Reporting Standards (IFRS) or accounting standards such as the updated UK Generally Accepted Accounting Principles (UK GAAP) derived from it are nowadays widely adopted, members are reminded that both IFRS and non-IFRS standards continue to evolve and are subject to clients' and auditors' interpretation and application of such standards – valuers should always refer to the standards current at the date to which the *financial statements* relate. Valuers should be aware that the auditor is required to consider the valuation report included in the *financial statement* and evaluate the relevance and reasonableness of the source data and valuation methods used and any *assumptions* or conclusions made by the valuer when preparing the valuation.

3 Prior to the latest revisions, UK GAAP applied only in the UK and to valuations in accordance with Financial Reporting Standard 15 (FRS 15), *Tangible Fixed Assets*, and FRS 11, *Impairment of Fixed Assets and Goodwill*, published by the UK Accounting Standards Board (ASB).

4 To reduce the burden on smaller entities, the *Financial Reporting Standards for Smaller Entities* (FRSSE) may be adopted as an alternative to FRS 15. Prior to the revisions to the UK GAAP, FRSSE provides that such entities, if revaluing, shall value their properties to *market value* unless it is considered not to be an appropriate basis by the directors, in which case the valuation provisions of FRS 15 may be adopted.

5 Where an entity previously adopted UK GAAP, and therefore did not prepare its *financial statements* under International Financial Reporting Standards (IFRS), FRS 15 prescribes two *bases of value* for owner-occupied property:

- existing use value (EUV) and
- for specialised properties, *depreciated replacement cost (DRC)*.

These measures derive from both FRS 11 and 15.

6 The impact on entities of the changes to UK GAAP effective from 1 January 2015 will depend on the accounting standards the entity currently applies:

- currently required to apply IFRS – no changes
- currently opt to apply IFRS – option to continue to do so or may apply FRS 102 (*The Financial Reporting Standard applicable in the UK and the Republic of Ireland*) or FRS 101 (*Reduced Disclosure Framework*)
- currently apply full UK GAAP – required to transition to FRS 102 or FRS 101
- currently apply FRSSE (the *Financial Reporting Standard for Smaller Entities*) 2008 – to be replaced by FRSSE 2015.

Accounting regime:	**Applicable to:**
EU-IFRS	Those required to apply by law or regulation. Optional for others.
FRS 101 *Reduced disclosure framework*	Individual accounts of qualifying parent and subsidiary entities.
FRS 102	Large and medium-sized entities. Optional for others not required to apply EU-IFRS.
FRS 102 with reduced disclosures	Individual accounts of qualifying parent and subsidiary entities.
FRSSE	Eligible small entities.

7 The main differences between FRS 102 and UK GAAP pre 1 January 2015 are that FRS 102 effective from 1 January 2015:

- introduces a new regime for financial instruments, in particular bringing all derivatives on balance sheet at *fair value*
- requires investment properties to be carried at *fair value*, with revaluation gains and losses recognised in profit and loss whenever such *fair value* can be measured reliably without undue cost or effort
- requires more *intangible assets* to be recognised separately from *goodwill* when there is a business combination
- presumes that the useful life of *goodwill* and *intangible assets* shall not exceed five years when no reliable estimate can be made

- requires additional deferred tax to be recognised – for example, on business combinations and on revaluations of property, plant and equipment and *investment properties*.

8 UKVS 1 expressly applies to valuations where the asset is an interest in *real estate* – however it must be stressed that the same principles apply across all asset classes and those embodied in UK GAAP (FRS 102) are of wider application.

Background

9 The updated UK GAAP (FRS 100–103 and FRSSE 2015) were published by the Financial Reporting Council (FRC) on 14 March 2013, and amended in July 2014. They introduced new Financial Reporting Standards (FRSs) for the United Kingdom and the Republic of Ireland (UK and ROI) effective on, and from, 1 January 2015, with early adoption permitted for accounting periods ending on or after 31 December 2012.

10 The previous UK GAAP accounting standards cannot be applied to accounting periods beginning on or after 1 January 2015.

11 The revised UK GAAP comprises four financial reporting standards, which together form the basis of the new UK and ROI accounting regime:

- **FRS 100** *Application of Financial Reporting Requirements* sets out and provides guidance on the overall reporting framework (FRSs 101–103 and, where it applies, FRSSE). It sets out which standards apply to which types of entity, when an entity can apply the reduced disclosure framework, and when an entity should follow a Statement of Recommended Practice (SORP).
- **FRS 101** *Reduced Disclosure Framework* permits disclosure exemptions from the requirements of EU-adopted IFRSs (as amended for the requirements of UK law) for certain qualifying entities.
- **FRS 102** *The Financial Reporting Standard applicable in the UK and Republic of Ireland* introduces a single standard based broadly on the IFRS for SMEs and replaces all existing FRSs, Statements of Recommended Practice (SORPs), Statements of Standard Accounting Practice (SSAPs) and the Accounting Standards Board (ASP) Urgent Issues Task Force (UITF) Abstracts.
- **FRS 103** *Insurance Contracts* consolidates existing financial reporting requirements for insurance contracts.

12 FRS 102 is based on the International Financial Reporting Standard (IFRS) designed for use by small and medium-sized entities (SMEs) – a simplified IFRS standard developed for non-publicly accountable entities that has been amended for UK-specific circumstances. Reduced disclosures are also available for certain qualifying entities applying FRS 102.

13 FRS 102 is based on IFRS but some of the key differences are that FRS 102:

- permits but does not require capitalisation of development costs and borrowing costs in some circumstances
- includes merger accounting for group reorganisations
- simplifies some of the IFRS requirements (for example accounting for deferred tax and financial instruments)

- requires *fair value* measurement for *investment property* when this can be obtained without undue cost or effort
- presumes goodwill and intangible assets have finite lives so does not require annual impairment reviews
- requires capitalisation of acquisition costs incurred on a business combination
- permits additional choices (including for the measurement of biological assets and recognition of government grants)
- includes requirements necessary for compliance with company law (such as the reversal of goodwill impairment losses, recognition of negative goodwill and accounting for contingent consideration)
- excludes some recent changes to IFRS (such as accounting for joint arrangements)
- includes requirements for specific entities and items (such as public benefit entities, heritage assets)
- presents discontinued operations differently
- has fewer disclosure requirements and
- complies with *Companies Act* formats.

14 The *Financial Reporting Standard for Smaller Entities* (FRSSE) applies in certain specified cases and is being revised.

15 All the standards that together comprise UK GAAP are freely available at www.frc.org.uk

UKVS 1.1 UK GAAP Basis of value (FRS 102)

Valuations for inclusion in *financial statements* prepared in accordance with UK Generally Accepted Accounting Principles (UK GAAP), which is effective from 1 January 2015, shall be measured on the basis of historical cost (the cost model) or *fair value* (the revaluation model) as defined in FRS 102:

(a) **In Section 2 paragraph 34(a), historical cost assumes the amount or *fair value* of the consideration as at the date of purchase/acquisition.**

(b) **In Section 2 paragraph 34(b), *fair value* assumes knowledgeable, willing parties, in an arm's length transaction. Further guidance is given either in the relevant sections of FRS or in Section 11 paragraphs 27–32.**

(c) **In Section 17 paragraph 15A, the cost model assumes cost less depreciation and impairment losses (accumulated).**

(d) **In Section 17 paragraphs 15B–15D, the revaluation model assumes the revalued amount at the revaluation date, less further depreciation and impairment loss.**

Commentary – focusing on fair value measurement

1 Valuers should note that the definition of *fair value* set out in FRS 102 is derived from IFRS 13 *Fair Value Measurement* – see **VPS 4 paragraph 1.5**. However,

although the definitions in FRS 102 and IFRS 13 are similar, they are not fully aligned and valuers providing information for *financial statements* are advised to become familiar with FRS 102.

2 IFRS 13 defines *fair value* and sets out in a single IFRS:

- a framework for measuring *fair value* and
- the requirements for disclosures about *fair value* measurements.

3 *Fair value* under IFRS 13 is a market-based measurement, not an entity-specific measurement. It means that an entity:

- shall look at how the market sector participants would look at the asset or liability under measurement and
- shall not take their own approach (e.g. use) into account.

4 *Fair value* under IFRS is 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market [sector] participants at the measurement date'.

5 This is the notion of an exit price (e.g. the price to sell an asset rather than the price to buy that asset). An exit price embodies expectations about the future cash inflows and cash outflows associated with an asset or liability from the perspective of a market participant (based on buyers and sellers who are independent and knowledgeable about the asset or liability).

6 When an entity performs the *fair value* measurement in accordance with IFRS 13, it must determine all of the following:

- the particular asset or liability that is the subject of the measurement (consistently with its unit of account)
- for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use)
- the principal (or most advantageous) market for the asset or liability and
- the valuation techniques appropriate for the measurement, considering:
  - the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and
  - the level of the *fair value* hierarchy within which the inputs are categorised.

7 FRS 102 Section 2 paragraph 34(b) defines *fair value* and Section 11 paragraphs 27–32 refer to valuation techniques and their application when determining *fair value*. Reference is also made to the expectation that *fair value* will normally be derived from market-based evidence rather than entity-specific measurement, although other methods (techniques) of valuation can be used if no comparable market evidence is available.

8 FRS 102 Section 17 paragraph 15C notes that market evidence is normally used to determine *fair value* and that professionally qualified valuers would complete this appraisal.

9 However, paragraph 15D recognises that such market evidence may not be available in certain circumstances, in which case either an *income approach* or a *depreciated replacement cost (DRC)* approach may be used.

10 Within FRS 102 are several areas likely to be impacted by *fair value* accounting:

- Biological assets (living plants and animals) can be measured using *fair values.*
- Business combinations where *intangible assets* are acquired, and whose values can be reliably measured, need to be separated from *goodwill* at acquisition.
- Some financial instruments (for example, derivatives) have to be carried at *fair value*.
- Investments can be held in the separate *financial statements* at cost less impairment OR at *fair value*, with fluctuations in *fair value* being passed through other comprehensive income or through profit or loss.
- Property, plant and equipment can be measured using either the revaluation model or cost model.
- *Investment property* whose *fair value* can be measured reliably without undue cost or effort shall be measured at *fair value* at each reporting date with changes in *fair value* recognised in profit or loss; otherwise it is measured using the cost model.

11 FRS 102 Section 34 provides specific guidance on financial reporting by entities involved in agriculture, extractive activities, and service concessions. It also addresses specific requirements for financial institutions, public benefit entities and retirement benefit plans, and provides accounting requirements for heritage assets, funding commitments and incoming resources from non-exchange transactions.

12 As a *basis of value*, *fair value* for financial reporting is defined in less specific terms than market value and is a broader concept running across most asset classes from an accounting consistency perspective. Although accountants consider that *fair value* as defined in IFRS 13 and FRS 102 are the same, it is noticeable that the terminology used in respect of *fair value* in FRS 102 is slightly closer to the IVS *market value* definition (see also **VPS 4 paragraph 1.2**) than that used in IFRS 13, reinforcing the view that – for most practical purposes – the figure to be reported as the *fair value* of an asset is likely to be conceptually the same as that which would be reported as its *market value* (**IVS 300 paragraph G2**). However, two cautionary notes should be sounded – see paragraphs 13 and 14 below.

13 As **VPS 4 paragraph 1.2.2** makes clear, market value 'represents the figure that would appear in a hypothetical contract of sale, or equivalent legal document, at the *valuation date*, reflecting all those factors that would be taken into account in framing their bids by market participants at large and reflecting the highest and best use of the asset'. The facts and circumstances of individual cases when reporting *fair value* will vary widely, not least the weight to be attributed to individual factors in the minds of market participants. Where the market value of any asset is materially different from its existing use value, it would be advisable – when reporting *fair value* – to alert the client (entity) and explain the rationale both to the client and, as appropriate, to the client's auditors before the report is finalised for inclusion in the *financial statement*. See **PS 2 paragraph 4.10** regarding the parameters within which any such discussion should be undertaken. This includes cases where the value to be reported reflects an expectation of a potential change in the circumstances of the asset in the future – see **VPS 4 paragraph 1.2.7**.

14 In the limited circumstances where a *special purchaser* other than the reporting entity can be identified, it is recommended that the client's attention is also expressly drawn to this and the *special value* separately reported or clearly identified and

disclosed when reporting the *fair value*, as would be the case when reporting market value generally (see **IVS Framework paragraphs 43 to 46**).

15 Valuers should note that FRS 102 Section 17 paragraph 32A states that if items of property, plant and equipment are stated at revalued amounts (i.e. at *fair value*) in the *financial statement*, the following disclosures are required:

(a) the effective revaluation date

(b) if an independent valuer was involved

(c) the methods used

(d) any assumptions applied and

(e) the carrying amount if the cost model had been used.

16 For the avoidance of doubt, UKVS 1 takes precedence over RICS Global Valuation Practice Application 1 (VGPA 1), Valuation for inclusion in financial statements, where the client expressly requires a valuation that complies with the revised UK GAAP effective from 1 January 2015.

17 The valuer should always agree with the client (and ideally with the auditors) the appropriate *basis of value* and assumptions that may impact on reported values at the outset when confirming the *terms of engagement*.

18 FRS 102 enables more flexibility in the frequency of valuations. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using *fair value* at the end of the reporting period.

19 Clients may ask the valuer to liaise with their auditors either before the report is made or subsequently, but if not the valuer should offer to do so. UK appendix 3 provides information about the relationship between the valuer and the auditor.

Publication statement

20 **VPS 3 paragraph 7(j)** states that where the purpose of the report requires a published reference to it, the valuer must provide a draft statement for inclusion in the publication. UK appendix 6 provides examples of published references where the valuation is for the purpose of financial reporting in accordance with UK GAAP.

Statements of recommended practice

21 Statements of recommended practice (SORPs) are sector driven recommendations on accounting practices for specialised industries or sectors which supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector.

22 The purpose for which the valuation is being prepared may also be the subject of a SORP. The SORP may specify the *basis of value*, the criteria for establishing the valuer's independence or the disclosures that have to be made.

23 Entities within the scope of a SORP will continue to apply the relevant SORP, where that remains extant, subject to any updating necessary to ensure consistency

with FRS 102. Valuers should therefore check the validity of any SORP and ensure that they are using the latest version that does not conflict with more recent financial reporting standards set out in FRS 102.

24 Many of the existing SORPs have either been updated, or are in the process of being updated. However, the SORP for the insurance sector, banking segments and leasing is extant from 1 January 2015.

25 The FRC website www.frc.org.uk holds full details of all SORPs and their interface with UK GAAP effective from 1 January 2015.

UKVS 1.2 Valuation date

Valuations for inclusion in *financial statements* must be as at the *date of the report*, or an earlier date.

Commentary

1 There is no general restriction on the *valuation date* in FRS 102.

2 Valuations for inclusion in *financial statements* that may be relied on by *third parties* should only be as at the *date of the report*, or an agreed earlier date, due to the increased uncertainty of any estimate of value at a future date.

3 If valuations are prepared in advance of the date of any statement into which they have been incorporated, and there has been a significant change either in market conditions or to the property asset itself between the *valuation date* and the date of the statement, this must be referred to in any published reference.

4 Where a preliminary valuation is reported in advance of the valuation, it must be clearly marked as a draft and **PS 2 paragraphs 4.10 to 4.14** will apply.

UKVS 1.3 Existing use value

1 Neither IFRS 13 nor FRS 102 makes any reference to 'existing use value'. However, when instructed to value **operational** property, plant and equipment for local authorities and assets for *financial statements* for central government, valuers should be aware that the *Code of Practice on Local Authority Accounting* published by the Chartered Institute of Public Finance and Accountancy (CIPFA) (see UKVS 1.11) and the *Government Financial Reporting Manual* (FReM), prepared by HM Treasury (see UKVS 1.14), require that the *basis of value* is existing use value as appropriate to the property, plant and equipment asset in question – and not *fair value* as defined in IFRS 13 or FRS 102.

2 However, non-operational 'surplus' property, plant and equipment is measured at *fair value*, arrived at in accordance with IFRS 13.

3 Existing use value (EUV) is to be used only for valuing property that is owner-occupied by an entity for inclusion in *financial statements*.

4 Valuations based on EUV shall adopt the definition set out below.

Definition:

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.

Commentary

5 The definition of existing use value (EUV) is the *market value* definition with one additional *assumption* and a further requirement to disregard certain matters. For most practical purposes the concept of *fair value* is consistent with that of market value. Therefore it is appropriate to apply the definition of existing use value in accordance with the conceptual framework of *market value* at **VPS 4 paragraph 1.2, Market value**, and **VPS 4 paragraph 1.5, Fair value**, together with the following supplementary commentary.

'… **the buyer is granted vacant possession** … '

6 The *assumption* that vacant possession would be provided on acquisition of all parts of the property occupied by the business does not imply that the property would be empty, but simply that physical and legal possession would pass on completion. Any parts of the property occupied by *third parties* should be valued subject to those occupations. Properties occupied by employees, ex-employees, or their dependants should be valued with regard to the circumstances of their occupation, including any statutory protection. This *assumption* also means that it is not appropriate to reflect any possible increase in value due to special investment or financial transactions (such as sale and leaseback), which would leave the owner with a different interest from the one that is to be valued. In particular the covenant of the owner-occupier must be ignored.

'… **of all parts of the property required by the business** …'

7 If parts of the 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*. If they can be occupied separately then they should be allocated to a separate category as surplus property and valued on the basis of *market value*. If separate occupation is not possible any surplus parts would have no more than a nominal EUV, as they would contribute nothing to the service potential of the property and would not feature in a replacement at least cost.

'… **disregarding potential alternative uses** …'

8 'Existing use', in the context of EUV, means that the valuer should disregard uses that would drive the value above that needed to replace the service potential of the property. An entity seeking to replace this potential at least cost will not buy a property if its value has been inflated by bids from other potential occupiers for whom the property has greater value because of alternative uses or development potential that are irrelevant to its own requirements.

The valuer must ignore any element of 'hope value' for alternative uses that could prove more valuable. However, it would be appropriate to take into account any value attributable to the possibility of extensions or further buildings on undeveloped land, or redevelopment or refurbishment of existing buildings, providing that these would be required and occupied by the entity, and that such construction could be undertaken legally and without major interruption to the current operation.

'… 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.'

9 There are circumstances where it may be appropriate for the valuer to ignore factors that would adversely affect the *market value*, but would not be characteristic of a replacement. Examples include:

- where an occupier is operating with a personal planning consent that could restrict the market in the event of the owner vacating
- where the occupier holds the property under a lease and there are lease covenants that impose constraints on assignment or alternative uses
- where a property is known to be contaminated, but the continued occupation for the existing use is not inhibited or adversely affected, provided there is no current duty to remedy such contamination during the continued occupation
- where an industrial complex is overdeveloped, and the extra buildings have either limited the market value or detracted from it, but would need to be replaced to fulfil the service potential to the business
- where the existing buildings are old and so have a limited market value, but would have a higher replacement cost to the business
- where the property is in an unusual location, or is oversized for its location, with the result that it would have a very low market value, but where the cost of replacing the service potential would be significantly greater and
- where the market is composed solely of buy-to-let investors, but the valuer believes that the replacement cost (the price agreed between a willing vendor and willing owner-occupier purchaser) would be higher.

10 Any value attributable to *goodwill* should normally be ignored.

11 The fact that a large property may be in single occupation does not necessarily mean that it has to be valued on the *assumption* that only bids from other potential occupiers for the whole can be taken into account. If the property is one where a higher value would be generated by the potential to divide it into smaller units for the existing use, this should be reflected in the valuation.

12 Valuers are reminded that EUV is no longer based on the 'open market value' definition, which featured in earlier editions of these standards but is no longer recognised. EUV now uses the *market value* definition.

13 Many market valuations are based on the existing planning use of the property, as it usually, but not invariably, generates the highest value. Such valuations have sometimes been described as 'existing use valuations'. However, this is incorrect and they should properly be expressed as *market values*. It is emphasised that EUV is only to be used when valuing property that is occupied by the owners of the interest being valued for the purpose of their business, for inclusion in *financial statements*.

UKVS 1.4 Events after the balance sheet date

Where a valuation may be materially affected by events after the balance sheet date, the valuer must refer to those events in the report and distinguish between adjusting and non-adjusting events.

Commentary

1 Under FRS 102 Section 32 *Events after the End of the Reporting Period*, an entity is required to adjust its statements to reflect adjusting events that occur between the balance sheet date and the date when the *financial statements* are authorised for issue.

2 An adjusting event is one which provides evidence of conditions (favourable and/or unfavourable) that existed at the balance sheet date. Examples include the determination of a sale price of a property on the market or the settlement of a rent review.

3 Events occurring after the balance sheet date that could not be anticipated at that time (for example, if a property is destroyed by fire) are classified as non-adjusting events. These are not to be reflected in any amendment.

4 Where non-adjusting events could influence the economic decisions of users taken on the basis of the *financial statements*, the entity is required to disclose the nature of the event and provide an estimate of its financial effect, or make a statement that such an estimate cannot be made.

UKVS 1.5 Costs to be excluded

The valuer must not include directly attributable acquisition or disposal costs in the valuation. Where asked by the client to reflect such costs, these must be stated separately.

Commentary

1 In determining the figure to enter into the balance sheet (the 'carrying amount'), FRS 102 requires the addition of notional, directly attributable acquisition costs, where material, to the *fair value*. Likewise, where property is surplus to the entity's requirements and valued on the basis of *fair value*, there should be a deduction for expected, directly attributable selling costs, where material. If requested to advise on these costs, the valuer should report them separately and not amalgamate them with the *fair value*, or existing use value. The valuation should reflect the valuer's opinion of the consideration that would appear in the hypothetical sale and purchase contract (see **VPS 4**).

2 FRS 102 states that directly attributable costs can include stamp duties, import duties and non-refundable purchase taxes, as well as professional fees. The valuer is alerted to a potential problem with a property that would, or would potentially, be subject to VAT in any transaction but the entity may not be able to reclaim that VAT. The decision whether or not to treat this as a directly attributable acquisition cost should be determined by the entity, together with its auditors. Even if this is the case the valuer should state clearly in the report what *assumptions* have been made and the likely impact of VAT in any transaction.

3 In the case of surplus properties, directly attributable selling costs that are material may need to be itemised separately. If so, they will include not only the transaction costs, but also any marketing costs that can be reasonably anticipated.

UKVS 1.6 Apportionments for depreciation

Where the valuer is required to advise on an apportionment of a valuation for depreciation purposes, or on the remaining useful economic life of the asset, the apportionment should be undertaken in accordance with the accounting principles set out in FRS 102 Section 17 paragraphs 16–23. Paragraph 18 requires the depreciable amount to be allocated on a systematic basis during the life of the asset.

Commentary

1 Where land and buildings are occupied by an entity in the normal course of its business, the value of those assets, as shown in the accounts, may be adjusted to reflect their depreciation over time.

2 The accounting principles for depreciation in FRS 102 advise that depreciation is applied systematically over the future useful economic life of the asset to the entity.

3 As depreciation is normally only applied to property occupied by the entity, the apportionment will be of *fair value*, or *depreciated replacement cost (DRC)*, based valuations.

4 As land and buildings are usually inseparable in reality, the apportionment should be reported as being hypothetical and for accounting purposes only.

UKVS 1.7 Treatment of leasehold interests

Where the interest to be valued is leasehold, the valuer shall, where appropriate, clarify with the client, confirm and record in the terms of engagement and report, which specific leasehold interests are to be valued. Specific reference should be made to the treatment of:

(a) **leases at rack rent or with short terms unexpired and/or**

(b) **inter-company leases.**

Commentary

(a) leases at rack rent or with short terms unexpired

1 Where a lease is held at a rack rent, or has a short term before expiry or before a review date to full rental value, the value (or in certain cases, the liability or negative value) to the business may not be material.

2 The valuer must discuss with the directors whether or not these specific leasehold interests are to be valued. If they are omitted from a valuation of an entire portfolio, the report needs to contain a reference to their omission on the grounds that their values are not material.

(b) Inter-company leases

3 Where a property is the subject of a lease or tenancy agreement between two companies in the same group, on arm's length terms and in accordance with normal commercial practice, it is acceptable to take account of the existence of that agreement.

4 However, on consolidation of the results and balance sheets of those companies into the group accounts, the existence of the lease must be disregarded and the property must be valued with vacant possession of the areas occupied by the group company, but subject to other leases or licences to *third parties*.

5 If asked to produce a valuation that takes account of an inter-company agreement the valuer should disclose in the report the relationship between parties to the agreement, and should draw attention to the fact that a valuation taking full account of the lease would not be suitable for adoption in group accounts.

6 Leasing of all assets by an entity is dealt with in FRS 102 in Section 20. However, Section 20 does not deal with the following types of leasing transactions:

- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see Section 34 *Specialised Activities*)
- licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights (see Section 18 *Intangible Assets other than Goodwill*)
- measurement of property, plant and equipment held by lessees that is accounted for as *investment property* and measurement of *investment property* provided by lessors under operating leases (see Section 16 *Investment Property*)
- measurement of biological assets held by lessees under finance leases and biological assets provided by lessors under operating leases (see Section 34) and
- leases that could lead to a loss to the lessor or the lessee as a result of non-typical contractual terms.

UKVS 1.8 Classification of leases under UK GAAP

Commentary

1 FRS 102 Section 20 determines the classification of a lease in much the same way as SSAP 21 *Accounting for Leases and Hire Purchase Contracts*. The overarching principle in the determination of whether a lease is financing or operating is considered in light of the substance of the arrangement – in other words looking at who bears the risks and rewards of ownership of the asset subject to the lease.

2 When, substantially, all the risks and rewards incidental to ownership of the asset are transferred from the lessor to the lessee, this will give rise to a finance lease. The asset will appear on the company's balance sheet (statement of financial position) together with a corresponding finance lease creditor. Where the risks and

rewards of ownership remain with the lessor, the lease is classified as an operating lease and rentals are charged to profit or loss as incurred.

3 The Guidance Notes to SSAP 21 *Accounting for Leases and Hire Purchase Contracts* contain a 90% test whereby should the present value of the minimum lease payments that the lessee is required to pay equate to 90% or more of the *fair value* of the leased asset then this will give rise to a finance lease. However, FRS 102 Section 20 does not contain any 90% benchmark that is currently seen in SSAP 21; instead it offers five examples of situations that individually, or in combination, would normally lead to a lease being classified as a finance lease, and a further three indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease.

4 It is important to understand that the situations above are **not** exhaustive and this is reflected in the wording in FRS 102 Section 20 paragraph 7, which confirms that all of the above situations are not always conclusive. The key to determining the correct lease classification will depend on whether the risks and rewards of ownership have transferred to the lessee or remain with the lessor at the inception of the lease. Section 20 paragraph 8 notes that the lease classification would not normally change (from operating to finance or vice versa) during the lease term, although the lessor and lessee can agree to do this. Where lease provisions are changed, the lease classification is then re-evaluated.

5 Lessee accounting – finance leases

(i) Once a lease has been determined as a finance lease, on initial recognition, Section 20 paragraph 9 requires a lessee to recognise its rights of use of that asset as an asset at an amount equivalent to the *fair value* of the leased asset or, if lower, the present value of the minimum lease payments which are determined at the start of the lease. Where a client incurs costs that are directly attributable in negotiating and arranging a lease, these costs are added to the amount recognised as an asset.

(ii) After initial recognition, FRS 102 Section 20 paragraph 11 requires a lessee to split the minimum lease payments between the capital element of the lease and the interest cost (as currently done in SSAP 21 and the FRSSE). However, the reduction in the outstanding liability is calculated using the 'effective interest method'. The effective interest method is a method of calculating the amortised cost of either a financial asset or a financial liability (or a group of financial assets and liabilities) and therefore allocating the interest component of the lease payments over the relevant period. Under the effective interest method:

- the amortised cost of the finance lease liability is the present value of future payments discounted at the effective interest rate and
- the interest expense in a period is equivalent to the carrying amount of the liability at the beginning of a period multiplied by the effective interest rate for the period.

(Section 20 paragraph 16)

(iii) For the purposes of this calculation, the effective interest rate is the rate that exactly discounts the future payments through the expected life of the lease.

6 Lessor accounting – finance leases

(i) Lessors recognise assets that are subject to finance leases in their balance sheet (statement of financial position) as a receivable (a debtor) at an amount

that is equal to the net investment in the lease (which is the gross investment in the lease, but discounted at the interest rate implicit in the lease). The gross investment is the total of the minimum payments due under the lease plus residual value (unguaranteed). (Section 20 paragraph 17)

(ii) Finance income is recognised in profit or loss based on a pattern that reflects a constant periodic rate of return on the lessor's net investment in the finance lease.

7 Lessee accounting – operating leases

(i) Payments under operating leases are generally considered as a straight-line expense over the term of the lease. Note that service charges are excluded. Section 20 paragraph 15 allows for limited alternatives to a straight-line basis under certain conditions.

(ii) If a lessee receives a lease incentive, this is accounted for as a reduction to the expense over the lease term (rather than to the date of the first rent review) on a straight-line basis, unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset.

8 Lessor accounting – operating leases

In most cases, assets that are subject to operating leases are recognised in the lessor's balance sheet (statement of financial position) depending on the nature of the asset, and income arising from the lease is recognised in the lessor's profit and loss account on a straight-line basis over the life of the lease.

UKVS 1.9 Exploration for and/or evaluation of mineral resources (extractive activities)

Under FRS 102 Section 34 paragraph 11 an entity using FRS 102 that is engaged in the exploration for and/or evaluation of mineral resources shall apply the requirements of IFRS 6 *Exploration for and Evaluation of Mineral Resources*.

When applying the requirements of IFRS 6, references made to other IFRSs within IFRS 6 shall be taken to be references to the relevant section or paragraph within FRS 102.

Commentary

1 IFRS 6 only addresses financial reporting for **the exploration for and evaluation of mineral resources**.

2 Exploration and evaluation assets are initially measured at cost. They are classified as tangible or intangible assets, according to the nature of the assets acquired. After recognition, the exploration and evaluation assets are measured using either the cost model or the revaluation model.

3 As soon as technical feasibility and commercial viability are determined, the assets are no longer classified as exploration and evaluation assets.

4 IFRS 6 therefore does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral reserves (such as activities before an entity has acquired the legal right to explore, or after the technical feasibility and commercial viability to extract resources have been demonstrated).

5 Activities and assets outside the scope of IFRS 6 are accounted for according to the applicable standards set out in FRS 102.

6 For example mineral bearing land or land suitable for waste disposal purposes will be measured in accordance with the cost model or revaluation (*fair value*) model in accordance with FRS 102 – see UKVS 1.1.

UKVS 1.10 Plant and equipment

1 **An entity shall measure an item of plant and equipment at initial recognition at its cost under FRS 102 Section 17, Property, Plant and Equipment, paragraph 9.**

2 **An entity shall measure items of property, plant and equipment after initial recognition using the cost model (in accordance with FRS 102 Section 17 paragraph 15A) or the revaluation model (in accordance with paragraphs 15B to 15F).**

3 **Under the revaluation model, an item of plant and machinery is measured at its *fair value* less any accumulated depreciation and subsequent impairment losses.**

Commentary

1 This basis is used to establish the plant and equipment's highest and best use value as part of a market sector participant's undertaking that it is expected to continue in operation for the foreseeable future.

2 Although FRS 102 is a specific UK and ROI standard, plant and equipment valuers may find the tone of IFRS 13 and IAS 16 standards conceptually useful in their approach to the revaluation of plant and equipment.

3 In order to calculate the *fair value,* the valuer must consider the value of the assets as an integrated package of assets, as may be used by market participants, rather than just the sum of individual asset values. Therefore, any incompatibility of particular plant assets, imbalances between the capacity of different production sections, underutilisation, poor plant layout and similar functional obsolescence factors that may affect the overall efficiency of the manufacturing facility should be recognised and taken into account.

4 In the context of *fair value*, the assembled subject plant and equipment assets' core draft value must also be tested/adjusted (if necessary) for economic obsolescence (often as part of/in conjunction with a wider business valuation/ impairment study). In the event that the valuer does not wish to test/adjust core draft values for economic obsolescence, this should be explicitly agreed as such with the client and referenced in the terms of engagement.

5 In the absence of relevant and meaningful market evidence, the replacement cost approach is usually adopted. Net current replacement cost is usually established by

depreciating the gross current replacement cost to reflect the value attributable to the remaining portion of the total useful economic working lives of the assets.

6 Gross current replacement cost is the total cost of replacing an existing asset with an identical, or substantially similar, new modern equivalent asset that has a similar production or service capacity, including costs of transport, installation, commissioning, consultants' fees and non-recoverable taxes and duties.

7 The depreciation applied to the *fair value* on a systematic basis over the useful life of the asset should take due account of the age, condition, functional and economic obsolescence, and other relevant factors, including any residual value at the end of the asset's useful economic working life.

8 Where suitable market evidence is available to the valuer, any cost based *fair value* should always be benchmarked with the cost of acquiring a similar assembled asset unit/facility (as defined by how market sector participants account for subject assets) in the open market, taking due account of the costs of transport and installation, etc.

9 Although the market approach is usually considered prime under *fair value* measurement, the income approach must also be considered. However as it is usually difficult to identify and/or allocate an income approach to individual assets, adoption of this approach is usually the exception for plant and equipment assets.

UKVS 1.11 Local authority asset valuations

Valuations of local authority assets for accounting purposes shall be in accordance with the IFRS-based *Code of Practice on Local Authority Accounting* (the 'Code') published by the Chartered Institute of Public Finance and Accountancy (CIPFA). The Code is based on the International Accounting Standards Board (IFRS) with specific adaptation and interpretation for the public sector.

The 2015/2016 Code (sixth edition) has effect for financial years commencing on or after 1 April 2015. Valuers must ensure that they are familiar with the latest publication.

Commentary

1 Local authorities in the United Kingdom are required to keep their accounts in accordance with 'proper (accounting) practices'. This is defined, for the purposes of local government legislation, as meaning compliance with the terms of the *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code).

2 The Code specifies the principles and practices of accounting required to prepare a Statement of Accounts that gives a true and fair view of the financial position and transactions of a local authority. The Code is usually updated annually.

3 The Code applies formally in Great Britain to local authorities, fire authorities (England and Wales), joint committees and joint boards of principal authorities. In Northern Ireland it applies to all district councils. The Code also applies to police and crime commissioners and other police bodies, as relevant.

4 In England and Wales, the local authority Code constitutes 'proper (accounting) practice' under the terms of section 21(2) of the *Local Government Act* 2003. In Scotland, the local authority Code constitutes proper accounting practice under section 12 of the *Local Government in Scotland Act* 2003. In Northern Ireland, the status and authority of the local authority Code derives from regulation 4 of the *Local Government (Accounts and Audit) Regulations (Northern Ireland)* 2006 and through the relevant accounts direction issued by Department of the Environment (Northern Ireland).

5 The general principles underlying the valuation of local authority assets are no different from those for other assets where there is a requirement to determine their *fair value* to the business.

6 Local authorities shall measure their assets and liabilities and provide disclosures in accordance with IFRS 13 *Fair Value Measurement*, where the Code requires or permits *fair value* measurement, except where adaptations to fit the public sector are detailed in the Code.

7 However, CIPFA and the Local Authority (Scotland) Accounts Advisory Committee (LASAAC) adapt IAS 16 *Property, Plant and Equipment* within the Code, to require that items of property, plant and equipment that are operational and therefore providing service potential for the authority are measured for their service potential either at existing use value, existing use value – social housing, or depreciated replacement cost and not at *fair value*. These measurement bases are described in the Code as current value (measurements).

8 Property, plant and equipment assets that do not provide service potential for the authority (that is those assets classified as surplus assets); are not measured for their service potential but for the economic benefits inherent in the assets. Therefore the current value measurement base for these assets is at *fair value* in accordance with the definitions and measurement requirements in IFRS 13.

9 UK appendix 5, Valuation of local authority assets, contains more detailed guidance on the specific valuation requirements of the Code.

UKVS 1.12 Valuations for registered social housing providers

1 A registered social housing provider is a social landlord that is registered in one of the registers by the Homes and Communities Agency or the Welsh Assembly Government under the *Housing Act* 1996 (as amended), the Scottish Housing Regulator under the *Housing (Scotland) Act* 2001 and the Department for Social Development (Northern Ireland) under the *Housing (Northern Ireland) Order* 1992 (all legislative references are as at December 2014).

2 *Financial statements* for registered social housing providers are prepared broadly in accord with UK GAAP (see UKVS 1.1), but are subject to the provisions of a Statement of Recommended Practice (SORP), *Accounting by registered social housing providers update 2010*, which applies to all registered social housing providers in the UK and provides essential guidance on, and interpretation of, accounting standards for the sector. The Financial Reporting Council (the FRC), the UK accounting body, subcontracts the development of the housing SORP collectively to:

- the National Housing Federation

- Community Housing Cymru (CHC) and
- the Scottish Federation of Housing Associations (SFHA).

3 The above SORP has been completely rewritten to reflect the changes in accounting standards in the revised UK GAAP, which comes into force on 1 January 2015.

4 Valuers must ensure that they are familiar with the latest publication.

Basis of value

Valuations of social housing for *financial statements* of registered social housing providers shall be on a basis of either:

(a) **existing use value for social housing (EUV-SH) for housing stock held for social housing or**

(b) ***fair value* in accordance with IFRS 13 for housing stock that is classified as surplus assets.**

Existing use value for social housing (EUV-SH) is an opinion of the best price at which the sale of an interest in a property would have been completed unconditionally for a cash consideration on the *valuation date*, assuming:

(a) **a willing seller**

(b) **that prior to the *valuation date* there had been a reasonable period (having regard to the nature of the property and the state of the market) for the proper marketing of the interest for the agreement of the price and terms and for the completion of the sale**

(c) **that the state of the market, level of values and other circumstances were on any earlier assumed date of exchange of contracts, the same as on the date of valuation**

(d) **that no account is taken of any additional bid by a prospective purchaser with a special interest**

(e) **that both parties to the transaction had acted knowledgeably, prudently and without compulsion**

(f) **that the property will continue to be let by a body pursuant to delivery of a service for the existing use**

(g) **that at the valuation date any regulatory body in applying its criteria for approval would not unreasonably fetter the vendor's ability to dispose of a property to organisations intending to manage their housing stock in accordance with that regulatory body's requirements**

(h) **that properties temporarily vacant pending re-letting should be valued, if there is a letting demand, on the basis that the prospective purchaser intends to re-let them, rather than with vacant possession and**

(i) **that any subsequent sale would be subject to all the same assumptions above.**

Commentary

5 EUV-SH is similar to *market value*, but with additional *assumptions* reflecting the continued use of the property for social housing. Although it shares some of the

characteristics of EUV, it should not be confused with this basis. The essential similarity is that both are aimed at establishing the service potential of the properties, but in the case of EUV-SH it is specifically for the delivery of the registered social housing provider's objectives. Therefore any value that may attach to a sale of the properties with vacant possession for use other than social housing must be ignored.

6 Properties owned by a registered social housing provider may be shown in the accounts at historic cost, net of housing association grant (HAG), or at valuation. Where the properties are shown at valuation, the figure should be the lower of replacement cost (the expense of purchasing at the least cost the remaining service potential of the asset at the balance sheet date) less HAG, or the recoverable amount (the higher of an asset's or cash generating unit's fair value less costs to sell and its value in use) less any HAG recovery.

7 If a registered social housing provider has embarked on a policy of disposing of properties with vacant possession, or has declared an intention to do so, then those properties will be surplus to requirements and should be valued to fair value. Any properties valued on this basis must be separately identified in the report.

8 The report must show the values of completed schemes separately from those for properties under construction. Where properties in the course of development are valued, the valuation should be in accordance with UK appendix 2, paragraph 3.21, on land and buildings in course of development.

9 Valuations must be split between properties held for letting, shared ownership properties and properties for outright sale. In the case of shared ownership properties, 'under construction' would include properties where the initial tranche of equity remains unsold.

10 Where a discounted cash flow (DCF) method has been used to derive EUV-SH, the valuer must state the key *assumptions* made, together with the discount rate(s) used.

11 A registered social housing provider may request valuations on alternative bases, for example, *fair value*, or *fair value* with vacant possession, and these alternative figures may be disclosed in the notes to the accounts.

12 The registered social housing provider's portfolio may include properties not used for housing purposes, for example, lock-up shops. These properties should be valued to *fair value* in accordance with IFRS 13.

UKVS 1.13 Inventories (previously referred to as trading stock)

Land and/or buildings and other assets held as inventories shall be valued in accordance with FRS 102, Section 13 Inventories, which is similar to the Statement of Standard Accounting Practice 9 (SSAP 9), *Stocks and long-term contracts*.

Commentary

1 Land and/or buildings and other assets held as inventory are not fixed assets and therefore require special rules where their value is to be included in the accounts. They are measured in the accounts at cost or, if lower, the estimated selling price less costs to complete and sell (under FRS 102 Section 13 paragraph 4).

2 In addition to the cost of building work, costs to complete includes (where appropriate) site works; the fees and expenses of the architects, engineers, quantity surveyors, project managers, solicitors and other professional advisers employed on the project; and interest charges. If a finance agreement exists with another party, the prescribed rate should be adopted.

3 In assessing costs to complete, it can normally be assumed that existing financing and other contractual arrangements will continue uninterrupted. If such agreements cannot be assigned to another party this should be stated in the report. Where the net realisable value is to be incorporated in *financial statements* that are subject to audit, it is normally appropriate to ignore such restrictions and assume a continuation of the existing business.

4 The valuer may sometimes be concerned with the actual cost to date, having possibly been asked to assist with apportioning costs. In such cases, the cost of development will be roughly the same as costs to complete, plus the actual cost of the land. However, the inclusion of any interest charges, land acquisition costs and irrecoverable VAT will depend on the accounting policy of the undertaking. The valuer should discuss this point with the client and state in the report whether or not such items have been included in the total amount reported.

5 Except in the case of farming stock valuations, the valuer should obtain written statements from the client setting out, as at the valuation date, the details of the cost of the works to date, and/or the estimated cost to complete. Details of any contracted lettings must also be obtained.

6 In the case of farming stock valuations, the basic principles of stocktaking are laid out in the HMRC Business Income Manual BIM55410 Farming: stock valuation, formerly BEN19, now help sheet IR232 (as at December 2014). All members undertaking farm stocktaking valuations should be familiar with this guidance, or any subsequent updates, which can be viewed on the HMRC website.

7 Further information on the principles of the valuation of land and buildings in the course of development can be found in UK appendix 2, paragraphs 3.22–3.23.

UKVS 1.14 Central government asset valuations

Valuations of central government assets for *financial statements* shall be in accordance with the *Government Financial Reporting Manual (FReM)*, prepared by HM Treasury and the devolved administrations.

Commentary

1 The *Government Financial Reporting Manual* (FReM) is the technical accounting guide to the preparation of *financial statements* and sets out the detailed requirements that entities must follow when dealing with accounting for tangible fixed assets.

2 FReM complements guidance on the handling of public funds published separately by the relevant authorities in England and Wales, Scotland and Northern Ireland. The Manual is prepared following consultation with the Financial Reporting Advisory Board (FRAB). In addition to the FReM, HM Treasury provides illustrative *financial statements* and supporting guidance on accounting matters helpful to those preparing *financial statements*.

3 The Manual applies EU-adopted international financial reporting standards (IFRS) and is kept under constant review. It is updated to reflect developments in international financial reporting standards (IFRS). The use of IFRS in general text in the Manual should be taken to include International Accounting Standards (IAS) and Interpretations of IAS and IFRS issued by the Standards Interpretations Committee (SIC) or the International Financial Reporting Interpretations Committee (IFRIC).

4 With regard to operational property, plant and equipment, FReM 2015–16 adopts IAS 16 *Property, Plant and Equipment*, interpreted and adapted for the public sector.

5 For in-use, non-specialised property assets, *fair value* should be interpreted as *market value* for existing use. It is for valuers to determine the most appropriate valuation methodology – which for specialist buildings, plant and equipment may be the depreciated replacement cost of the asset.

6 Property, plant and equipment that does not provide service potential, i.e. those assets classified as non-operational surplus assets, will not be measured for their service potential but for the economic benefits inherent in the assets. Therefore the current value measurement base for these assets will be at *fair value* in accordance with the definitions and measurement requirements in IFRS 13.

7 The authoritative version of the Manual for any financial year is available by the start of the financial year to which it relates. The valuer should check the version applicable to the relevant financial year before preparing valuations.

8 FReMs and the guidance are available at www.gov.uk/government/collections/government-financial-reporting-manual-frem

UKVS 1.15 Valuations based on depreciated replacement cost

1 In the private sector

A valuation of a property in the private sector using a *depreciated replacement cost (DRC)* method should be accompanied by a statement that it is subject to the adequate profitability of the business, paying due regard to the value of the total assets employed. This is especially important in the context of *DRC* valuations, which may ultimately be provided for accounting statements under IFRS or UK GAAP, and which will require adjustments for economic viability/obsolescence and wider market metrics.

2 In the public sector

A valuation of a property in the public sector using a *DRC* method should be accompanied by a statement that it is subject to the prospect and viability of the continued occupation and use, but again attention must be paid to any wider public sector IFRS-related accounting regulations.

3 Comparison with alternative market values

When reporting a valuation that has been estimated by using a *DRC* methodology, the valuer must state in the report:

(a) the *fair value* for any readily identifiable alternative use, if higher, or

(b) if appropriate, that the *fair value* on cessation of the business would be materially lower.

Commentary

1 In the private sector

1.1 Accounting standards require entities to review their assets periodically for 'impairment', which is a permanent loss in the value of the asset to the entity. The appropriate figure to be included in the balance sheet for an asset following an 'impairment review' is the higher of either its 'value in use' as defined in the accounting standard, or its *fair value*, less costs to sell. In simple terms this means that the amount in the balance sheet should be the higher of either the current value of the future benefits that will be derived by the entity from the continued use of the asset, or the proceeds the entity would gain from the asset's immediate retirement and disposal.

1.2 The *fair value* of an asset derived by reference to the sales of similar assets will usually approximate to the sum that the entity could obtain from the retirement and sale of the asset. If the value in use of the asset is lower than a *fair value* based on sales comparisons, the latter figure can safely be relied on as the base figure for inclusion in the accounts. This figure is an amount recoverable by the entity regardless of whether it continues to use or retire the asset.

1.3 In contrast, *depreciated replacement cost (DRC)* is used for assets that due to their nature and/or configuration for particular market sector participants are rarely, if ever, sold except as part of a sale of the entire operation of which they form part. The *assumption* that there will be demand for the current use of the asset is an inherent feature of the method. As a consequence, a *fair value* derived using this method will often not equate to the figure that would be obtained if the asset were retired and sold. If the value in use is lower than a *fair value* arrived at by using a *DRC* method, the latter figure cannot be relied on as the base figure, as it may not bear any relation to the amount that the entity would receive following a cessation of operations.

1.4 The possibility that a valuation derived using a *DRC* method would be materially affected by a cessation of operations is covered by the disclosure requirement. However, the requirement to indicate additionally that the valuation is subject to 'adequate profitability' emphasises to the entity that even if the value in use of the asset is lower than the reported *fair value*, it may still be higher than the net realisable value on cessation. It may therefore be necessary to write the reported *market value* down to the value in use in an impairment review.

2 In the public sector

2.1 The need to consider 'impairment' (permanent loss in the value of the asset to the entity) is also a requirement of public sector accounting. But because public sector assets are almost universally held for service delivery rather than for profit, it is necessary for the valuer to make it clear that the validity of a valuation derived using the *DRC* method depends on a continuing requirement to use the asset for the provision of the specialist service in question. Combined with any appropriate

disclosure this emphasises to users that the valuation cannot be relied on as an indication of the amount that could be recovered if the service was discontinued and the asset retired.

3 Comparison with alternative use values

3.1 As part of the process of valuing any property, the valuer needs to consider if there is potential for an alternative use that would be reflected in the *fair value*. In the case of *specialised property* that can only be valued using the *DRC* method, any alternative use value is likely to relate only to the land because the buildings or other improvements may be unsuitable for any alternative use.

3.2 Where it is clear that a purchaser in the market would acquire the property for an alternative use of the land because that use can be readily identified as generating a higher value than the current use and is both commercially and legally feasible, the value for this alternative use would be the *fair value* and should be reported as such. However, the report should state that this value reflects an alternative use and does not take account of the costs of business closure or disruption, or any other costs associated with realising this value.

3.3 Realising a *fair value* based on an alternative use may be inconsistent with the going concern *assumption* upon which *financial statements* are normally prepared. In addition, the costs that an entity might incur in closure or relocation could exceed any additional value that could be realised by an alternative use. Accordingly, an entity may request advice on the value derived from the *DRC* method, which assumes the existing use will continue to assist it in quantifying the extent of any redevelopment potential.

3.4 Frequently, the potential for an alternative use in the event of the specialised use being discontinued can be broadly identified, but the value for that use may not be reliably determined without significant research. For example, it may require the valuer to research into the prospects of obtaining statutory consents, the conditions that would be attached to those consents, the costs of clearance, the cost of new infrastructure, etc. In such cases a simple statement that the value of the site for a potential alternative use may be significantly higher than the value derived from using the *DRC* method will be sufficient.

3.5 If valuations are required on alternative *assumptions* these should be clearly stated.

3.6 If the valuer considers that the value of the asset would be materially lower if it ceases to be part of the going concern, this should be drawn to the attention of the client. However, there is no requirement to report that figure.

UKVS 2 Valuations for financial statements – specific applications

UKVS 2.1 Valuation reports in prospectuses and shareholders circulars to be issued by UK companies

Valuation reports for inclusion in prospectuses and circulars to the shareholders of UK companies shall be in accordance with the RICS specification in UK appendix 7.

Valuations for this purpose are regulated purpose valuations (see UKVS 4.1) and the various disclosure requirements within UKVS 4.2 and UKVS 4.3 will apply.

Commentary

1 In the UK, the Financial Conduct Authority (FCA) is the competent authority for listing pursuant to Part VI of the *Financial Services and Markets Act* 2000 and is responsible for:

- the Prospectus Rules, which set out rules and guidance for companies seeking FCA approval to publish a prospectus pursuant to EU Directive 2003/71/EC ('the Prospectus Directive' (PD)) and European Commission Regulation 809/2004 ('the PD Regulation') and
- the Listing Rules, which set out rules and guidance applicable to companies admitted, or seeking admission, to the Official List of the FCA (UK-listed companies) and which include, among other things, rules governing the contents of circulars issued by UK-listed companies to their shareholders.

2 Where a company is issuing a publication under either the Prospectus Rules or the Listing Rules, there are requirements for a valuation report to be included in that publication. However, it is recognised that reports may be substantial documents and therefore in certain circumstances the reports may be published in a condensed form.

3 The RICS specification for reports for this purpose is in UK appendix 7.

4 Valuers requiring further information about the regulatory requirements may access the full text of the rules through the FCA website (www.fca.org.uk).

5 Valuers may be requested to provide valuations for inclusion in an application for admission to the alternative investment market (AIM). On initial application, the company is required only to reveal the value of property as shown in its latest

accounts. The values do not have to be current unless they are shown as such in the accounts. Where the valuer is requested to provide current valuations, these must be given in accordance with the particular accounting standards that the company has adopted. For that purpose, either **VPGA 1** or UKVS 1.1 will apply. However, where the company has been listed on the AIM for at least 18 months, the publications must comply with the FCA rules and this *valuation standard*.

UKVS 2.2 Takeovers and mergers

Valuations in connection with takeovers and mergers shall be in accordance with the Takeover Code (the Code) issued by the Takeover Panel.

Valuations for this purpose are regulated purpose valuations (see UKVS 4.1), and the various disclosure requirements within UKVS 4.2 and UKVS 4.3 will apply.

Commentary

1 The Takeover Panel (the 'Panel') is an independent body, established in 1968, whose main functions are to issue and administer the Takeover Code (the 'Code'), and to supervise and regulate takeovers and other matters to which the Code applies, in accordance with the general principles and rules set out in the Code. The Code is designed principally to ensure that shareholders are treated fairly and are not denied the opportunity to decide on the merits of a takeover, and that shareholders of the same class are afforded equivalent treatment by an offeror. The Code also provides an orderly framework within which takeovers are to be conducted. In addition, it is designed to promote, in conjunction with other regulatory regimes, the integrity of the financial markets.

2 Since its establishment, the composition and powers of the Panel have evolved as circumstances have changed and the marketplace has developed. In 2006 it was designated as the supervisory body to carry out certain regulatory functions in relation to takeovers pursuant to the European Directive on Takeover Bids. Its statutory functions are set out in Chapter 1 of Part 28 of the *Companies Act* 2006.

3 The Code applies to all advisers who advise on matters to which the Code applies. The valuer is considered to be an adviser and must therefore comply with the Code.

4 The Code requires valuations to be made in accordance with these standards, but imposes additional requirements for this purpose. Information on the effect of the relevant parts of the Code is in UK appendix 8, Takeovers and mergers.

5 A valuer who attends meetings with clients and other advisers, such as lawyers, stockbrokers, accountants and merchant bankers, should be wary of assuming any role that could be regarded as that of a 'financial adviser' within the provisions of the *Financial Services and Markets Act* 2000. A financial adviser must be a registered *member* of a professional regulatory organisation. Although the role of a valuer would not normally fall within the definition, any extended involvement could, for example, in providing profit forecasts or commenting on them. If *members* have any doubt about their position, legal advice should be taken, preferably before attending any meeting.

UKVS 2.3 Collective investment schemes

Valuations for collective investment schemes shall be in accordance with the requirements of the Financial Conduct Authority (FCA) New Collective Investment Schemes Sourcebook.

Valuations for this purpose are regulated purpose valuations (see UKVS 4.1), and the various disclosure requirements within UKVS 4.2 and UKVS 4.3 will apply.

Commentary

1 Under Part XVII of the *Financial Services and Markets Act* 2000 only certain collective investment schemes may be promoted to the public. These are:

- investment companies with variable capital (ICVC) constituted in the UK
- authorised unit trusts (AUTs) constituted in the UK, which are collective investment schemes authorised by the FCA and
- collective investment schemes constituted outside the UK and recognised by the FCA.

2 The Investment Managers Association has issued a statement of received practice (SORP) that provides guidance on the effective implementation of the accounting standards: *Financial Statements of Authorised Funds* is available from www.investmentfunds.org.uk

3 With regard to valuations the SORP provides that the *basis of value* shall be open market value. However, the valuer reports *market value* in accordance with the detailed requirements set out in UK appendix 9, Collective investment schemes.

UKVS 2.4 Unregulated property unit trusts

Valuations for unregulated property unit trusts shall be on the basis of *market value*.

Valuations for this purpose are regulated purpose valuations (see UKVS 4.1), and the various disclosure requirements within UKVS 4.2 and UKVS 4.3 will apply.

Commentary

1 Unregulated property unit trusts are a form of collective investment scheme where assets are held in trust for the participants that do not have day-to-day control over the management of those assets. They may not be marketed to the general public and are thus distinguished from AUTs (see UKVS 2.3).

2 There is no regulatory requirement for an independent valuation, but most trust deeds require an independent valuer. If the trustee and/or the manager requests an independent valuer, the valuer must check the criteria and confirm that he or she meets them (see **PS 2 paragraph 4, Independence, objectivity and conflict of interest**).

3 Valuations of land and buildings are critical to the pricing of units and should be reviewed at frequent intervals. Every valuation must be as up to date as possible with regard to the valuer's judgment of the trends of the most recent transactions in the market, even if those trends may be short term.

4 In normal circumstances, the valuer is employed by, and reports to, the fund manager, but copies of the report should be provided for the trustees.

UKVS 2.5 Adequacy of financial resources of insurance companies

Valuations for inclusion in the assessment of the adequacy of financial resources for insurance companies shall be in accordance with the Prudential Regulation Authority (PRA) sourcebook for insurers (INSPRU).

Commentary

1 European directives require financial institutions to make assessments of the adequacy of their financial resources. In the UK the PRA INSPRU provides that the value of assets for checking financial adequacy shall be the same as that adopted by the entity for its accounting purposes.

2 The value of assets is to be measured in accordance with:

(a) the insurance accounts rules, or the *Friendly Societies (Accounts and Related Provisions) Order* 1994

(b) FRS and SSAP issued or adopted by the ASB and

(c) statements of recommended practice (SORPs), issued by industry or sectoral bodies recognised for this purpose by the ASB or

(d) IAS

as applicable to the *firm* for the purpose of its external financial reporting (or as would be applicable if the *firm* were a company with its head office in the UK).

3 Valuations for this purpose will therefore be in accordance with the relevant **IVS** (see **VPGA 1**) or UKVS 1.1, and must include a statement that they comply with the provisions of the sourcebook.

4 The INSPRU sourcebook is freely available at www.fshandbook.info/FS/html/PRA/INSPRU

UKVS 2.6 Adequacy of financial resources for financial institutions

Valuations for inclusion in the assessment of the adequacy of financial resources for banks, building societies and investment firms shall be in accordance with the Prudential Regulation Authority (PRA) sourcebook for banks, building societies and investment firms (BIPRU).

Commentary

1 European directives require financial institutions to make assessments of the adequacy of their financial resources. In the UK the PRA BIPRU sets out detailed rules for which such assessments shall be made.

2 BIPRU 3.4 states:

> 3.4.66(1) The requirements about monitoring of property values … are as follows:
> (a) the value of the property must be monitored on a frequent basis and at a minimum once every three years for residential real estate;
> (b) more frequent monitoring must be carried out where the market is subject to significant changes in conditions;
> (c) statistical methods may be used to monitor the value of the property and to identify property that needs revaluation;
> (d) the property valuation must be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices; and
> (e) for loans exceeding €3 million or 5% of the *capital resources* of the *firm*, the property valuation must be reviewed by an independent valuer at least every three years.
> (2) For the purposes of (1), 'independent valuer' means a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.
> 3.4.77 The property must be valued by an independent valuer at or less than the market value. In those *EEA States* that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or less than the mortgage lending value.
>
> BIPRU 3.4.66 and 3.4.77, © The Prudential Regulation Authority

Note that BIPRU states that 'necessary qualifications' need not be professional qualifications, but the valuer should be able to demonstrate that he or she has the necessary ability and experience to undertake the review.

3 The definition of *market value* is the same as adopted in these standards (see **VPS 4 paragraph 1.2, Market value**).

4 Mortgage lending value is not normally used in the UK. In 2006 an explanatory note on this was prepared by the European Mortgage Federation (www.hypo.org). RICS has no responsibility for the contents, and the European Mortgage Federation paper is neither mandatory nor approved guidance.

5 The full BIPRU is freely available at www.fshandbook.info/FS/html/PRA/BIPRU

UKVS 3 Valuations of residential property

UKVS 3.1 Residential property mortgage valuations

Valuations of residential property for mortgage purposes shall be in accordance with the RICS residential mortgage valuation specification (see UK appendix 10).

Commentary

1 When valuing residential properties on behalf of building societies, banks and other lenders for mortgage purposes, the valuer shall comply with the specification in UK appendix 10, unless otherwise agreed in writing, in advance, with the client.

2 The mortgage valuation specification may also be relevant to the provision of advice for the following purposes:

- re-*inspections*
- retypes and transcriptions
- further advances
- buy to let
- valuations without internal *inspection* and
- retrospective valuations.

Guidance on the provision of advice for these purposes is in UK appendix 11.

3 In Scotland the accepted procedures for buying residential property differ from those in England, Wales and Northern Ireland. Due to time restrictions it may be difficult to issue *terms of engagement* within the requirements of **VPS 1, Minimum terms of engagement**. Therefore, RICS Scotland has issued advice (reproduced in UK appendix 12) that aims to reflect best endeavours on behalf of the *member* or *firm*.

Loan classification

4 In general, *firms* that provide advice on residential mortgages are regulated by the FCA Mortgages and home finance: conduct of business sourcebook (FCA MCOB). The regulations apply to 'regulated mortgage contracts'. In order for a loan to fall within the definition of a regulated mortgage contract, at least 40% of the total of the land to be given as security must be used as, or in conjunction with, a dwelling. To be 'residential property', at least 40% of the land must normally be used as or in connection with one or more dwellings, or has been or is to be developed or adapted for such use.

5 A lender may ask the valuer for advice on the extent of the use of the property for residential purposes. The advice required should relate to the use of the property, and the valuer should not be influenced by the relative capital values or floor areas in isolation from the accompanying land.

UKVS 3.2 Repossession proceedings

Valuations of residential property for the purpose of possible possession proceedings, or the proposed sale of a repossessed property, shall be on the basis of projected market value (PMV) as expressly defined in UKVS 3.3, subject to the following *special assumptions* that:

- during the marketing period the property has been unoccupied and all furnishings and fittings have been removed and
- the vendor (the mortgagee) has to sell the property within a reasonable period to recover the secured debt.

Commentary

1 Projected market value (PMV, see UKVS 3.3 below) is a special *basis of value* used in relation to possession proceedings and the marketing of repossessed property.

2 The requirement to assume that the property has been empty means that the valuer has to take into account the adverse effect this may have on its marketability.

3 A valuation on the basis of PMV, in connection with possession proceedings, will exclude the value of furnishings and fittings, although it is likely that their removal will have an adverse impact on marketability and the value of the property.

4 The conceptual framework for *market value* in **VPS 4 paragraph 1.2, Market value**, applies, but the second *special assumption* does slightly modify 'and without compulsion'. While a mortgagee is not compelled to sell, there is a requirement to capitalise a non-performing asset. Therefore there is less flexibility than a typical owner-occupier would have. In certain market conditions this could affect the price that could be achieved.

5 The mortgagee as vendor has a duty to secure the best price available in the prevailing market conditions and has to act reasonably. If the mortgagee imposes restrictions on the available marketing period, then these should be identified by the valuer in any *special assumptions* made.

6 In Scotland, in recognition of the Single Survey, the *basis of value* for a lender's repossessed property, which is being exposed to the market, will be the same as any other property being brought to the market, that is, *market value*. Should the lender require any other method of valuation, this must be made clear in the report.

UKVS 3.3 Projected market value of residential property

Valuations of residential property on the basis of projected market value shall be in accordance with the definition settled by RICS, Council of Mortgage Lenders (CML) and the Building Societies Association (BSA).

Definition:

The estimated amount for which an asset is expected to exchange at a date, after the *valuation date* and specified by the valuer, between a willing buyer and a willing seller, in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

Commentary

1 The date specified by the valuer must be stated clearly whenever a PMV is provided. It should reflect the period that the valuer considers will be necessary for adequate marketing and the completion of negotiations.

2 This basis should be used to provide clients with an estimated valuation in respect of a future exchange, assuming that marketing begins on the date that the valuation is prepared.

3 The definition of PMV is based on *market value*, save for the stipulation that the valuer's estimate should reflect what the amount is projected to be at a future, specified date. **IVS Framework paragraphs 29–34 Market Value** should therefore apply with the exception that the phrase 'on the *valuation date*' is modified as follows:

> '… **at a date, after the *valuation date* and specified by the valuer** …'

The *valuation date* is the date on which the estimate is given, but represents the valuer's opinion, based on facts, market sentiment and public forecasts then existing of anticipated market changes during the period up to the specified date. A PMV is therefore a projection and not a forecast. The definition also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might otherwise occur.

4 PMV is designed to provide residential mortgage lenders with a simple numeric indication of the valuer's opinion of short-term market trends, and it must be used only for this purpose. It recognises that most reports for this purpose are based on a simple pro-forma, and that the degree of market analysis and commentary required in commercial lending situations is inappropriate.

5 The purpose of PMV is simply to illustrate the valuer's opinion of whether the market is likely to fall, rise or remain static in the period that it is anticipated will be necessary to complete the sale. Values can change rapidly due to unpredictable events, thus an earlier provision of a PMV is not a substitute for a current *market value*, nor is it necessarily the case that the two figures will be the same.

UKVS 3.4 Valuations for home finance products

Valuations for home finance products shall be in accordance with the requirements of the Financial Conduct Authority (FCA) Mortgages and home finance: conduct of business sourcebook (FCA MCOB).

Commentary

1 *Firms* that carry out activities related to home finance transactions are regulated by the FCA MCOB. A home finance transaction may be one of four products:

- regulated mortgage contracts (which includes lifetime mortgages)
- home reversion plans
- sale and leaseback and
- home purchase plans.

Lifetime mortgages and home reversion plans are together referred to as 'equity release products'. Equity release products and associated valuations are highly sensitive due to the age of the occupants.

2 The regulations apply to 'regulated mortgage contracts' (see UKVS 3.1 paragraphs 4 and 5, Loan classification). The full regulations may be obtained at www.fca.org.uk/handbook

3 The valuation of residential property for home finance products requires consideration over and above the standard mortgage valuation specification.

4 Although the purpose for which these valuations are required is regulated, they are not regulated purpose valuations and therefore UKVS 4.1 does not apply.

Lifetime mortgages

5 In this form, repayment is deferred until the sale of the property (lifetime).

6 Apart from indicating that the provider may include a property valuation in its illustration, there are no specific valuation requirements for lifetime mortgages. Such valuations should therefore be provided in accordance with UKVS 3.1, Residential property mortgage valuations, and UK appendix 10, RICS residential mortgage valuation specification.

7 The main differences between a lifetime mortgage and a conventional mortgage are:

(a) the redemption date is not fixed but comprises the date of death of the mortgagor and

(b) no repayments of capital are made, and the interest is 'rolled up' and compounded over the length of the mortgage term.

Therefore the amount of mortgage debt to be redeemed at the end of the term (the date of death of the mortgagor) is much greater than with a conventional mortgage, because of the lack of any capital repayment during the term and the accumulation of 'rolled up' interest. Due to the undetermined length of the mortgage term and the higher than normal amount to be redeemed at the term date, valuation advice should include comments on sustainability (especially in respect of features of design, condition and location) that may influence value over a longer term.

8 It is also important to appreciate that the lifetime mortgage lender places more emphasis on maintenance items and the timing of essential repairs as a condition of the mortgage. The forms and guidance published by the lender should therefore be considered in order to establish if they differ from the normal mortgage specification.

Home reversion

9 In this form the occupant sells all or part of the home to a reversion company or an individual. The occupant no longer owns all or part of the home, but continues to live there rent-free for the remainder of his or her life.

10 The regulations provide that valuations for home reversion products must be carried out by a competent valuer who is independent of the reversion provider. The reversion provider *firm* must also provide the customer with copies of the valuation report.

11 In the absence of any specific valuation requirements, valuations for home reversion products should be provided in accordance with **VPGA 2, Valuation for secured lending**. However, they should be treated in the same way as under UKVS 3.1 in most respects, except as mentioned in paragraphs 12 and 13 below.

12 Equity release products for home reversion, although for residential property, may need to be treated differently where there is some development potential reflected in the *market value* (in contrast to paragraph 4.2 of UK appendix 10, RICS residential mortgage valuation specification, where such value is usually excluded). The title to the property, and thus the benefit of any development potential, passes to the company on completion of the equity release transaction. The exploitation of any development potential would effectively be deferred until the company realises the value of its reversion on the death of the applicant. The development potential could be released during the term of the investment (the life of the applicant), but only with the applicant's consent.

13 Where the *market value* reflects development potential, whether arising from actual planning consents or the prospect of future development, the lender should be advised accordingly. So that the lender can assess the significance for underwriting purposes, the valuer may be requested to provide further information and a valuation on the *special assumption* that no development would be permitted.

Sale and rent back

14 Sale and rent back (SRB) is a facility whereby individuals sell their homes to an authorised firm at a discount, in return for the right to remain as a tenant for as set period. The tenancy has to be for a minimum term of five years on a fixed-term assured shorthold tenancy (AST), or equivalent in Scotland and Northern Ireland.

15 The regulations prescribe a procedure for commissioning a valuation that has the following elements:

(a) The valuation must be commissioned jointly by the SRB firm and the customer. A standard joint instruction letter is provided by the FCA, but its use is optional.

(b) The valuation must be carried out by a valuer who is independent of the SRB firm.

(c) The SRB provider must ensure that the valuation is carried out by a valuer who owes a duty of care to the customer in valuing the property. The FCA has suggested that the following wording is to be included in the appointment letter:

> 'By accepting this instruction you acknowledge that you owe a duty at common law to exercise reasonable care to both *[name of firm]* and *[name of owner]*, the property owner, and in addition you agree with each of *[name of firm]* and *[name of owner]*, the property owner, that you will carry out this instruction with reasonable skill and care.'

- A valuer may be considered independent if:

- the customer can choose the valuer, subject to the SRB provider's objection on reasonable grounds and to the valuer being competent
- the valuer owes a duty of care to the customer in valuing the property and
- the customer has an appropriate remedy against the valuer under a complaints procedure, which will allow the complaint to be referred to an independent professional whose decision is binding on the valuer.

16 The *basis of value* is *market value* at the reporting date.

Valuations for prospective lenders to sale and rent back (SRB) companies

17 Where the valuer is requested by an SRB provider or *third party* to provide a valuation for a prospective lender to an SRB company, it should be made clear that:

(a) while the original SRB valuation was on the basis of *market value* assuming vacant possession, the valuation provided to a prospective lender will be on the basis of *market value* on the *special assumption* that the property is subject to a five-year tenancy and

(b) these two valuations may be different from one another.

18 Where the valuer is requested directly by a lender to provide a mortgage valuation in respect of an application to finance an SRB purchase, the valuer must make clear to the lender that:

(a) the valuation will be on the basis of *market value* on the *special assumption* that the property is subject to a five-year tenancy and

(b) this may differ from the original SRB valuation on the basis of *market value* assuming vacant possession.

Home purchase plans

19 A home purchase plan serves the same purpose as a regular mortgage, but it is structured in such a way that makes it acceptable under Islamic Law.

20 The regulations do not provide any specific valuation requirements, and in the absence of specific instructions, valuations should be provided in accordance with UKVS 3.1.

UKVS 3.5 RICS HomeBuyer Service

***Members* accepting instructions to provide the RICS HomeBuyer Service (HBS) must comply with the extant HBS practice note.**

Commentary

1 The RICS HomeBuyer Service (HBS) is a product developed and owned by RICS, designed specifically as an economical service which may be provided only by RICS *members*.

2 The HBS comprises:

- an *inspection* of the property
- a concise report based on the *inspection* and

- a valuation.

It reports on the general condition of the main elements of the property and particular features that affect its present value and may affect its resale. The report focuses on matters that the surveyor judges to be serious and/or urgent.

3 *Members* who provide the HBS must comply with the practice note as published by RICS. In particular, the standard documentation and report form must be used without alteration as set out in the current edition of the practice note.

4 The HBS documentation and reports may be used only under copyright licence obtained from RICS. Further details can be found on the Home Surveys section of the RICS website: www.rics.org/homesurveys

5 Changes to the RICS HomeBuyer service (HBS) are being considered at the time of publication of this revision to the UK standards. Any change to the HBS will be notified on the RICS website. See the Home Surveys section of the website: www.rics.org/homesurveys

UKVS 3.6 The Home Report in Scotland

Members **accepting instructions to provide the Home Report in Scotland must comply with the legislation set out in the *Housing (Scotland) Act* 2006 and the *Housing (Scotland) Act (Prescribed Documents) Regulations* 2008.**

Commentary

1 The Home Report is legislation introduced by the Scottish Parliament. RICS Scotland has developed products in response to this legislation introducing a requirement for the provision of a report when a house or flat is brought to market. The Home Report was effective from 1 December 2008.

2 The Home Report comprises three elements, which are prescribed documents:

- Single Survey
- Energy Report and Energy Performance Certificate (EPC) and
- Property Questionnaire.

Collectively they cover the general condition of the property and particular features that affect its present value and may affect its resale. The Home Report focuses on matters that the surveyor judges to be urgent or significant, and it also includes a valuation of the property.

3 *Members* who provide services as part of the Home Report service must comply with the standard documentation and report form, which must be used without alteration.

Mandatory documentation

4 Mandatory documentation of the Home Report includes:

- terms and conditions, with a generic mortgage valuation report (MVR)
- terms and conditions without a generic MVR and
- Single Survey report, including the scope of *inspection*.

These documents ensure that *members* carry out the same Single Survey in accordance with the regulations and prescribed report format.

Optional documentation

5 Optional documentation providing guidance for the Home Report includes:

- letter of engagement with a generic MVR
- letter of engagement without a generic MVR and
- property *inspection* technical guidance for completing Single Surveys.

The letters of engagement are not prescribed as it is expected that *members* will develop their own in accordance with their *firms'* style. They are therefore available as examples only.

6 Paper versions of all the documents are available from RICS Scotland, and digital versions can be found at www.rics.org/uk/knowledge/more-services/guides-advice/home-surveys/home-reports-in-scotland/home-report-member-information

UKVS 3.7 Shared ownership

The value of a share in a shared ownership property shall be in the same proportion of the *market value* of the whole interest with vacant possession as that share bears to the whole.

Commentary

1 There is a wide range of schemes that enable an individual to purchase a dwelling using a combination of part ownership and part rental. Such schemes usually allow the part owner to purchase further shares in the dwelling, called 'staircasing', usually in 20% or 25% tranches. The RICS *guidance notes*, *Valuation of land for affordable housing* (2010) and *Valuation of land for affordable housing – Scotland* (2013), contain a brief explanation of the various forms of part ownership.

2 The valuer may be asked to provide either the *market value* of the dwelling, where the share value is calculated according to the individual arrangements, or the value of the share to be acquired.

3 Where *market value* of the whole is provided, the sharing terms are ignored but any other terms that are in place, such as restrictions on purchasers or price and lease terms, are reflected. It is essential that the valuer is aware of the shared ownership document.

4 Where a share value is provided, there may be evidence that a share has sold at a higher or lower price than the same arithmetical share of the value of the whole property. If the different price can be identified and quantified, the report should include a reference to it.

UKVS 3.8 Shared equity schemes

Valuations for individual properties under a shared equity scheme shall be the *market value* of the whole interest.

Commentary

1 Shared equity arrangements may arise as a result of developers offering either their own shared equity scheme, or a scheme as a result of government initiatives. Several different types of scheme exist, and valuers should ensure they are aware of the nature of the scheme proposed in respect of the property to be valued.

2 The valuer will usually be asked to provide the *market value* of the whole interest. Where this is provided, any restrictions on purchasers or resale price, or other restrictive terms, must be reflected. It is essential that the valuer is fully aware of the shared equity arrangements as well as any other restrictions.

3 Where there are circumstances that may unduly affect the resale value of the property because of the nature of the scheme, the valuer should provide further information to the lender and reflect this in the *market value* figure.

4 Generally, the buyer purchases an interest in the whole property, but only pays a percentage of the price. The remaining percentage is financed by a company in the form of an equity loan, and the company will take a second charge on the property. Some schemes require the equity loan to be repaid in full or in part at a specified date.

5 Conventional shared equity may enable the buyer to make partial repayments of the equity loan, thus increasing the purchaser's percentage share of the whole. Fixed shared equity does not enable the buyer to make partial repayments. Perpetual shared equity, more commonly associated with social housing schemes, does not allow for the repayment of the equity loan on sale, but perpetuates the arrangement on the same terms for a new purchaser. This may also be associated with restrictions regarding the nature of purchasers, for example, key workers.

6 On sale, the proceeds are shared in the same ratio as the initial percentages. This may result in either a gain or a loss for both parties, depending on whether the sale proceeds are more or less than the original purchase price.

7 Where it is not clear that the lender is aware that the property is being purchased under a shared equity scheme, the valuer should inform the lender.

UKVS 3.9 Secured lending valuations for registered social landlords

Valuations of a registered social landlord's housing stock for secured lending purposes shall be on the basis of either:

- ***market value*** **or**
- **existing use value for social housing (EUV-SH).**

Commentary

1 This statement applies to the provision of valuations to lenders considering the provision of finance to registered social housing providers for the development, or acquisition and retention, of an equity stake in residential property that would be let as shared ownership.

2 Guidance on the approach to these valuations can be found in UK appendix 13.

UKVS 3.10 Trustee mortgage valuations

Valuations undertaken for trustee mortgages must be by an 'independent valuer' in accordance with section 8 of the *Trustee Act* 1925.

Commentary

1 Under the Act a trustee must obtain a report of the value made 'by a person whom he reasonably believes to be an able practical surveyor or valuer instructed and employed independently of any owner of the property', and the loan must be 'made under the advice of the surveyor or valuer expressed in the report'.

2 As a result of case law it should be noted that:

- the surveyor or valuer must be instructed and employed independently of both the mortgagor and his or her solicitor in the transaction
- the amount or payment of the fee must not in any way depend on the proposed loan being effected and
- where a security is introduced by the surveyor or the valuer, the latter should not be employed to make the valuation.

[Schedule 4 of the *Trustee Act* 2000 has since repealed Part 1 (sections 1–11) of the *Trustee Act* 1925.]

UKVS 3.11 Affordable rent and market rent

Rental valuations provided for registered social housing providers in connection with the assessment of affordable rent shall be at *market rent*.

Commentary

1 This standard applies only in England.

2 Legislation requires that the landlord of affordable rent properties funded by the Homes and Communities Agency (HCA) must be a registered provider of social housing and is therefore subject to Tenant Services Authority (TSA) regulation.

3 Registered social housing providers will be able to let a property at an affordable rent of up to 80% of the gross market rent. The regulations provide that the gross market rent is to be assessed in accordance with an 'RICS recognised valuation method'.

4 Gross market rent has the same meaning as *market rent*, as defined in **VPS 4 paragraph 1.3, Market rent**. The valuer will provide a *market rent* as specified in UK appendix 14.

5 Valuations for this purpose do not fall within any of the exceptions specified in **PS 1 paragraph 6, Exceptions**, and therefore **VPS 1–4** are of mandatory application, subject to the additional requirements set out in UK appendix 14.

6 Although the purpose requiring these valuations is regulated, they are not regulated purpose valuations and therefore UKVS 4.1 will not apply.

UKVS 4 Regulated purpose valuations

UKVS 4.1 Regulated purpose valuations

Regulated purpose valuations are:

- **valuations for *financial statements* under VPGA 1, Valuation for inclusion in financial statements and UKVS 1.1**
- **valuation reports for inclusion in prospectuses and circulars to be issued by UK companies under UKVS 2.1**
- **valuations in connection with takeovers and mergers under UKVS 2.2**
- **valuations for collective investment schemes under UKVS 2.3 and**
- **valuations for unregulated property unit trusts under UKVS 2.4.**

Commentary

1 Valuations provided for these purposes also fall under **PS 2 paragraph 8, Disclosures**. UKVS 4.2 and UKVS 4.3 provide more stringent requirements that must be complied with where this *valuation standard* applies.

UKVS 4.2 Exclusion of certain properties

Where a regulated purpose valuation includes:

(a) **one or more properties acquired by the client within the 12 months preceding the *valuation date* and**

(b) **the valuer, or the valuer's *firm*, has in relation to those properties:**

- **received an introductory fee, or**
- **negotiated that purchase on behalf of the client,**

the valuer shall not undertake a regulated purpose valuation of the property (or properties) identified under (a), unless another *firm* unconnected with the valuer's *firm* has provided a valuation of that property for the client at the time of, or since, the transaction was agreed.

Commentary

1 There are many circumstances where conflicts of interest may arise (see **PS 2 paragraph 8, Disclosures**). This standard deals specifically with the conflict that may arise where the valuer or *firm* could be involved in the introduction and acquisition of property by the client and in the provision of a regulated purpose valuation of the same property.

2 This *valuation standard* requires that where the specified circumstances occur, the valuation should be provided by another *firm*. This will remove any perception that there could be pressure applied to justify earlier advice provided by the original valuer or the *firm*.

UKVS 4.3 Disclosures

Where a valuation is a regulated purpose valuation, the valuer shall state all of the following in the report and any draft published reference to it:

(a) **in relation to the *firm's* preceding financial year the proportion of the total fees, if any, payable by the client to the total fee income of the valuer's *firm* expressed as either less than 5%, or if more than 5%, an indication of the proportion within a range of 5 percentage points and**

(b) **where, since the end of the last financial year, it is anticipated that there will be a material increase in the proportion of the fees payable, or likely to be payable by the client, the valuer shall include a further statement to that effect, in addition to (a) above.**

Commentary

1 In complying with this *valuation standard*, the valuer is not required to provide a comprehensive account of all work ever undertaken by the *firm* for the client. A simple, concise statement that discloses the nature of other work done and the duration of the relationship is all that is required. If no relationship exists other than the valuation instruction, a statement to that effect should be made.

2 It may be both impractical and immaterial to establish and evaluate every relationship between the *firm* and every party connected with the instructing party. However, it is the valuer's responsibility to make reasonable enquiries to identify the extent of the fee-earning relationship with all parties having a material connection with the client, and to ensure that the principles of this standard are followed. Where there is a material connection or relationship, the disclosures required by this standard relate to the relationship of the valuer's *firm* with all the parties involved and the aggregate fees earned from those parties.

3 The information required under item (a) of this statement should be expressed, when required, in the form of 'between *[x]*% and *[y]*%', with the difference between the two figures being no more than 5 percentage points.

4 The purpose of item (b) is to recognise that there may be circumstances where a significant increase in the proportions of fees is anticipated between the end of the previous financial year and the *date of the report*. Because detailed information on the proportion will probably not be readily available, the valuer will need to make enquiries and form a judgment as to the likely proportions to be disclosed.

5 Where a reference to a report is to be published, the statement for inclusion in the publication (see **VPS 3 paragraph 7(j), Restrictions on use, publication and distribution**) should refer to all the information given in complying with this *valuation standard*. A note of the enquiries made and the source of the information used in complying with this *valuation standard* must be retained in the file.

4 RICS UK appendices

UK appendix 1 UK GAAP – Accounting concepts and terms used in FRS 102

UK Generally Accepted Accounting Principles (UK GAAP, FRS 100–103)

1 Introduction

1.1 This appendix provides information on the accounting concepts and some of the terms used in FRS 102 *The Financial Reporting Standard Applicable in the UK and the Republic of Ireland*.

1.2 Under FRS 102 Section 17, property, plant and equipment (PP&E) and *investment property* whose *fair value* cannot be measured reliably without undue cost or effort is initially recognised at cost as it is under FRS 15 *Tangible Fixed Assets* and Statements of Standard Accounting Practice (SAAP) 19 *Accounting for Investment Properties*. After initial recognition PP&E may be subsequently measured at *fair value*.

1.3 FRS 102 Section 16 Investment Property applies to *investment property* whose *fair value* can be measured reliably without undue cost or effort.

2 The required accounting concept

2.1 The Financial Reporting Council's (FRC's) FRS 102 Section 17 paragraph 15 requires entities to measure all items of property, plant and equipment – after initial recognition in the *financial statement* – using the cost model or the revaluation model.

2.2 Cost model

The cost model uses cost minus depreciation and impairment losses (both accumulated).

Historical cost assumes the amount or *fair value* of the consideration as at date of purchase/acquisition.

For liabilities historical cost is the amount of proceeds of cash or cash equivalents received or the *fair value* of the non-cash assets received in exchange for the obligation at the time the obligation is incurred.

2.3 Revaluation model

Where the revaluation model is selected, this shall be applied to all items of property, plant and equipment in the same class (i.e. having a similar nature, function or use in the business).

As with the cost model, the revaluation amount is minus further depreciation and impairment losses (both accumulated).

2.4 Accounting terms used are:

- Recoverable amount: the higher of an asset's (or cash generating units') *fair value* less costs to sell and its value in use.
- Value in use: this is the present value of the future cash flows expected to be derived from an asset or cash generating unit.

2.5 FRS 102 prescribes that the value of a tangible fixed asset in the accounts must be set at a level that is sufficient to reflect the *fair value* in the market of replacing its service potential. This is sometimes referred to as the 'deprival value', which is the price of the asset that, if the organisation were deprived of a particular asset, it or any other potential occupier would pay in the market to replace that asset for the same use to enable operations to continue.

2.6 In considering the concept of deprival value in relation to *fair value*, the actual circumstances of the entity should not be taken into account as this would be an assessment of *worth*. To avoid reflecting any additional bid that may be made by the actual entity because of its particular circumstances, the valuer may find it helpful to consider a bid that would be made by a hypothetical purchaser to occupy the property for the same use and in a similar manner to the actual occupier.

2.7 Alternative use values incompatible with the use of the asset in the business have no relevance in the accounts of an entity. However, an alternative use that increases the value of a property owned and occupied by the reporting entity to a level above that needed to fulfil the service potential may be relevant to an overall appraisal of the entity's situation, and should be disclosed in the valuation report.

2.8 While the above may assist valuers in understanding the context in which valuations for *financial statements* are required, the use of the word 'value' in the expression 'value in use' does not mean that a valuer is necessarily competent to determine this figure. The term should not be regarded as an alternative valuation basis for fixed assets and should not be used by valuers when preparing valuations. The valuer's role will normally be confined to providing advice on the replacement cost or the *fair value*.

2.9 However valuers with a particular knowledge of, or skill in, an asset class or industry may be competent to assist in the calculation of value in use. Requirements and guidance on the measurement of value in use can be found in FRS 102.

3 Frequency of valuations

3.1 FRS 102 is less prescriptive than FRS 15 in its requirements for entities to revalue. Whereas FRS 15 prescribes revaluations over a five-year cycle, with

particular requirements in years three and five, FRS 102 only requires valuations to be performed with 'sufficient regularity' to ensure that the book value does not differ materially from the *fair value*. The requirement is therefore driven by material movements in *fair value* rather than prescribed frequency.

3.2 However both FRS 15 and FRS 102 state that property held as tangible fixed assets at *fair value* shall be depreciated over its useful economic life.

4 Small companies

4.1 The UK *Financial Reporting Standards for Smaller Entities* (FRSSE) sets out which entities are eligible to use the standard. Its use is restricted to small companies or small groups, as defined by the *Companies Act* 2006, which are not 'ineligible' and to entities that would meet that definition had they been incorporated under companies' legislation (excluding building societies).

4.2 The *Financial Reporting Standard for Smaller Entities* (FRSSE) brings together in a single place the accounting standards and the accounting requirements of company law applicable to smaller companies. The measurement bases in the FRSSE are generally the same as those in UK GAAP. However, in many cases, the disclosure requirements of the accounting standards included as part of the FRSSE have been significantly reduced.

4.3 In July 2013, the Financial Reporting Council (FRC) published an updated FRSSE effective from January 2015. This updates the FRSSE (effective April 2008) for the changes resulting from the introduction of FRS 100 *Application of Financial Reporting Requirements*, FRS 101 Reduced Disclosure Framework and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

4.4 The FRSSE (effective January 2015 and which can be found at www.frc.org.uk/asb) removes references to reporting standards and Urgent Issues Task Force (UITF) Abstracts – these were withdrawn with the introduction of FRS 101 and FRS 102 which are effective for accounting periods beginning on or after 1 January 2015. It also makes a small number of consequential amendments to provisions in the FRSSE whose underlying requirements now change as a result of the introduction of FRS 102.

4.5 A company qualifies as small (and eligible to use the FRSSE) if, during a financial year, it satisfies any two of the following criteria:

- turnover less than £6,500,000
- total assets less than £3,260,000
- number of employees less than 50.

A company is ineligible from being a small company if it is a plc, a financial services or insurance company, or part of a group containing any of these or containing a European Economic Area (EEA) listed company.

UK appendix 2 Property categorisation for company accounts prepared under UK GAAP

UK Generally Accepted Accounting Principles (UK GAAP, FRS 100–103)

1 Introduction

1.1 This appendix provides guidance on the identification of categories and *bases of value* of property, plant and equipment, as set out in the revised UK Generally Accepted Accounting Principles (UK GAAP, FRS 100–103) and referred to in UKVS 1.

1.2 FRS 102 (effective from 1 January 2015) states that tangible assets include property, plant and equipment, and *investment property*. Note that Section 17 paragraph 2 assumes use for business purposes and for more than one accounting period.

1.3 Even though FRS 102 identifies only three classes of tangible property assets, valuers should agree and identify the types of property that should be valued in compliance with **VPS 1 paragraph 2(d)**. They should either report those values separately, or provide a breakdown where an aggregated figure is reported.

2 Categories of property

2.1 The following are examples of the different categories of property that may be identified in a valuation for incorporation in a *financial statement*:

- owner-occupied
- held as an investment
- *specialised property*
- inventories (previously referred to as *trading stock*)
- fully-equipped as an operational entity
- held for non-specialised or specialised development
- land and buildings in the course of development

- minerals
- surplus to requirements
- joint development contracts and joint ventures and
- options and other contractual rights which may be saleable and of value.

3 Basis of value

Valuations for inclusion in *financial statements* prepared in accordance with UK Generally Accepted Accounting Principles (UK GAAP), which is effective from 1 January 2015, shall be measured on the basis of historical cost (the cost model) or *fair value* (the revaluation model) as defined in FRS 102.

Refer to UKVS 1.1 for a more detailed commentary on the UK GAAP FRS 102 basis of value for inclusion in *financial statements*.

Note:

The following commentary focuses on property, plant and equipment that is measured in accordance with FRS 102 under the revaluation model (*fair value*) and not the cost model (cost of acquisition).

Commentary

Owner-occupied

3.1 Owner-occupied property will usually be valued on the basis of *fair value*, assuming vacant possession. It may be necessary to divide the amounts of the valuation between freehold, long leasehold (over 50 years) and short leasehold properties.

Property held as an investment

3.2 Only *investment property* whose *fair value* can be measured reliably without undue cost or effort on an ongoing basis is accounted for in accordance with FRS 102, Section 16 Investment Property, at *fair value*, through profit and loss.

3.3 All other *investment property* is accounted for as property, plant and equipment using the cost model in FRS 102 Section 17, Property, Plant and Equipment. Such property remains within the scope of Section 17 unless a reliable measure of *fair value* becomes available – and it is expected that *fair value* will be reliably measurable on an ongoing basis.

Specialised property

3.4 FRS 102 Section 34 refers to Specialised Activities. It provides specific guidance on financial reporting by entities involved in agriculture, extractive activities, and service concessions. It also addresses specific requirements for financial institutions, public benefit entities and retirement benefit plans, and provides accounting requirements for heritage assets, funding commitments and incoming resources from non-exchange transactions.

The *basis of value* is usually the:

(a) *fair value* model as set out in FRS 102 Section 34 paragraphs 4–7B or

(b) cost model set out in FRS 102 Section 34 paragraphs 8–10A.

3.5 If the market for an asset is not active, and recent transactions of an identical asset are not a good estimate of *fair value*, estimates of *fair value* may be provided by using a valuation technique.

3.6 The objective of using a valuation technique is to arrive at a *fair value* by estimating what the transaction price would have been on the measurement date in an arm's length exchange, motivated by normal business considerations.

3.7 While valuation techniques using recent arm's length market transactions should be used if possible, if there is a valuation technique commonly used by market participants to price the asset and that technique has been demonstrated to provide reliable estimate of *fair value*, entities may use that technique.

3.8 FRS 102 Section 17 paragraph 15D allows the use of an *income approach* or a *depreciated replacement cost (DRC)* approach where there is no market evidence available.

Inventories [previously referred to as trading stock]

3.9 An entity measures inventories at the lower of the cost and selling price of the asset, less costs to complete and sell (similar to net realisable value although the term is not used in FRS 102).

3.10 Inventories are governed by FRS 102 Section 13 Inventories. They are not fixed assets and are dealt with in different ways in *financial statements* – according to whether or not they are classified as long-term contract work.

3.11 Where valuations for this purpose are required, inventories are governed by FRS 102 Section 13 Inventories.

Property that is fully equipped as an operational entity

3.12 Property that is fully equipped as an operational entity will be valued to *fair value*.

3.13 Certain operations can be carried out only under statutory consents, permits and licences. Any *assumption* that operations will continue must be stated specifically in the report.

3.14 Where a business has been closed down and the property stripped of fixtures, fittings and furniture, it will normally be available for redevelopment, refurbishment or change of use. In such case, it should be valued accordingly as surplus to requirements, if so declared by the directors. If it is intended that the property will be re-opened for the purposes of the business, its value for balance sheet purposes must reflect the additional costs that would be incurred compared with an existing, fully-operational property, and this must be explained in the report.

Property held for non-specialised development

3.15 Property that is held for non-specialised development will be valued to *fair value*.

3.16 This is property that is held for development for investment purposes, or that the client has declared is being held for development at a foreseeable date for future occupation by the undertaking (sometimes called 'reserve' property).

3.17 Where pre-development procedures have started, such as:

- where an agreement for a building lease has been signed
- steps have been taken to obtain vacant possession or
- demolition of existing buildings has begun,

the valuer will need to agree with the client whether the property should be correctly classified as land and buildings in course of development. In this case, paragraph 3.22 below will apply.

Property held for specialised development

3.18 Property that is held for specialised development will be valued to *fair value*.

3.19 Land and buildings for specialised development should be valued either:

- for the proposed use by the business, provided that planning consent has been granted or
- in its existing state.

3.20 The application of these bases is subject to the accounting policy of the undertaking. The valuer should discuss the matter with the client in the light of that policy.

3.21 The valuer may be concerned only with the value of the land. At this stage, this may not be either a material part of the total cost of the property when development is completed, or a material element in the total value of the fixed assets, thus a current valuation may not be required.

Land and buildings in the course of development

3.22 Where land and buildings in the course of development are to be revalued, they are to be included in the *financial statements* at their *fair value*.

3.23 In estimating the EUV for social housing (EUV-SH), as defined in UKVS 1.12, the valuer will need to reflect the costs, including any appropriate allowances for risk and profit that are required to complete the project at the *valuation date*. Unless advised that the development is to be terminated or curtailed, the valuer may assume that all contracts in place at the *valuation date* will remain in place and can be transferred to a hypothetical buyer.

Minerals

3.24 An entity reporting under FRS 102 and that is engaged in the **exploration for and/or the evaluation of mineral resources (extractive activities)** shall apply the requirements of IFRS 6 *Exploration for and Evaluation of Mineral Resource* (as set out in FRS 102 Section 34 paragraph 11). Valuers should note that IFRS 6 **only** addresses financial reporting for the exploration for and evaluation of mineral resources.

3.25 Exploration and evaluation assets are initially measured at cost. They are classified as tangible or *intangible assets*, according to the nature of the assets acquired. After recognition, the exploration and evaluation assets are measured using either the cost model or the revaluation model. As soon as technical feasibility and commercial viability are determined, the assets are no longer classified as exploration and evaluation assets.

3.26 IFRS 6 therefore does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral reserves (such as activities before an entity has acquired the legal right to explore or after the technical feasibility and commercial viability to extract resources have been demonstrated).

3.27 Mineral activities and assets outside the scope of IFRS 6 are accounted for according to the applicable standards set out in FRS 102. For example, mineral-bearing land or land suitable for waste disposal purposes will be measured in accordance with the cost model or the revaluation (*fair value*) model in accordance with FRS 102 – see UKVS 1.1.

Property that is surplus to requirements

3.28 Property that is surplus to requirements will be valued to *fair value*. This is property that the directors of the undertaking declare to be no longer required for occupation for the purposes of the undertaking within the foreseeable future.

Joint development contracts and joint ventures

3.29 Joint development contracts and joint ventures will be valued to *fair value*.

3.30 Agreements for these purposes take many forms. The report must clearly differentiate between:

- the acquisition of a legal estate that gives the right to realise a sum of money, either in capital or income terms, linked to the underlying characteristics of the legal estate to which it is attached and
- a joint development contract, the successful performance of which will bring an entitlement to a sum of money.

3.31 In the case of large-scale projects, or development schemes involving a relatively high degree of uncertainty, developers often enter into binding, non-transferable agreements with landowners to undertake an agreed form of development. The responsibilities and risks are shared in varying proportions, and the ownership of the legal estate can be transferred to a new enterprise or another party. The valuer may be called on to undertake valuations of the interests of the parties involved. In such circumstances the valuer should discuss with the client which approach to adopt.

3.32 Joint development contracts do not require the developer to hold any legal estate, but may include an option or a licence to acquire one. The developer may therefore expect to incur financial benefit or detriment arising directly or indirectly from its involvement. Such contracts, which often include a management fee, also allow for a profit, in accordance with a pre-determined formula, in the event of a successful outcome.

3.33 The valuation of a joint development contract will therefore involve an assessment of the value of the right to receive a financial benefit at a future date,

contingent on performance. The developer, as the recipient of potential future benefit under the contract, must fulfil the obligation to perform all of the terms of the contract. The valuer should consider and interpret all relevant factors, including political, financial, fiscal, legislative, social, economic, market trends and so on, in assessing the developer's probable reward.

3.34 A joint venture may be carried out by a company that owns the land, with shares held by the former landowner and the developer in stated percentages. It can also be undertaken as a partnership between two or more parties, but a partner may have a general or limited liability. Another method is a trust for sale. Such joint ventures will usually provide a formula for the percentage holdings and trading rights of the parties.

Options and other contractual rights that may be saleable and of value

3.35 Options and other contractual rights that may be saleable and of value will be valued to *fair value*.

3.36 The valuer must discuss with the client the actual terms of the options to establish the precise nature of the valuation required.

UK appendix 3 Relationship with auditors

1 Introduction

1.1 This appendix provides guidance to valuers on their relationship with auditors when valuations are to be used as audit evidence by those auditors – usually where the valuation is included or disclosed in published *financial statements*. It also provides an indication of the information auditors are likely to require.

2 The role of the auditor

2.1 Auditors have a statutory obligation, for UK incorporated entities, to express an opinion on whether or not the accounts:

- have been properly prepared in accordance with the *Companies Act* 2006 (in particular, in accordance with its disclosure requirements)
- have been prepared in accordance with applicable accounting standards and
- give a true and fair view.

2.2 In order to express this opinion, Auditing Standards (set by the Auditing Practices Board) require that auditors obtain reasonable assurance about whether the *financial statements* as a whole are free from material misstatement, whether due to fraud or error.

2.3 The International Standards on Auditing (UK and Ireland) (ISAs (UK and Ireland)) and the International Standard on Quality Control (UK and Ireland) (ISQC (UK and Ireland)) are based on the similarly-titled International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) issued by the International Auditing and Assurance Standards Board (IAASB), published by the International Federation of Accountants (IFAC) in 2009.

2.4 ISA 700, *Forming an Opinion and Reporting on Financial Statements*, as issued by the IAASB, has not been adopted in the UK. The applicable standard issued by the Financial Reporting Council (FRC) is ISA (UK and Ireland) 700, *The Auditor's Report on Financial Statements*, which addresses the requirements of company law and also provides for a more concise auditor's report. The main effect of this is that the form of UK and Ireland auditors' reports may not be exactly aligned with the precise format of auditors' reports required by ISA 700 issued by the IAASB. However, ISA (UK and Ireland) 700 has been designed to ensure that compliance with it will not preclude the auditor from being able to assert compliance with the ISAs issued by the IAASB.

2.5 International Standards and Auditing (UK and Ireland) Audit Evidence 500 (ISA (UK&I) 500), effective for audits of *financial statements* for periods ending on or after

15 December 2010, 'explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence [so as] to be able to draw reasonable conclusions on which to base the auditor's opinion'. [para 1, ISA 500] Valuers are advised to become familiar with both ISA (UK&I) 500 and ISA (UK&I) 620 as referred to in subsection 3 below.

2.6 Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the *financial statements* are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, due to the inherent limitations of an audit – because most of the audit evidence on which auditors draw their conclusions and base their opinions is persuasive rather than conclusive.

2.7 Most auditors' work in forming their opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry.

2.8 Auditors apply the concept of materiality in performing their work. Under most financial reporting frameworks, misstatements (including omissions) are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions taken on the basis of the *financial statements*.

2.9 In evaluating audit evidence in support of their opinion, auditors must apply professional scepticism in reaching a judgment as to whether the evidence is relevant, reliable, sufficient and appropriate.

2.10 Auditors remain solely responsible for the audit opinion at all times, and regardless of the degree of use of expert's work as audit evidence. For entities that apply the *UK Corporate Governance Code* in the preparation of their Annual Report – principally Premium Listed entities on the London Stock Exchange (LSE) Main Market (a company can list on the Main Market of the LSE in either the Premium or Standard segment in accordance with the Financial Conduct Authority (FCA) listing categories) – the auditors have to disclose the scope of their audit and how that scope addressed the assessed risks of material misstatement and in doing so could be expected to make reference to their use of the work of experts (where applicable). For other entities, auditing standards expressly preclude auditors from referring to the work of an expert in their report and, if they do make such a reference, indicate that this reference does not reduce their responsibility for their opinion.

2.11 Auditors encounter the work of experts as audit evidence in two scenarios, each with two possible bases of appointment:

(a) where the expert is acting as management's expert (whether as an *internal valuer* or an *external valuer*, i.e. either as an employee of the audited entity or as an independent consultant) and

(b) where the expert is engaged directly by the auditor as the auditor's expert (whether as an employee of the auditor or as an independent consultant).

2.12 The consequences of being appointed in one of these two roles – in other words as management's expert or the auditor's expert – are explained in more detail below.

3 The auditor's evaluation of the work of experts as audit evidence

Where a valuer is acting as either a management expert or the auditor's expert, that valuer is advised to read ISA (UK&I) 500 or 620 as appropriate to ensure they understand what is required.

Management's expert

3.1 In ISA (UK&I) 500 a management expert may be either an individual or an entity. In paragraph 5(d) the role is described in terms of having (non-accounting/non-auditing) professional expertise that a company will use to help prepare *financial statements*.

3.2 ISA (UK&I) 500 paragraph 8 requires the auditor to evaluate, in relation to the work in hand, the 'competence, capabilities and objectivity' of the valuer. Each of these terms is described further in paragraph A37 of ISA (UK&I) 500. Valuers are advised to check the ISA in relation to the specific circumstances of any work accepted for *financial statements*.

3.3 Paragraph 8 also requires auditors to develop some understanding of the valuer's work, enabling them to assess 'the appropriateness of that expert's work as audit evidence'.

3.4 In addition, ISA (UK&I) 500 paragraph 7 requires the auditor to 'consider the relevance and reliability of information to be used as audit evidence'.

The nature, timing and extent of audit procedures to assess these requirements will depend on a number of factors. These are described in paragraph A36, but in essence relate to:

- the risk of error affecting value
- what alternative evidence is available (to the auditor)
- the valuer's scope of work
- the nature of the valuer's employment/engagement relationship with the entity
- how much control over the valuer's work is exercised by the entity
- the valuer's professional standards and how they are regulated.

The auditor's expert

3.5 ISA (UK&I) 620 (revised) requires the auditor to determine whether to use the work of an auditor's expert in a situation where expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence. An auditor's expert can be a partner or a staff member of the auditor's firm, including a temporary staff member, or a network firm, or can be an external expert.

3.6 Paragraph 9 requires the auditor to check the valuer's competence, capabilities and objectivity for the relevant purpose. This would include checking for potential conflict of interest.

3.7 Paragraph 10 requires auditors to develop 'sufficient understanding of the [valuer's] field of expertise to … determine the nature, scope and objectives of the [valuer's] work' and assess if it is fit for purpose.

3.8 Paragraph 11 specifies that certain items be agreed in writing. These relate to:

- the roles and responsibilities of both auditor and expert
- 'the nature, scope and objectives' of the work itself and
- the communication arrangements between the two.

3.9 Paragraph 12 describes how the auditor would evaluate the work of the expert. Key elements are the relevance and reasonableness, in the circumstances, of:

- the valuer's final opinion
- any assumptions the valuer applies
- the method(s) chosen by the valuer
- any source data used by the valuer, including its completeness and accuracy.

The auditor would also consider how consistent the valuer's opinion is with any other evidence assessed.

3.10 Paragraph 8 recognises that the nature, timing and extent of procedures undertaken to fulfil the above requirements depends on:

- the 'nature of the matter' that the work relates to
- the risk of error affecting value
- 'the significance of that expert's work in the context of the audit'
- any previous experience the auditor has of the valuer's work
- whether any quality assurance procedures are applied to the valuer's work by the auditing company.

4 Summary of the auditor's evaluation and commentary on the valuer's response

4.1 The nature, timing and extent of the auditor's requests and process of evaluation of the extent to which the work of a valuer can be used as audit evidence will vary according to the factors set out in paragraph 3.10 above, as well as the precise capacity in which the valuer is acting (see paragraph 2.11). The auditor may need to obtain information and explanation and, where appropriate, review documentation in relation to all or any of the matters set out below. These summarise the requirements set out in sections 2 and 3 above, and also indicate how compliance with an auditor's requirements can be demonstrated and met.

Acting as management's expert	Acting as auditor's expert	Valuer's response
Details of the expert's experience, qualifications, membership of professional body or similar and the relevance of the expert's specialism to the matter being audited		Member qualification and experience requirements, including RICS Valuer Registration requirements, are covered in the Red Book (global) at PS 2 section 3
Details of published papers or books written by that expert		A matter of fact in each individual case – though publication of books or papers is not a requirement in order for a valuer to demonstrate sufficient expertise

Acting as management's expert	Acting as auditor's expert	Valuer's response
An understanding of the expert's knowledge of relevant accounting requirements	An understanding of the expert's knowledge of relevant accounting and auditing requirements	A matter of fact in each case
Details of any interests and relationships that may create threats to objectivity and any applicable safeguards against this, including financial interests, business and personal relationships, provision of other services. Where the expert is an employee of the entity they will not be regarded as being more likely to be objective than other employees of the entity.	Details of any interests and relationships that may create threats to objectivity and any applicable safeguards against this, including financial interests, business and personal relationships, provision of other services. A written representation about these interests or relationships may be requested.	Independence and objectivity requirements are covered in Red Book (global) at PS 2 section 4, which also addresses issues and risks concerning conflicts of interest. Note that a valuer who is in the employ of either the enterprise that owns the assets, or the accounting firm responsible for preparing the enterprise's financial records and/or reports is an *internal valuer*.
What professional or other standards and regulatory or legal requirements apply to the expert's work		Compliance and regulation in relation to the Red Book (global) is covered in PS 1. Valuers should be alert to any other regulatory or legal requirements that apply in individual cases.
What assumptions and methods are used by the expert and whether they are generally accepted within that field and appropriate for financial reporting purposes		*Assumptions* are covered in the International Valuation Standards (IVS) Framework and in the Red Book (global) at VPS 4 section 2. Note that *special assumptions* should not normally be used where valuations are to be included in *financial statements* – see VPS 4 paragraph 3.9. Methods are a matter of judgment for the valuer, and their general acceptance and appropriateness are matters that will depend on individual circumstances.
The nature of internal and external data or information the expert uses		The nature and source of the information relied on is covered under IVS 101 and in the Red Book (global) at VPS 3 paragraph 7(h).
Obtain a copy of the expert's engagement contract or other written agreement between the expert and management.		The valuer should provide the auditor with a copy of the terms of engagement agreed with the client and any subsequently agreed variations of those terms.

5 The auditor's requests and the valuer's response – further issues

5.1 The auditor will usually obtain a copy of the expert's report, either from the audited entity or directly from the expert, and will then review the report and discuss it with the expert, among other things addressing the issues and questions set out in 3.9 above.

5.2 Legal advice obtained by RICS indicates that there is no legal relationship between the auditors and an *external valuer*. An *external valuer* can therefore refuse to produce the file, and even refuse to answer an auditor's questions, though the valuer should be satisfied that there are reasonable grounds for refusal before taking this action. This does not apply to an *internal valuer*, who is an officer of the company within the meaning of the *Companies Act* 2006. However, if an *external valuer* refuses to cooperate this could constitute a limitation on the scope of the auditors' work. It may therefore lead the auditors to qualify the reports on the accounts and make some comment that it was not possible to obtain all the information and explanations necessary to the valuation.

5.3 The valuer should therefore be prepared to cooperate reasonably and responsibly with any auditors, and as necessary have the directors' permission to override any confidentiality obligations in their engagement contract with the company. Indeed, prior to issuing the report, the valuer should bring to the auditors' attention, and discuss as appropriate, matters relating to the valuation that may have an impact on the audit and the auditors' responsibilities. This is important because it is an offence under UK company law to make a statement to an auditor that is knowingly or recklessly misleading, false or deceptive. Additionally, there will be occasions when the valuer will welcome the opportunity to verify information and *assumptions* relevant to valuations. In some cases a discussion between the auditor and the valuer before the latter starts to fulfil the audited entity's instructions can be helpful to both parties, and will promote smooth completion of the audit.

5.4 The valuer may be asked, in falling markets, whether the property value has suffered a diminution of value. The valuer should be prepared to give an opinion on the basis of a definition of 'diminution' provided by management.

UK appendix 4 Accounting for depreciation and associated apportionments under UK GAAP

UK Generally Accepted Accounting Principles (UK GAAP, FRS 100–103)

1 Introduction

1.1 This appendix provides information on the accounting concepts and standards governing the consideration of depreciation, and associated apportionments, for the purposes of *financial statements* under UK Generally Accepted Accounting Principles (UK GAAP, FRS 100–103).

1.2 This appendix focuses on the accounting guidance found in FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland*. FRS 102 includes guidance for all tangible fixed assets including investment properties, and deals with depreciation of assets carried in an entity's accounts either at cost or at *fair value*. Entities applying FRS 101 *Reduced Disclosure Framework* follow (in general) the principles of IFRS for accounting measurement. This appendix refers expressly to land and buildings, but the information on depreciation applies equally to plant and equipment.

1.3 Depreciation, in accordance with accounting conventions, should not be confused with the deductions made in the course of valuation, for instance, in a *depreciated replacement cost (DRC)* valuation. The valuer provides the amount for the asset that is included in the balance sheet if the revaluation model rather than the cost model is applied. The accountant then calculates the provision for depreciation based on the carrying amount of the asset, or an apportionment if required. Impairment of the asset should also be considered.

1.4 The useful life of an asset is defined in FRS 102 in terms of the asset's expected utility to the entity and may not be the same as the economic life for valuation purposes – which is defined as the number of years in which the asset returns more value to the owner than it costs to own, operate, and maintain. When these costs exceed returns, the asset is beyond its economic life.

1.5 The asset management policy of an entity may involve the disposal of assets after a specified time or after the consumption of a specified proportion of the future economic benefits embodied in the asset.

1.6 The useful life of the asset may therefore be shorter than the economic life.

2 Depreciation

2.1 Depreciation is the reduction of the stated value of an asset in a *financial statement* staged over its useful working life.

2.2 FRS 102 requires that depreciation should be allocated on a systematic basis over the future useful economic life of a fixed asset. The depreciation method used should reflect, as fairly as possible, the pattern in which the asset's economic benefits are consumed by the entity. FRS describes the future useful life of an asset in terms of either time periods or production/other measurable units. All buildings have a limited life due to physical, functional and environmental changes that affect their useful economic life to the business.

2.3 As indicated earlier, the future useful life of the tangible fixed asset is defined as the period during which the entity in whose accounts the asset is carried expects to derive economic benefit from that asset. This may be its total physical or economic life, however, if there is an expectation that the asset will be sold before the end of its physical or economic life, this period will be shorter.

2.4 In normal circumstances depreciation is not applicable to freehold or feuhold land. Exceptions to this include land that has a limited life due to depletion (for example, by the extraction of minerals), or that will be subject to a future reduction in value due to other circumstances. One example would be where the present use is authorised by a planning permission for a limited period, after which it would be necessary to revert to a less valuable use.

2.5 Leasehold assets must, by their nature, have a limited life to the lessee, although the unexpired term of a lease may exceed the life of the buildings on the land. Any contractual or statutory rights to review the rent, or determine or extend a lease, must also be considered.

2.6 The assessment of depreciation and the remaining useful economic life of the asset are the responsibility of the directors of the entity (company), or their equivalent in other organisations. However, the valuer should expect to be consulted on matters relevant to the assessment, such as the degree of obsolescence, condition, market factors, town planning and so on.

3 The depreciable amount

3.1 As it will be desirable to maintain consistency of practice in future years, the valuer should choose the basis of calculating the depreciable amount in consultation with the directors and auditors.

3.2 The FRS 102 definition of the depreciable amount includes cost but excludes residual value.

3.3 Residual value as defined in FRS 102 depends on the assumed disposal proceeds after costs, once the asset is no longer viable. It should be determined

using a basis consistent with that used to determine the carrying amount of the asset. For example, where an asset is valued at *fair value*, the residual value should also be measured on a *fair value* basis.

3.4 Tangible fixed assets are measured in *financial statements*, in accordance with FRS 102 Section 17. The carrying amount of a tangible fixed asset is its cost or revalued amount less accumulated depreciation.

3.5 An entity shall measure all items of property, plant and equipment after initial recognition using the cost model (in accordance with Section 17 paragraph 15A), or the revaluation model (in accordance with Section 17 paragraphs 15B–15F). Where the revaluation model is selected, this shall be applied to all items of property, plant and equipment in the same class (i.e. having a similar nature, function or use in the business).

(a) **Cost model** – The cost model uses cost minus depreciation and impairment losses (both accumulated), (paragraph 15A).

(b) **Revaluation model** – The revaluation model uses the revalued amount minus further depreciation and impairment losses (both accumulated), (paragraph 15B). Paragraph 15C points out that market evidence is to be assessed, usually by a properly qualified valuer. However, paragraph 15D allows the use of an *income approach* or a *depreciated replacement cost (DRC)* approach where there is no market evidence available.

(c) **Impairment loss** – FRS 102 Section 27 covers impairment loss, which is the amount by which the carrying amount of an asset exceeds:

- in the case of inventories, its selling price – less costs to complete and sell or
- in the case of other assets, its recoverable amount (which is the higher of the asset's *fair value* less costs to sell and its value in use).

3.6 An entity may ask the valuer to provide an estimate of residual value in order to calculate the depreciable amount. Where the residual amount is material, it should be reviewed at the end of each accounting period.

3.7 In some cases the future useful life of the asset to the entity will be considered to be equal to the physical or useful life of the buildings composing the asset. In such cases the valuer will need to consider whether the residual value will comprise a bare site value less relevant costs, or whether the existing buildings or other site improvements will have some continuing value, for example, for refurbishment.

3.8 In other cases there may be an expectation that the asset will either become surplus, or be disposed of before the end of its physical or useful life. Under these circumstances the residual value would reflect the continuing life of the asset beyond the date at which the directors anticipated disposal. Such an expectation would also affect the life during which the asset is to be depreciated, which would become the anticipated period of ownership.

3.9 FRS 102 Section 17 paragraph 8 requires land and buildings to be accounted for separately, whether or not they were purchased separately. Therefore, where a property is carried in the balance sheet at cost, or has been the subject of a past or present valuation, the valuer will need to ascertain the amount applicable to the buildings and to the land, by an apportionment of the cost or valuation.

4 Apportionment

4.1 The purpose of the apportionment – the removal of the land element from the valuation so as to depreciate only the building element – should be kept firmly in mind. Site works, such as roads, fences, paved areas and the like, are normally included in the value of the buildings and do not, therefore, feature in the land valuation.

4.2 At the end of the useful economic life of the buildings, the full potential of the site for redevelopment within the existing use would be realisable. However, allowance would have to be made for any material costs associated with demolition, site clearance or contamination treatment.

4.3 When providing figures for the purposes of depreciation, the valuer will need to emphasise in the report that the resultant figures, the depreciable amount and the residual amount, are apportionments derived solely for accounting purposes, and that they do not represent formal valuations of the individual elements.

4.4 The apportionment is arrived at in one of the following two ways:

(a) One way is by deducting, from the cost or valuation of the asset, the value of the land for its existing use at the relevant date. In effect this calculates the residual value, unless the valuer believes that there is an additional residual value element in the buildings or site improvements. It is not appropriate to consider alternative uses unless they are reflected in the value at which the property has been included in the balance sheet.

(b) Where there is little or no evidence of land values, greater reliance will have to be placed on making an assessment of the net current replacement cost of the buildings at the relevant date. This figure will be derived from the gross current replacement cost, which is then reduced to the written-down cost or net current replacement cost to reflect the value of the asset to the business. In effect this is a direct calculation of the depreciable amount.

4.5 Gross current replacement cost is defined as either:

(a) the actual cost of constructing the asset if this was incurred close to the relevant date or

(b) the estimated cost of erecting the building, or a modern substitute building with the same gross internal area as that existing, at prices current to the relevant date. This figure may include fees, any irrecoverable VAT, finance charges appropriate to the construction period, if required by the accounting policy, and other associated expenses directly related to the construction of the building. A definition of the directly attributable costs can be found in FRS 102 Section 17 paragraph 10.

4.6 Net current replacement cost is the gross current replacement cost, reduced to reflect the physical and functional obsolescence and environmental factors, in order to arrive at the value of the building to the business at the relevant date.

4.7 The relevant date is the effective *valuation date* or date of apportionment.

4.8 In the case of leasehold land and buildings, the total value will be the depreciable amount, except where the lease is likely to continue beyond the remaining useful life of the asset.

4.9 The valuer should make it clear that in assessing the depreciable amount, the availability of government grants should be ignored, leaving the entity to make any appropriate adjustments.

4.10 The inclusion and exclusion of plant and equipment in a valuation of land and buildings should normally follow **VPGA 5, Valuation of plant and equipment**.

5 Valued as an operational entity

5.1 Where the valuation relates to property valued fully equipped as an operational entity, the valuation figures may need to be apportioned among:

- land
- buildings
- fixtures and fittings.

In relation to trading potential, recognised and accepted accounting practice suggests that it would not be appropriate to treat that associated with the property as a separate component of the value of the asset if its value and life were inherently inseparable from that of the property (see also **VPGA 4, Valuation of individual trade related properties**).

6 Future useful life

6.1 In order to form an opinion of the future useful life of buildings, the valuer will need to take into account the following matters:

- **physical obsolescence** – the age, condition and probable costs of future maintenance (assuming prudent and regular maintenance)
- **functional obsolescence** – suitability for the present use, and the prospect of its continuance or use for some other purpose by the business. In the case of buildings constructed or adapted for particular uses, including particular industrial processes, the valuer will need to consult with the directors to ascertain their future plans
- **economic obsolescence** – a loss in value to a property caused by factors external to the property itself
- **environmental factors** – existing uses must be considered in relation to the present and future characteristics of the surrounding area, local and national planning policies, and restrictions likely to be imposed by the planning authority on the continuation of these uses
- **policy on future disposals** – the valuer will need to consult with the entity to ascertain whether there is any intention or policy to dispose of assets before the end of their natural lifespan.

6.2 It is frequently difficult, even impossible, to put a precise life on a building or a group of buildings. The valuer may therefore have to resort to 'banding'. It should be possible to identify buildings that are unlikely to remain beyond 20 years, as well as other buildings with a life of more than 50 years, in which case, those should be noted as having a life of 'not less than 50 years'. Clearly the valuer's task will be made easier by the use of broad bands, and in most cases it is likely that these will meet the company's requirements.

6.3 Where a property comprises a number of separate buildings, for example, large factory premises, the buildings should be grouped and, wherever possible, a single life allocated to all buildings within each group. Such an approach can be justified by the fact that the life of individual buildings can usually be extended, within reasonable limits, by a higher standard of maintenance or minor improvement. It is normally uneconomical to carry out piecemeal redevelopment.

6.4 It would not be appropriate to group buildings if they are used for different industrial processes with different accommodation requirements, or where the client requires each building to be considered individually.

6.5 If consulted on the remaining useful economic life of leaseholds, the valuer must also consider the duration of the lease, any options to determine or extend, the date of the next rent review and whether this is to full, or a proportion of, rental value.

7 Depreciation of a wasting asset

7.1 Provision of depreciation for a wasting asset is not primarily the concern of the valuer. Generally, the depreciable amount will be the difference between the present *fair value* and the 'after-use' value, but associated costs, such as restoration costs, may also need to be taken into account. The future useful life will be assessed by the entity once it is advised of the life that the valuer has assumed for the purposes of the valuation.

8 Apportionments of value in respect of property that comprises only part of a building

8.1 Special care is recommended in dealing with the apportionment of value in respect of property that comprises only part of a building (of particular relevance in Scotland), with the remaining parts being separately owned by one or more other proprietors. This care is particularly relevant in considering the residual amount representing the value of land.

8.2 It is commonplace in Scotland for premises to be owned in perpetuity, even though those premises do not exclusively occupy the land on which they are situated. A building can contain various proprietors, and it is quite usual for this type of ownership to carry with it a common interest on the part of the various proprietors in certain sections of the building out with the actual premises occupied by them.

8.3 The presence (or otherwise) of other proprietors within the building, and the existence of common interest on their part, should be established as part of the examination of titles and other documentation prior to the completion of the valuation.

8.4 The valuer dealing with an apportionment of value in cases where common interest exists must judge to what extent, if any, the apportionment and the residual amount, in particular, should be adjusted to allow for that common interest on the part of other owners in the building.

8.5 When dealing with property where there are other proprietors in the building, and where rights of common interest might exist, the apportionment of the valuation of the asset for depreciation purposes should be carried out by calculating the net current replacement cost of the building.

8.6 There might be cases where complications are encountered in defining or ascertaining the rights of the other proprietors in the building, but it is essential that if common interest exists, its effect is taken into account. If this is done, the valuer should be able to arrive at an apportionment where the depreciable amount fairly reflects the part of the *fair value* or cost of the whole property at the time it was acquired or valued. This can be expressed at that time as the value to the business of the buildings on the land. Similarly, the residual amount should properly represent the element of land value that could be realised at the end of the day.

UK appendix 5 Valuation of local authority assets

1 Introduction

1.1 The *financial statements* of local authorities from 2010/11 onwards must be prepared in accordance with the International Financial Reporting Standards (IFRS)-based *Code of Practice on Local Authority Accounting in the United Kingdom* (the 'Code'), published by the Chartered Institute of Public Finance and Accountancy (CIPFA). The Code is reviewed continuously and is issued annually. The edition of the Code that is applicable for any given financial year is based on accounting standards in effect on 1 January prior to the start of that financial year – thus for the 2015/16 Code, this means EU-adopted accounting standards with an effective date of 1 January 2015 or earlier.

1.2 This appendix provides guidance to valuers on the application of the Code to the valuation requirements. The original material in this appendix was developed in conjunction with CIPFA. Valuers are strongly advised to refer to the current Code of Practice for the financial period in which the valuation is undertaken and to ensure that their client's precise accounting prerequisites are addressed.

1.3 The general principles underlying the valuation of local authority assets are no different from those for any entities, but the Code incorporates additional guidance for public sector bodies and introduces the concept of service potential.

1.4 The new standards introduced in the 2015/16 Code include the adoption of IFRS 13 *Fair Value Measurement*. The Standard, IFRS 13, provides a single definition of *fair value*. It is designed to apply to assets and liabilities covered by those IFRS standards that currently permit or require measurement at *fair value* (with some exceptions).

1.5 The IFRS 13 definition of *fair value* is based on exit values and market prices for assets and liabilities. For property, plant and equipment the Code requires a valuation to be at the asset's highest and best use and is a measure of financial capacity. CIPFA/Local Authority (Scotland) Accounts Advisory Committee (LASAAC) considers that the most appropriate measure of operational property, plant and equipment should be based on the service potential that the assets provide in support of the services of the authority. This means that these assets will be measured at:

- existing use value
- existing use value – social housing, or
- *depreciated replacement cost*,

as appropriate to the property, plant and equipment asset in question. These measurement bases are described in the Code as current value (measurements) and should not be confused with the *bases of value* set out in VPS 4.

Valuation requirements

1.6 Apart from infrastructure, community assets and assets under construction, the Code sets out that the *basis of value* for all property, plant and equipment assets is to be current value. Valuers should note that the Code permits local authorities to measure community assets at 'valuation' in accordance with the measurement requirements for heritage assets in Section 4.10 of the Code.

There are four measurement approaches to calculating current value in the Code:

- For operational property, plant and equipment:
  - existing use value (EUV) in accordance with the definitions in UKVS 1.3,
  - existing use value – social housing (EUV-SH): the Code defines EUV-SH as:

> '… the estimated amount for which a property should exchange, on the date of valuation, between a willing buyer and a willing seller, in an arm's-length transaction, after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion, subject to the following further assumptions that:
> - the property will continue to be let by a body and used for social housing
> - at the valuation date, any regulatory body, in applying its criteria for approval, would not unreasonably fetter the vendor's ability to dispose of the property to organisations intending to manage their housing stock in accordance with that regulatory body's requirements
> - properties temporarily vacant pending re-letting should be valued, if there is a letting demand, on the basis that the prospective purchaser intends to re-let them, rather than with vacant possession
> - any subsequent sale would be subject to all of the above assumptions'.
>
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- For specialised assets – *depreciated replacement cost (DRC)* in accordance with UKVS 1.15 and UKGN 2.
- For surplus assets *fair value* as defined under IFRS 13 and as adopted by the Code.

Leases of land and buildings are to be separated into land and building elements, and classified and accounted for separately (see section 4).

Investment property is to be valued at *fair value*, including *investment property* under construction where its *fair value* can be reliably determined (see section 5).

Assets held for sale shall be valued at *fair value* less costs to sell as appropriate to the measurement requirements of the Code (see section 6).

Heritage assets are measured at valuation (or may be recognised at cost). These valuations may be made by any method that is appropriate and relevant. See Section 4.10 of the Code.

For depreciation purposes assets are to be recognised on a component basis, where components have a significant cost and the components have materially different asset lives, or different depreciation methods are used (see section 7).

Residual values are to be based on current prices at the balance sheet date.

1.7 The valuer's role is to provide assistance on the identification and classification of assets and, essentially, to provide the current value or *fair value* of those assets in accordance with the Code where such a value is required – see paragraph 1.6.

1.8 The valuer will not normally be involved in any interpretation of the Code relating to the treatment of assets in the accounts once the values have been established.

2 Classification of assets

2.1 Property assets are to be classified into one of the following groups:

- **Property, plant and equipment**: Authorities shall account for all property, plant and equipment in accordance with International Accounting Standards (IAS) 16, *Property, Plant and Equipment*, except those more specifically listed in this appendix or where the Code has detailed interpretations or adaptations to fit the public sector (see section 3). See section 1 above and Section 4.1 of the Code for the valuation requirements for property, plant and equipment assets.
- **Leases and lease type arrangements**: Authorities shall account for leased assets in accordance with IAS 17, *Leases*, except where the Code has detailed interpretations or adaptations to fit the public sector (see section 4).
- ***Investment property***: Authorities shall account for *investment property* in accordance with IAS 40, *Investment Property*, except where the Code has detailed interpretations or adaptations to fit the public sector (see section 5).
- **Assets held for sale**: Authorities shall account for assets held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, except where the Code has detailed interpretations or adaptations to fit the public sector (see section 6).
- **Heritage assets**: are measured at valuation (or may be recognised at cost). These valuations may be made by any method that is appropriate and relevant (see Section 4.10 of the Code).

3 Valuation of property, plant and equipment

3.1 Infrastructure, community assets (note: may be measured at valuation or may be recognised at cost – valuations may be made by any method that is appropriate and relevant in accordance with Section 4.10 of the Code) and assets under construction shall be measured at historical cost, and the option given in IAS 16 to measure at *fair value* is withdrawn. Examples of this category of asset are given in section 8.

3.2 All other assets in this category shall be measured at current value. Note that the definition of current value of property, plant and equipment includes surplus assets measured at *fair value*. The separate valuation requirements that apply to leases, *investment property*, assets held for sale and depreciation are dealt with in sections 4 to 7, respectively.

3.3 The Code requires the following values to be reported:

- For operational land and buildings, current value is to be interpreted as the amount that would be paid for the asset in its existing use. This requirement is met by providing a valuation on the basis of EUV in accordance with UKVS 1.3, EUV-SH in accordance with the definition in paragraph 1.6 above or by adopting the *DRC* approach in accordance with UKVS 1.15 and UKGN 2.
- Surplus assets are to be measured at *fair value* in accordance with IFRS 13, as adopted by the Code.

3.4 Where the existing use value and *market value* are significantly different (higher or lower), *market value* (that is, the valuation does not disregard alternative uses) is to be reported in addition to the existing use value. A statement should be made that no account has been taken of issues such as reducing the service potential or disruption, and the associated costs that would be incurred in achieving that alternative use.

3.5 The role of the valuer is to provide relevant valuations and discuss with authorities the reasons for the differences in the values provided. Authorities will decide the appropriate accounting treatment.

3.6 The use of *depreciated replacement cost (DRC)* is recognised in appropriate circumstances. The valuer must have regard to the requirements of UKVS 1.15, Valuations based on depreciated replacement cost. In addition, UKGN 2, Depreciated replacement cost method of valuation for financial reporting, contains detailed information on the use and application of *DRC* when valuing for *financial statements*.

3.7 In England, Scotland and Wales the current value of council dwellings shall be measured using EUV-SH (see 1.6 above). Guidance on this is available in *Stock Valuation for Resource Accounting: Guidance for valuers – 2010*, published by the Department for Communities and Local Government in January 2011. In Scotland the Local Authority Scotland Accounts Advisory Committee (LASAAC) has issued guidance on dwelling valuation methodology stating that by 2015/16 at the latest the valuation of council dwellings must be achieved using a Beacon Approach (Adjusted Vacant Possession) methodology. In Wales the *basis of value* is also EUV-SH, but there is no specific valuation guidance covering the housing revenue account. In Northern Ireland the District Councils are not responsible for social housing.

3.8 The detailed requirements with regard to private finance initiative (PFI) and public private partnership (PPP) arrangements are in section 4.3 of the Code. In broad terms the arrangement is initially recognised under IAS 16 and measurement is at *fair value* based on estimations of cost. Subsequent measurement of the infrastructure is the same as other property under IAS 16, and the detailed requirements are set out in the Code in chapter 4, paragraphs 4.3.2.8 to 4.3.2.11.

4 Leases and lease type arrangements

4.1 Leases are recognised, measured and accounted for in accordance with IAS 17 subject to the interpretations in the Code. Leases that are held as *investment property* by lessees, or *investment property* held by lessors under operating leases, are measured under IAS 40, *Investment Property* (see section 5).

4.2 Where the valuer is requested to provide advice to assist in the classification of a lease as being financial or operational, the guidance in **IVS 300, paragraphs G20 to G37, Lease classification**, applies. In addition, the information on the approach to classification in UKGN 1, Land and buildings apportionments for lease classification under IFRS, may also be of assistance.

4.3 The amounts to be recognised in the balance sheet where a lease is a finance lease are calculated in accordance with IAS 17. In summary this states that lessees should recognise assets acquired under finance leases as such and the associated lease obligations as liabilities. The assets and liabilities should be recognised at amounts equal at the inception of the lease to the *fair value* of the leased property or, if lower, at the present value of the minimum lease payments.

4.4 The valuer may be requested to provide the *fair value* of the leased property. This is not the value of the interest in the lease, but the underlying *fair value* of the property reflecting the presumption of a finance lease that transfers all risks and rewards incidental to ownership of the asset.

4.5 The Code provides specific rules for the recognition of leases and distinguishes between those held as lessee and those held as lessor.

Held as lessee

4.6 Operating lease: Lease payments are recognised as an expense on a straight-line basis over the lease term, unless another systematic basis is more representative of the benefits received by an authority. No valuation is required as assets are not held on the balance sheet of a lessee under an operating lease.

4.7 Finance lease: Initial recognition as assets and liabilities in the balance sheet is at amounts equal to the *fair value* of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. After initial recognition, leased assets are measured in the same way as any other assets under IAS 16 and are subject to impairment checks under IAS 36, *Impairment of Assets*.

Held as lessor

4.8 Operating lease: Initial recognition as assets in the balance sheet is at cost. After initial recognition, leased assets are measured in the same way as any other assets under IAS 16 and are subject to impairment checks under IAS 36. Income is recognised on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which the benefit derived from the leased assets is diminished.

4.9 Finance lease: The asset is recognised as a receivable at an amount equal to the net investment in the lease. The Code provides that the finance income shall be

calculated so as to produce a constant periodic rate of return on the net investment. The valuer is not involved in this calculation.

4.10 Leases of land and buildings are classified as finance or operating leases in the same way as leases of other assets. However, the land and building elements of a lease of land and buildings are considered separately for the purposes of lease classification, therefore an apportionment is required between the land and the building elements. UKGN 1 provides detailed information on apportionment methods. An apportionment for this purpose should not conflict with any apportionment required for the calculation of depreciation (see section 7).

5 Valuation of investment property

5.1 An *investment property* is one that is used solely for rentals or capital appreciation, or both. Property that is used to facilitate service delivery, as well as for rentals or capital appreciation, is not *investment property* and should be recognised and measured under IAS 16.

5.2 *Investment property* is to be accounted for in accordance with IAS 40 at *fair value* and the option to measure at cost model is not permitted.

5.3 The Code requires the valuer to provide the *fair value* of the property reflecting any current leases, current cash flows and reasonable *assumptions* about future rental income or outgoings.

5.4 Property held by a lessee under an operating lease may be accounted for as an *investment property* only if the property would otherwise meet the definition of *investment property*. In such cases the lease shall be accounted for as if it were a finance lease.

5.5 The *fair value* of *investment property* held under a lease (that is, where the authority is the lessee) is in respect of the lease interest, not its underlying *market value*.

6 Valuation of assets held for sale

6.1 The authority is required to identify and separately account for assets where they meet the strict criteria, as set out in the Code (also see IFRS 5), for classification of assets as held for sale.

6.2 Assets held for sale may be included at *fair value* less costs to sell (if lower than the carrying amount of the asset). Where the valuer makes an adjustment for the costs to sell, this must be made clear in the report to avoid double counting.

7 Accounting for depreciation

7.1 General guidance on depreciation for accounting purposes is given in UK appendix 4.

7.2 IAS 16 recognises that, with a few exceptions, land does not depreciate and therefore requires the land and buildings to be recognised as separate assets. The allocation of the value between these two elements has been a requirement for many years.

7.3 IAS 16 also provides that:

- 'each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately' (IAS 16 paragraph 43).

However:

- where there is more than one significant component part of the same asset that has the same useful life and depreciation method, such component parts 'may be grouped [together] in determining the depreciation charge' (IAS 16 paragraph 45) and
- 'to the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant' (IAS 16 paragraph 46).

7.4 In practice, IAS 16 requirements can be satisfied by separately accounting for only those significant components that have different useful lives and/or where different depreciation methods are applied to the remainder of the asset. However, an entity may choose to depreciate separately the parts of an asset that do not have a cost considered significant in relation to the total cost of the asset.

7.5 For this purpose the 'asset' is the non-land element recognised in the accounts. An explanation of the principles and the accounting requirements is set out in the CIPFA Local Authority Accounting Panel (LAAP) Bulletin 86, *Componentisation of Property, Plant & Equipment under the 2010/11 IFRS-based Code*, originally published in June 2010, which should be read in conjunction with this advice. This advice has recently been updated by the LAAP. Valuers should ensure that they take into account the requirements of the updated LAAP Bulletin.

7.6 This appendix does not cover the derecognition and recognition of components (that is, when enhancement expenditure takes place). This is discussed in detail in LAAP Bulletin 86 (as updated), in paragraphs 60.1 to 60.14, which complies with the requirements of the Code in chapter 4, paragraphs 4.1.2.50 to 4.1.2.51.

8 Examples of asset categories measured at cost

Assets under construction

8.1 *Investment property* under construction is valued at *fair value*, where this can be measured reliably.

Infrastructure assets

8.2 Examples of infrastructure assets include:

- roads
- sea defences
- bridges
- permanent ways
- water supply and drainage systems and

- street furniture.

Note: Appendix D to the Code indicates that from 2016/17 transport infrastructure assets (i.e. those assets within the scope of CIPFA's *Code of Practice on Transport Infrastructure Assets*) will be measured at *depreciated replacement cost* in accordance with the methodologies in that Code.

Community assets

8.3 Community assets are described in the Code as 'assets that the local authority intends to hold in perpetuity, that have no determinable useful life, and that may have restrictions on their disposal'. If the asset is used for a specific operational purpose, it does not qualify as a community asset and should be valued accordingly.

8.4 Examples of community assets include:

- parks (but not a golf course within a park)
- cemeteries and crematoria (land only) and
- allotments (where there are restrictions on alternative uses).

8.5 The following questions can be used to test for community assets:

(a) Is the intent to hold the asset forever?

(b) Does the asset have an indeterminable useful life?

(c) Are there restrictions on disposal?

To qualify as a community asset, the answers for questions (a) and (b) have to be 'yes', while an affirmative answer to question (c) is not obligatory but a helpful contributory factor.

UK appendix 6 Examples of published references to valuation reports

1 Introduction

1.1 The following examples are intended to be illustrative only of the typical degree of detail required for published references to valuation reports. The valuer must have due regard to the requirements of **VPS 3 paragraph 7(j), Restrictions on use, publication and distribution**, and produce a statement that reflects the scope and nature of the property valued.

2 Valuation by an external valuer

2.1 The company's freehold and leasehold properties were valued on 1 January 2015 by an *external valuer*, Joe Smith, FRICS of Alpha Chartered Surveyors. The valuations were in accordance with the requirements of the *RICS Valuation – Professional Standards 2014* and FRS 102 *The Financial Reporting Standard applicable in the United Kingdom and Republic of Ireland* (and any other regulatory requirements).

2.2 The valuation of each property was on following *bases of value* and *assumptions*:

- owner-occupied property: valued to *fair value* assuming that the property would be sold as part of the continuing business
- investment property: valued to *fair value* (IFRS 13/FRS 102 Section 16) assuming that the property would be sold subject to any existing leases

  [Note – measurement at *fair value* in FRS 102 is only required if this can be established 'without undue cost or effort', and if this is not possible the property is treated as if it were normal property, plant and equipment (that is, held at cost less depreciation) as set out in FRS 102 Section 17.]
- surplus property and property held for development: valued to *fair value* assuming that the property would be sold with vacant possession in its existing condition.

2.3 The valuer's opinion of *fair value* was primarily derived using (include as appropriate):

- comparable recent market transactions on arm's length terms
- *depreciated replacement cost* approach, because the specialised nature of the asset means that there are no market transactions of this type of asset, except as part of the business or entity

- an estimate of the future potential net income generated by use of the property, because its specialised nature means that there is no market-based evidence available.

2.4 Similar comments may be appropriate where the valuation is of plant and equipment or mineral bearing land.

2.5 A full and comprehensive statement regarding disclosures (agreed with the entity and recorded in the terms of engagement) should be made in accordance with **VPS 3 paragraph 7** and **UKVS 4.3**.

3 Valuation by an internal valuer

3.1 The statements will be the same as those for valuations by an *external valuer*, except for the following variations of the first sentence:

> The company's freehold and leasehold properties were valued by an internal valuer, Joe Smith FRICS, the company's Property Director, as at 1 January 2015.
>
> The company's freehold and leasehold properties were valued as at 1 January 2015, by the directors in conjunction with the company's own professionally qualified staff.

Where appropriate, at the end of the statement, the following variation may be included:

> A representative sample of properties was also valued on the same basis by external valuer, ABC Chartered Surveyors, who confirmed that values proposed by the company's professionally qualified staff are at level(s) consistent with its own figures.

UK appendix 7 FCA Listing Rules

RICS specification for reports for inclusion in prospectuses or shareholders circulars to be issued by UK companies

1 Introduction

1.1 This specification is supplementary to **VPS 3, Valuation reports**. It does not replace VPS 3, but provides guidance on the content of reports prepared for this purpose. Where the valuation is of a portfolio of properties, VPGA 8 is relevant.

1.2 The FCA Handbook allows valuations for inclusion in prospectuses or shareholder circulars to be in a condensed form in specified circumstances. However, a condensed report must still meet the requirements of **VPS 3, Valuation reports**, and published references to them. A condensed report must be distinguished from a publication statement under **VPS 3 paragraph 7(j), Restrictions on use, publication and distribution**.

1.3 The FCA Listing Rules can be found at www.fshandbook.info/FS/html/FCA/LR

2 Reports for inclusion in prospectuses

2.1 All UK-domiciled property companies seeking FCA approval, under the FCA Prospectus Rules for the publication of a prospectus, must include a property valuation report by an expert valuer in the prospectus. However, the report may be in a condensed form. Property companies are defined as those issuers whose principal activity is the purchase, holding and development of properties for letting and retention as an investment.

2.2 A condensed valuation report may also be included when the prospectus relates to a ‘property collective investment undertaking’, which is a collective investment undertaking whose investment object is the participation in the holding of property long term.

3 Reports for inclusion in circulars

3.1 When a UK-listed company proposes an acquisition or disposal of property, and the transaction is classified under the FCA Listing Rules as either a class 1 transaction (where the size of the transaction exceeds 25% of the value of the company) or a ‘related party’ transaction, the company must seek shareholder

approval. In either instance, it must include a property valuation report by an expert valuer in the circular to shareholders. The company decides the classification of the transaction, but full definitions may be found in the FCA Listing Rules.

3.2 A UK-listed company must also include a property valuation report where it makes significant reference to the value of property in a class 1 circular to shareholders.

4 Status of the valuer

4.1 The valuation report must be prepared by an independent expert. For this purpose an independent expert is an *external valuer* as defined in the Glossary.

4.2 The independent expert must disclose any material interest, if any, in the issuer. A material interest includes the following circumstances:

- ownership of securities issued by the issuer or any company belonging to the same group, or options to acquire or subscribe for securities of the issuer
- former employment of, or any form of compensation from, the issuer
- membership of any of the issuer's bodies and
- any connections to the financial intermediaries involved in the offering or listing of the securities of the issuer.

4.3 It is the issuer's responsibility to consider if the information provided will result in a material interest, taking into account the type of securities offered. The issuer is also responsible for clarifying that these securities have been taken into account, in order to fully describe the material interest (if any) of the expert, to the best of the issuer's knowledge.

4.4 The valuer and the valuer's staff must be aware of the *Criminal Justice Act* 1993, Part V – Insider dealing, and the valuer must ensure compliance with the law. In case of doubt, legal advice should be sought.

4.5 A valuer who attends meetings with clients and other advisers (such as lawyers, stockbrokers, accountants and investment bankers) should be aware of assuming any role which could be regarded as that of a 'financial adviser' within the provisions of the *Financial Services and Markets Act* 2000. If this were the case, the valuer must be a registered member of a professional regulatory organisation. Although the role of a valuer would not normally fall within the definition, an extended involvement could lead to this – for example, in providing profit forecasts or commenting on them. If valuers have any doubt about their position, they should take legal advice, preferably before attending any meeting.

5 Valuation requirements: the Prospectus Rules

5.1 Valuations for the FCA Prospectus Rules are to be on the same basis as adopted by the issuer for accounting purposes (either IFRS or UK GAAP).

5.2 Where the issuer is a property company resident in the UK, a valuation report must be included in the prospectus, but it can be in a condensed form only.

5.3 The effective *valuation date* can be up to one year prior to the date of publication of the prospectus, provided that the issuer affirms in the prospectus that

no material changes have occurred since the *valuation date*. If the valuer has previously provided a valuation for accounting purposes and the date of that valuation is within the time limit, the condensed report will relate to that valuation and no additional valuation is required.

5.4 Where the issuer cannot affirm that no material changes have occurred, the effective *valuation date* must be at the latest practical date. Where the material change relates to only part of the issuer's portfolio, only that part needs be valued at the latest practical date.

5.5 Where the report to be published includes information considered by the issuer to be commercially sensitive, the issuer may decide to delay disclosure of that information, which is acceptable provided its omission will not mislead the public. In such cases the valuer may amend the report appropriately, but must make a reference to the omission and state that this has been done on the express instructions of the issuer.

6 Valuation requirements: the Listing Rules

6.1 The *basis of value* for the FCA Listing Rules is *market value*.

6.2 Where the valuation report refers to a portfolio of 60 or more properties, the valuation report to be included in the publication may be in a suitably condensed format.

6.3 The effective *valuation date* must be within 42 days of the date of the circular. The report is to be dated the same day as the circular is issued, or the same day as any other documents that will be incorporated.

7 Framework for condensed reports

7.1 A condensed report need not include descriptive details of the properties, but must include the minimum information required by **VPS 3, Valuation reports**, and UKVS 4, Regulated purpose valuations. The following framework adopts the minimum terms set out in **VPS 3** but with comments specific to the preparation of reports under the Prospectus Rules and Listing Rules.

Item	Comment
(a) Identification and status of valuer	The report must confirm the valuer is acting as an *external valuer* and as an independent expert under the rules. The statement that the valuer has the knowledge, skills and understanding to undertake the valuation competently should be made in this section. As this is a regulated purpose valuation, the disclosures required by UKVS 4.3 must be included.
(b) Identification of the client and any other intended users	The report must be addressed to the client, or its representatives.

(c) Purpose of the valuation	This may include a comment that the report is a condensed version prepared for the relevant rules.
(d) Identification of the asset or liability to be valued	A brief overview of the asset(s) being valued is required – i.e. the number of interests involved, whether freehold or leasehold, type (e.g. retail, industrial, leisure), location (e.g. throughout UK, in central London) and whether held as investment(s), for development or for owner occupation.
(e) Basis of value	For prospectuses the basis required is the same as required for inclusion in the company's accounts. For circulars the basis is *market value*.
(f) Valuation date	This must be within one year of the publication date for a prospectus and 42 days for a circular.
(g) Extent of investigation	The report must record the date(s) and extent of the *inspection(s)* undertaken. Where a substantial number of properties are being valued, a generalised statement of these aspects is acceptable, provided that it is not misleading.
(h) Nature and source of information relied on by the valuer	A summary of the information relied on is acceptable, provided that it is not misleading. Valuers should also include any additional information that has been available to, or established by, them that they believe to be crucial to the reader's ability to understand and benefit from the valuation.
(i) Assumptions and special assumptions	All *assumptions* must be stated together with any reservations that may be required (see **VPS 4 paragraph 2, Assumptions**). Where property is located in more than one state, any variation of *assumptions* in each state must be made clear. *Special assumptions* (**VPS 4 paragraph 3, Special assumptions**) must be clearly stated and confirmed as agreed with the client. Where the valuation reflects marketing constraints (**VPS 4 paragraph 4, Valuations reflecting an actual or anticipated market constraint and forced sales**), restricted information (**VPS 3 paragraph 7(h)**) or limited *inspection* (**VPS 3 paragraph 7(g)**), the report must include full particulars. Any *departures* from the standards must be stated and explained (**PS 1 paragraph 7, Departures**).

(j) Restrictions on use, distribution or publication	As this condensed report will be published in its entirety, it will be appropriate to include consent for publication in the specific prospectus or circular in it, but otherwise to reserve the valuer's rights to it being reproduced or referred to in any other document. For prospectuses, the report should not include any disclaimer to the effect that liabilities to the *third parties* are excluded. For circulars, the report may include a disclaimer to the effect that liabilities to *third parties* are excluded but may not disclaim responsibility to the company, its directors or its shareholders. A statement that the report may not be used for any other purpose than that stated may be included, provided that the purpose of the valuation report is clearly stated in the report as being for inclusion in the issuer's prospectus.
(k) Confirmation that the valuation has been undertaken in accordance with these standards	Where the report is for inclusion in a prospectus and the company has adopted IFRS, confirmation is also required that the valuation accords with these standards and with International Valuation Standards.
(l) Valuation approach and reasoning	This is as **VPS 3 paragraph 7(l), Valuation approach and reasoning**.
(m) Amount of the valuation or valuations.	The valuations are to be summarised in the same categories determined under (d), identifying separately freeholds and leaseholds. Any negative values (liabilities) must be reported separately. The aggregate values and numbers of properties in each category are to be stated. Where the value of any individual property amounts to more than 5% of the aggregate valuation, the property must be specifically identified and the individual value disclosed. Where appropriate, state the currency that has been adopted. It may be appropriate to state that further details of individual properties are available for *inspection*, or on request, if this has been agreed with the client.

	Subject to any agreement that certain property information be kept confidential, the report should not omit information that would assist the reader to interpret the valuations. The following disclosures therefore must also be made, where appropriate: • reports must include a statement about the extent to which the values are supported by market evidence, or are estimated using other valuation techniques (which shall be disclosed) because of the nature of the property, limited transactions or any combination of these factors • where *special assumptions* have been made, alternative figures may be required to illustrate their effect and • for property in the course of development, the *market value* will reflect the value of the completed property, assuming that it had been completed at the *valuation date*, less the anticipated costs to complete, including the costs of finance and other holding costs. Statements must be also be made as to whether or not: • any allowance has been made for liability for taxation that may arise on disposal, whether actual or notional • the valuation reflects costs of acquisition, disposal or reorganisation.
(n) Date of the valuation report	The *date of the report* is to be the same as the date of issue, or such other date that is the same as any other documentation to be published.

UK appendix 8 Takeovers and mergers

1 Introduction

1.1 This appendix contains a summary of the asset valuation provisions set out in Rule 29 of the Takeover Code. According to this rule, the valuer is considered to be an adviser and must comply with the Code. Before accepting instructions, it is essential that the valuer checks the extant version of the Code to ensure that all its requirements are met (see www.thetakeoverpanel.org.uk).

1.2 All the valuer's colleagues (professional, administrative and secretarial) who provide assistance may be considered to be advisers. Other partners and employees not involved are normally excluded.

1.3 A register of the holdings of securities that the valuer and colleagues have in the company, or companies, concerned must be maintained, including 'nil' returns and the holdings of spouses and dependent children. The valuer should advise the client of the totals or of any nil return.

1.4 No dealings in shares and other securities, or rights over these, may be made before or during the offer. The restrictions of the *Criminal Justice Act* 1993 apply, as does Rule 4, Restrictions on Dealings, of the Code. The valuer and any colleagues involved in a takeover or merger must observe the law, which also embraces spouses and dependent children. The rules also cover acquisitions and realisations of share holdings, and the valuer and colleagues must comply with them.

1.5 The valuer may consult the Executive of the Panel directly to seek advice. It is not necessary to do this through the company's advisers. In fact, the valuer may prefer not to involve them, particularly if subject to pressure to do something that is not in accordance with professional and ethical standards and these standards.

2 Status of the valuer

2.1 The valuation must be provided by a named independent valuer. The Code states that an independent valuer means a corporate *member* of RICS who is an *external valuer* as defined in these standards, and who has no connection with other parties to the transaction.

2.2 The valuer must be able to demonstrate compliance with **PS 2 paragraph 3, Member qualification**, and with any legal or regulatory requirements that apply.

2.3 The Code contains various provisions relating to the independence of advisers. Where potential conflicts are identified it may not be possible to resolve them by isolating information or assigning different personnel to the transaction. 'Chinese walls' may not be regarded as adequate (see **PS 2 paragraph 5, Maintaining strict**

separation between advisers). Where doubt exists, the compliance unit, or a similar disinterested unit of the valuer's *firm*, must consult the Panel. Otherwise, legal advice should be sought.

3 Basis of value

3.1 The *basis of value* will normally be *market value* as defined in **VPS 4 paragraph 1.2, Market value**. If the company's accounts are prepared under UK Generally Accepted Accounting Principles (UK GAAP) with the consent of the Panel, the *basis of value* set out in UKVS 1.1 may be used.

3.2 The *basis of value* must be clearly stated in the valuation report. Only in exceptional circumstances should it be qualified, in which case the valuer must explain the meaning of the words used. Similarly, *special assumptions* (see **VPS 4 paragraph 3, Special assumptions**) should not normally be made in a valuation, but if *assumptions* are permitted by the Panel, they should be fully explained (see **VPS 3 paragraph 7(i), Assumptions and special assumptions**).

3.3 In the case of land currently being developed or with immediate development potential, in addition to giving the *market value* in the state as at the *valuation date*, the valuation should include:

(a) the value after the development has been completed

(b) the value after the development has been completed and let

(c) the estimated total cost, including carrying charges, of completing the development, and the anticipated dates of completion and of letting or occupation, and

(d) a statement whether planning consent has been obtained and, if so, the date thereof and the nature of any conditions attaching to the consent that affect the value.

4 Reporting the valuation

4.1 The effective date at which the assets were valued must be stated together with the professional qualifications and address of the valuer. If a valuation is not current, the valuer must state that a current valuation would not be materially different. If this statement cannot be made, the valuation must be updated.

4.2 The Code requires that the opinion of value must be contained in the offer document, and the valuation report must also be put on display (see **VPS 3 paragraph 7(j), Restrictions on use, distribution or publication**). Where the valuation report includes material that may be commercially sensitive, the Panel may allow publication in a summarised form.

4.3 In some exceptional cases, it will not be possible for a valuer to complete a full valuation of every property. The Panel may be prepared to regard the requirements of Rule 29 as met if the valuer carries out a valuation of a representative sample of properties and reports those valuations. In such case the directors must take sole responsibility for an estimate, based on the sample, to cover the remaining properties. This procedure will be available only where the portfolio as a whole is within the knowledge of the valuer, who must also certify the representative nature of

the sample. Where this is done, the document should distinguish between properties valued professionally and those where the directors have made estimates on the basis of the sample valuation. The document should also compare such estimates with book values.

UK appendix 9 Collective investment schemes

1 Introduction

1.1 This appendix provides information on the land and property valuation requirements in the FCA Collective Investment Schemes Sourcebook (COLL).

1.2 To avoid confusion, valuers should be aware that the sourcebook uses the term 'scheme property' in a very wide sense, which is not restricted to real estate. An 'immovable' is a freehold or leasehold interest in England and Wales, any interest or estate in or over land, or heritable right (including a long lease in Scotland) or, if not in either of those jurisdictions, an equivalent interest.

1.3 For more detailed information about collective investment schemes, the full text of the sourcebook is available at www.fca.org.uk and follow the links to the handbook. A guide on investment schemes is also available in the handbook at www.fshandbook.info/FS/html/handbook/COLL. This guide provides some general background material on the regulatory structure surrounding scheme regulation in the UK.

1.4 Qualified investor schemes are authorised funds that may only be sold or marketed to sophisticated investors. They have a more relaxed set of rules governing their operation than that for retail schemes, particularly regarding their investment powers. A qualified investor scheme is essentially a mixed asset type where different types of permitted asset may be included as part of the scheme property, depending on the investment objectives and policy of that scheme and any restrictions in the rules.

2 Basis of value

2.1 Any valuation by an appropriate valuer or a standing independent valuer must be on the basis of *market value* as defined in these standards and any special provisions within the instrument constituting the scheme.

3 The valuer

3.1 The COLL requirements for an appropriate valuer are given in the following extract.

(7) An appropriate valuer must be a person who:
(a) has knowledge of and experience in the valuation of immovables of the relevant kind in the relevant area;
(b) is qualified to be a standing independent valuer of a non-UCITS[1] retail scheme or is considered by the scheme's standing independent valuer to hold an equivalent qualification;
(c) is independent of the ICVC[2], the depositary and each of the directors of the ICVC or of the authorised fund manager and depository of the AUT[3] or ACS[4]; and
(d) has not engaged himself or any of his associates in relation to the finding of the immovable for the scheme or the finding of the scheme for the immovable.

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1 UCITS: undertakings for collective investment schemes in transferable securities
2 ICVC: investment company with variable capital
3 AUT: authorised unit trust
4 ACS: authorised contractual scheme

3.2 The COLL requirements for a standing independent valuer are given in the following extract:

5.6.20 (1) The following requirements apply in relation to the appointment of a valuer:
(a) the authorised fund manager must ensure that any immovables in the scheme property are valued by an appropriate valuer (standing independent valuer) appointed by the authorised fund manager; and
(b) the appointment must be made with the approval of the depositary at the outset and upon any vacancy.

(2) The standing independent valuer in (1) must be:
(a) for an AUT or ACS, independent of the authorised fund manager and depository; and
(b) for an ICVC, independent of the ICVC, the directors and the depositary.

(3) The following requirements apply in relation to the functions of the standing independent valuer:

(a) the authorised fund manager must ensure that the standing independent valuer values all the immovables held within the scheme property, on the basis of a full valuation with physical inspection (including, where the immovable is or includes a building, internal inspection), at least once a year;

(b) for the purposes of (a) any inspection in relation to adjacent properties of a similar nature may be limited to that of only one such representative property;

(c) the authorised fund manager must ensure that the standing independent valuer values the immovables, on the basis of a review of the last full valuation, at least once a month;

(d) if either the authorised fund manager or the depositary becomes aware of any matters that appear likely to:

(i) affect the outcome of the valuation of an immovable; or

(ii) cause the valuer to decide to value under (a) instead of under (c);

it must immediately inform the standing independent valuer of that matter;

(e) the authorised fund manager must use its best endeavours to ensure that any other affected person reports to the standing independent valuer immediately upon that person becoming aware of any matter within (d); and

(f) any valuation by the standing independent valuer must be undertaken in accordance with [VPS 4 paragraph 4, Valuations reflecting an actual or anticipated market constraint and forced sale of the *RICS Valuation – Professional Standards 2014* (The Red Book)], or in the case of overseas immovables on an appropriate basis, but subject to COLL 6.3 (Valuation and pricing).

(4) In relation to an immovable:

(a) any valuation under COLL 6.3 (Valuation and pricing) has effect, until the next valuation under that rule, for the purposes of the value of immovables; and

(b) an agreement to transfer an immovable or an interest in an immovable is to be disregarded for the purpose of the valuation of the scheme property unless it reasonably appears to the authorised fund manager to be legally enforceable.

5.6.20A In considering whether a valuation of overseas immovables by the standing independent valuer is made on an appropriate basis for the purpose of COLL 5.6.20R(3)(f), the authorised fund manager should consider whether that valuation was made in accordance with internationally accepted valuation principles, procedures and definitions as set out in the International Valuation Standards published by the International Valuation Standards Committee.

COLL 5.6.20 and 5.6.20A, © The Financial Conduct Authority

RICS UK appendices

UK appendix 10 RICS residential mortgage valuation specification

1 Introduction

1.1 This specification provides a standard approach to the provision of valuation advice to prospective lenders where the security offered is either:

(a) an individual residential property that is intended to be occupied, or is occupied, by the prospective borrower or

(b) an individual residential property purchased as a buy-to-let investment.

Where the instruction is to provide one valuation of two or more individual securities, the valuation approach will not be in accordance with this specification but should comply with **PS 1, Compliance with standards and practice statements where a written valuation is provided**, and **PS 2, Ethics, competency, objectivity and disclosures**.

1.2 It is recognised that although the report is provided to the lender there is established case law that the valuer may have a duty of care to the prospective purchaser, who may or may not be provided with a copy of the report, or a summary of its relevant recommendations.

1.3 It has been agreed with the Council of Mortgage Lenders (CML) and the Building Societies Association (BSA) that this specification is to be incorporated into the commissioning requests for valuation advice from members of those organisations throughout the UK.

1.4 The specification has been arranged under the following headings:

- application of the *RICS Valuation – Professional Standards* (the 'Red Book')
- *inspection*
- *basis of value*
- factors that may have a material impact on value
- *assumptions* and *special assumptions*
- the form of the valuation report and
- reporting factors that have a material impact on value.

1.5 The report will include the valuer's opinion of value at the specified date, together with comments on the factors that may materially impact the value established during the *inspection* and any matter identified that is not in accordance with the standard *assumptions.*

2 Application of the Red Book

2.1 Valuers are reminded that the Red Book applies to the provision of valuation advice for residential mortgages. In addition to the general requirements of **PS 1, Compliance with standards and practice statements where a written valuation is provided**, and **PS 2, Ethics, competency, objectivity and disclosures**, **PS 2 paragraph 4, Independence, objectivity and conflict of interest** will apply because the FCA requires that the 'property shall be valued by an independent valuer at or less than market value'. An independent valuer is defined as 'person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process'.

2.2 The role of the valuer is to advise the lender:

(a) on the nature of the property and any factors revealed during the *inspection* that are likely to materially affect its value

(b) the *market value* (and/or *market rent* if required), with specified *assumptions* or *special assumptions* and

(c) where there are serious cases of disrepair or obvious potential hazards revealed during the *inspection* that have a material impact on the value.

2.3 The valuer must not accept instructions to make recommendations as to the length of the mortgage term, or the amount to be advanced. In addition, advice must not be given as to a lender's underwriting decisions, for example, whether the property is suitable for mortgage lending. These decisions are solely the responsibility of the lender. For the avoidance of doubt, the restriction in this paragraph does not apply to cases which fall outside the paragraph 1.1 criteria, i.e. it does not apply to commercial secured lending against residential property.

2.4 When agreeing *terms of engagement* the valuer must comply with the requirements of **VPS 1, Minimum terms of engagement**. Reference to this specification will provide most of the information required under the minimum terms (a) to (l) of VPS 1 paragraph 2, but specific mention must be made of:

- identification and status of the valuer (paragraph (a))
- restrictions on use, distribution or publication (paragraph (j))
- confirmation that the valuation will be undertaken in accordance with the IVS (paragraph (k)) and
- the additional requirements in VPS 1.3 paragraphs (m) to (o).

2.5 Some lenders may have standard *terms of engagement* that refer to this specification. The valuer must ensure that in confirming the terms, whether as a generic standing instruction or for an individual instruction, all the requirements within **VPS 1, Minimum terms of engagement**, are addressed. Where generic standing *terms of engagement* are in place, these must be assumed to apply in all subsequent cases, subject to any specific amendments that may be required.

2.6 Where a request incorporates special requirements – for instance a limited, or no, *inspection*, or *special assumptions*, the valuer must clarify them and consider any potential impact on the fee before accepting the instruction.

2.7 In some cases, for instance, where the property is known to be exceptional, has extensive grounds, is of architectural or historical interest, is located in a

conservation area or is of unusual construction, consideration should be given as to whether the valuer has the appropriate knowledge and skills to undertake the valuation competently on standard terms. If not, the instruction should be declined (see **PS 2, Ethics competency, objectivity and disclosures**). Where it is discovered on arrival at the property that it is exceptional, etc., or even includes some commercial property element, the valuer should consider referring back to the lender and seeking further instructions.

2.8 In Scotland, due to time restrictions sometimes created by the traditional and accepted procedures for buying residential property, it may be difficult to confirm the *terms of engagement* prior to issuing the valuation report. In these circumstances specific guidance has been issued by RICS Scotland (see UK appendix 12).

3 Inspection

3.1 The purpose of an *inspection* for a mortgage valuation is to provide a valuation upon which the lender can base the terms of a loan, and to identify and report those matters that may have a material effect on the value.

3.2 The valuer will inspect the property to be valued.

3.3 The visual *inspection* covers as much of the exterior and interior of the property as is readily accessible without undue difficulty or risk to personal safety. Although personal judgment has to be used, this *inspection* should include all of the property that is visible when standing at ground level within the boundaries of the site and adjacent public/communal areas, and when standing at the various floor levels.

3.4 More specifically, and subject to the *assumptions* set out in subsection 6, are the following:

(a) Roof voids and underfloor voids are not to be inspected. Furniture and effects are not to be moved, and floor coverings are not to be lifted. Cellars and basements should be inspected where there is safe access.

(b) The availability of services, including green technologies, should be recorded but are not tested.

(c) The *inspection* includes garaging, car parking, other outbuildings (excluding leisure complexes) of permanent construction and any other structures attached to the dwelling. If relevant, their impact on the value of the property is to be noted.

(d) The valuer is not expected to comment on the size, condition or efficiency of any leisure facility in the grounds of the property. However, comment may be expected where:

- (i) there is obvious evidence of serious disrepair
- (ii) the siting of the installation (for example, of a swimming pool) is a potential hazard to the dwelling, or poses a threat in other terms and
- (iii) the installation covers an unacceptably large area in relation to the confines imposed by site boundaries.

3.5 The land within the ownership should be inspected, subject to the comments in paragraphs 2.6 and 2.7, and any material matters recorded and reported. This will include any obvious access restrictions and easements.

3.6 Where there are locational factors that may impact value they should be recorded and reported. Certain problems, such as flooding, mining settlement, subsidence, woodworm, invasive vegetation, radon gas, mundic and other issues are particularly prevalent in certain districts. If appropriate, the valuer should make some reference to these defects, even if the subject property does not appear to be affected at the time of the *inspection*. Where appropriate, the valuer should advise that an environmental assessment or a mining report should be obtained.

3.7 The energy-efficiency rating provided within the Energy Performance Certificate (EPC) is to be considered, if it is available.

3.8 In Scotland the valuer is not required to read the Home Report documents unless carrying out the original Single Survey, in which case the valuer is not required to read the Property Questionnaire.

3.9 Where the property is a flat or maisonette, the following additional requirements will apply:

- The external *inspection* will be of the main building within which the flat or maisonette is located.
- The external *inspection* will include the primary communal access areas to the property and any communal areas on the floor on which the flat or maisonette is located.
- Where communal services are provided it may be assumed that the right to use these and have them maintained passes with the property, subject to an appropriate and reasonable service charge.
- The general standard of management and maintenance may have an impact on the service charge, and the possibility of the owner having to contribute to capital expenditure may have a substantial effect on the value. The valuer does not have to provide any estimates of such costs, but will draw attention to them in the report.

3.10 To be able to respond to a future enquiry, legible notes (which may include photographs) of the findings and, particularly, the limits of the *inspection* and the circumstances in which it was carried out must be made and retained. The notes should also include a record of any comparable transactions and/or valuations considered when arriving at the valuation.

3.11 In relation to *inspections* generally, regard should be had to the RICS *guidance note*, *Surveying safely*.

4 Basis of value

4.1 The *basis of value* to be adopted is *market value*.

4.2 Where an existing property has, or has a reasonable prospect of obtaining, planning approval for future development, that value is to be excluded from the assessment of *market value* by way of a *special assumption* unless instructed otherwise by the lender.

5 Factors that may have a material impact on value

5.1 The *inspection*, and enquiries made, may reveal various factors that could have a material impact on the value.

These include:

- the tenure of the interest offered as security and, if known, the terms of any tenancies to which that interest is subject
- where the property is leasehold, the length of the remaining lease term
- the location, age, type, accommodation, fixtures and features, and amenities of the property
- the apparent general state of, and liability for, repair, form of construction and apparent major defects, liability to subsidence, and/or other risks
- the location of a property in an area known to be at risk from flooding
- any current or potential valuation impact of the Energy Performance Certificate rating
- any easements, servitudes, burdensome or restrictive covenants, and *third party* rights and
- any obligations relating to planning conditions, for instance Section 106 agreements or restrictions related to affordable housing conditions.

5.2 The valuation of a new-build property should be approached in the same way as any other valuation. There are, however, specific aspects of the new-build residential market that have led certain mortgage lenders to require an alternative approach to valuation. In all instances, the notified sale price must be treated with caution. The RICS *guidance note*, *Valuation of individual new-build homes* (2012), is relevant when valuing these types of property.

6 Assumptions and special assumptions

6.1 Considering the limited nature of an *inspection* for a mortgage valuation, the valuer is entitled to make reasonable *assumptions* with regard to the state of the property and other factors that may affect value.

6.2 Unless instructed otherwise the following *assumptions* and *special assumptions* may be made without verification:

(a) The property will be transferred with vacant possession.

(b) All required, valid planning permissions and statutory approvals for the buildings and for their use, including any extensions or alterations, have been obtained and complied with. It is not necessary for the valuer to make enquiries into town planning and other matters. These should be left to the lender's or borrower's legal advisers. Any obvious breach of planning control, however, should be reported. The lender should be advised of any obvious, recent and significant alterations and extensions, so that the lender's legal adviser is alerted to the possible need to make enquiries. The valuer is not obliged to search for statutory notices, although the lender's legal advisers may ask if any such matters that come to light during searches have a material effect on value. Consideration may have to be given to known, or suspected, planning restrictions or conditions. The valuer is under no duty to search, but may be called on for advice as to any material effect on value if they are disclosed.

(c) In the case of a building that has not yet been constructed, the valuer will, unless instructed otherwise, provide a valuation on a *special assumption* that

the development had been satisfactorily completed, as at the date of the *inspection*, in accordance with planning permission and other statutory requirements.

(d) No deleterious or hazardous materials have been used in the construction. However, if the limited *inspection* indicates that there are such materials, this must be reported and further instructions requested.

(e) The site is not contaminated and is free from other environmental hazards. No enquiries regarding contamination or other environmental hazards are to be made but, if a problem is suspected, the valuer should recommend further investigation. The valuer will not carry out an asbestos *inspection* and will not be acting as an asbestos inspector in completing a mortgage valuation *inspection* of properties that may fall within the *Control of Asbestos Regulations* 2012.

(f) The property is not subject to any unusual or especially onerous restrictions, encumbrances or outgoings, and good title can be shown.

(g) The property and its value are unaffected by any matters that would be revealed by a local search (or their equivalent in Scotland and Northern Ireland), replies to the usual pre-contract enquiries or any statutory notice that may indicate that the property and its condition, use or intended use are, or will be, unlawful.

(h) An *inspection* of those parts that have not been inspected, or a survey *inspection*, would not reveal material defects or cause the valuer to alter the valuation materially.

(i) There is unrestricted access to the property, and the property is connected to, and has the right to use, the reported main services on normal terms.

(j) Sewers, main services and the roads giving access to the property have been adopted, and any lease provides rights of access and egress over all communal estate roadways, pathways, corridors, stairways and use of communal grounds, parking areas and other facilities.

(k) In the case of a newly constructed property, it has been built under a recognised builder's warranty or insurance scheme approved by the lender, or has been supervised by a professional consultant capable of fully completing the CML Professional Consultant Certificate acceptable to the lender.

(l) There are no ongoing insurance claims or neighbour disputes.

6.3 Where the *inspection* reveals matters that affect any *assumption* or the value of the property, the details are to be included in the report together with, if appropriate, recommendations for further action to be taken.

6.4 Where the proposed security is part of a building comprising flats or maisonettes, the following *assumptions* will also be made, unless instructed to the contrary:

(a) The costs of repairs and maintenance to the building and grounds are shared equitably between the flats and maisonettes.

(b) There are suitable, enforceable covenants between all leaseholds, or through the landlord or the owner.

(c) There are no onerous liabilities outstanding.

(d) There are no substantial defects, or other matters requiring expenditure (in excess of the current amount or assumed amount of service charge payable on an annual basis), expected to result in charges to the leaseholder or owner of the subject property during the next five years, that are equivalent to 10% or more of the reported *market value*.

6.5 Where the dwelling is leasehold, and it is not possible to inspect the lease or details have not been provided, the following *assumptions* will be made, unless instructed to the contrary:

(a) The unexpired term of the lease is assumed to be 85 years, and no action is being taken by any eligible party with a view to acquiring the freehold or extending the lease term.

(b) There are no exceptionally onerous covenants upon the leaseholder.

(c) The lease cannot be determined, except on the grounds of a serious breach of covenant in the existing lease agreement.

(d) If there are separate freeholders, head and/or other subhead leaseholders, the terms and conditions of all the leases are in the same form and contain the same terms and conditions.

(e) The lease terms are mutually enforceable against all parties concerned.

(f) There are no breaches of covenant or disputes between the various interests concerned.

(g) The leases of all the properties in the building/development are materially the same.

(h) The ground rent stated, or assumed, is not subject to unreasonable review and is payable throughout the unexpired lease term.

(i) In the case of blocks of flats or maisonettes of over six dwellings, the freeholder manages the property directly, or there is an appropriate management structure in place.

(j) There is a dutyholder, as defined in the *Control of Asbestos Regulations* 2012, and there are in place an asbestos register and an effective management plan, which does not require any immediate expenditure, pose a significant risk to health, or breach Health and Safety Executive (HSE) requirements.

(k) Where the subject property forms part of a mixed residential or commercially used block or development, there will be no significant changes in the existing pattern of use.

(l) Where the property forms part of a development containing separate blocks of dwellings, the lease terms of the property apply only to the block. There will be no requirement to contribute towards costs relating to other parts of the development, other than in respect of common roads, paths, communal grounds and services.

(m) Where the property forms part of a larger development whose ownership has since been divided, all necessary rights and reservations have been reserved.

(n) There are no unusual restrictions on assignment or subletting of the property for residential purposes.

(o) There are no outstanding claims or litigation concerning the lease of the subject property or any others within the same development.

(p) Where the property benefits from additional facilities within the development, the lease makes adequate provisions for the occupier to continue to enjoy them without exceptional restriction, for the facilities to be maintained adequately and for there being no charges over and above the service charge for such use and maintenance.

6.6 In respect of insurance, the following *assumptions* will be made, unless instructed to the contrary:

(a) the property can be insured under all-risks cover for the current reinstatement cost and is available on normal terms

(b) there are no outstanding claims or disputes

(c) where individuals in a block make separate insurance arrangements, the leases make provision for mutual enforceability of insurance and repairing obligations and

(d) any landlord responsible for insurance is required to rebuild the property with such alterations as may be necessary to comply with current Building Regulations and planning requirements.

Reinstatement cost

6.7 An insurance reinstatement cost, often referred to as a 'fire insurance valuation', will not be provided unless specifically requested.

6.8 Where the lender requests that an insurance replacement cost be provided it shall be in accordance with Building Cost Information Service (BCIS) guidance. The rebuilding costs used refer to the expense of demolishing and clearing away the existing structure, and then rebuilding it to its existing design in modern materials, using modern techniques, to a standard equal to the existing property and in accordance with current Building Regulations and other statutory requirements. It excludes VAT, except on fees.

6.9 Where the building is not of modern materials, or is a protected building that is required to be reinstated exactly and is therefore outside the scope of BCIS guidance, the reinstatement cost should not be provided unless the valuer has expertise in that type of property. In these circumstances a professional cost assessment should be recommended.

6.10 Where the subject property is a flat or maisonette, the valuer should assess the reinstatement cost of that part of the total structure constituting the proposed security. It is the lender's responsibility to enquire whether a management committee or the landlord arranges insurance for the building as a whole, and whether that cover is adequate.

6.11 Any exceptional risks likely to affect the premiums for insurance purposes should be reported. There is, however, no obligation for the valuer to seek out such factors. The duty is limited to factors that come to notice during the ordinary course of *inspection*.

7 The form of the valuation report

7.1 The lender will often provide a general valuation report format. Whatever format is used the information provided in the report should comply with **VPS 3, Valuation reports**. It should be sufficient to enable the prospective lender to understand the nature of the security being offered, although unnecessary detail should be avoided.

7.2 The valuer's duty is to prepare a report on the basis of the information or questions contained in the instructions received, unless there are obvious errors or inconsistencies.

7.3 If other *assumptions* are made in addition to those described in section 6 above, they must be explicitly stated in the report.

8 Reporting factors that have a material impact on value

8.1 In addition to reporting the value, an important part of the report is to identify those factors that may have materially impacted value, or may be expected do so in the future. Where such factors are identified the valuer will recommend appropriate action.

8.2 If it is suspected that hidden defects exist that could have a material effect on the value of the property, the valuer should recommend more extensive investigation. It may be appropriate, in exceptional circumstances, to defer making a valuation until the results of the further investigations are known.

8.3 If it is not reasonably possible to carry out any substantial part of the *inspection* this should be stated.

8.4 The report should include reference to:

(a) the form of construction

(b) the existence of any obvious, recent and significant alterations and extensions

(c) any obvious evidence of serious disrepair or potential hazard to the property, and any other matters likely to materially affect the value (although minor items of disrepair, poor design or lack of decoration that do not materially affect the value of the security do not need to be reported)

(d) items that are not serious at the date of *inspection* but could become so if left unattended and

(e) other items of disrepair or poor design, or a lack of maintenance, that may adversely affect the structure in the future and lead to a material effect on the value of the security.

8.5 Where there is a basic structural defect, such that renovation ceases to be possible or economic, a valuation should not be provided, subject to the lender's more specific reporting requirements.

8.6 Where the proposed security is part of a building comprising flats or maisonettes, the valuer should comment on:

(a) any apparent deficiencies in the management and/or maintenance arrangements observed during the *inspection* that materially affect the value

(b) the current amount of the annual service charges payable, if available, and

(c) any situation where the apparent sharing of drives, paths or other areas might materially affect the value of the subject property.

8.7 If the valuer's *inspection* reveals anything that gives reason to suspect an encumbrance, for instance, easements and other rights pertaining to way, light and drainage, they must be reported even if the report is in the lender's format and no provision is made on the form for such information to be provided.

8.8 If the *inspection* reveals the possibility that *third parties* have the right of occupation this must be reported in all cases.

8.9 Where the valuer does not have the necessary expertise to estimate any repair and maintenance costs and their impact on value, specialist advice should be obtained or the instruction declined. One example would be a property of architectural or historic interest, listed as such, or in a conservation area. Another would be a property of unusual construction, where any remediation of defects may require planning permission, or other consent. The repairs may also have to be to a standard that would not be detrimental to the property's architectural or historic integrity, its future structural condition or the conservation of the building fabric.

Treatment of incentives

8.10 Sales incentives and the marketing of property, especially new-build homes, have become increasingly more innovative and sophisticated. Incentives can differ between development sites, between properties being sold and between the types of purchaser being attracted by the seller (owner-occupier or buy-to-let investor).

8.11 Where the property is a new-build, the valuer must obtain a copy of the developer's Disclosure of Incentives Form. More detailed guidance on the treatment of incentives and how to report on their impact is contained in the RICS *guidance note*, *Valuation of individual new-build homes* (2012).

8.12 Where the property is a new-build, it is recommended that the valuer considers including a statement to the following effect:

> 'It should be appreciated that the valuation provided is for the property as new. It may not be possible to obtain the valuation figure if the property is resold as second-hand, especially if comparable new property is on offer at the same time.'

UK appendix 11 Application of the RICS residential mortgage valuation specification to related purposes

1 Introduction

1.1 This appendix contains guidance on various matters related to residential mortgage valuation advice that are not dealt with in the residential mortgage specification. These are:

- re-inspections
- retype reports and transcriptions
- further advances
- buy to let
- valuations without internal *inspection* and
- retrospective valuations.

1.2 Valuation advice may also be sought on a variety of other matters, such as mortgage rescue and accounts in arrears. Unless the instructions specify otherwise, the *basis of value* will be *market value*.

2 Re-inspections

2.1 A 're-*inspection*' is a further visit to a property for which the valuer has previously provided a report where the lender has either imposed conditions, or made a retention.

2.2 The cases that may arise include:

- consideration of the release of money by way of stage payments applicable to the stage of construction reached
- whether the (new, or newly-converted or improved) property has been completed to the state assumed in the initial mortgage valuation report (where a mortgage offer has been made on this basis, but no advance has actually been made) and
- in circumstances where part of the advance has been retained until specified works have been undertaken, whether those works have apparently been completed as assumed in the initial valuation report, or as otherwise specified

by the lender, to a standard satisfactory to justify lending on them and without significant adverse effects on the value of the property.

2.3 The valuer may be asked to advise whether the previous valuation report (which must always be available to the valuer) is still sufficiently accurate for the lender to assess the adequacy of the security, when deciding whether or not to release a retention or stage payment. In this case the valuer's duty is to inspect only those parts of the property with which the lender is concerned. It is not the task of the valuer to inspect the whole property.

2.4 The lender must be advised if, during the re-*inspection*, the valuer:

- becomes aware of any material changes or factors additional to those in the previous report, which would materially affect the valuation of the proposed completed security
- becomes aware of any other factor that might materially affect the valuation
- is of the opinion that the valuation of the proposed completed security would be materially different from that previously reported
- considers that the property may have been affected adversely by the works carried out
- observes new defects and/or repair requirements and/or unsatisfactory workmanship and/or
- becomes aware that the problem originally causing the need to carry out the remedial works is now affecting another part of the structure, or that part of the structure which is the subject of the required *inspection* is suffering from a further defect.

However, there is no requirement to provide a revised valuation unless requested to do so.

2.5 A new figure for reinstatement insurance purposes is not to be provided, unless requested by the lender.

3 Retype reports and transcriptions

3.1 A 'retype report' is the generic name applied to a request for a 'copy report' or 'transcription', which is commonly requested by brokers and lenders. When receiving instructions from a *third party* (e.g. broker) to complete a retype, the valuer should be clear as to the acceptability of such reports by the lender whose report form is being completed. The lender's requirements will usually be made clear in the lender's panel contract and guidance. These requirements will always prevail over any contrary instructions from *third parties*, particularly in respect of retype acceptability, timescales, applicable *valuation dates* and valuation definitions.

3.2 Some requests for a retype report can lead to a potential conflict of interest, which should be considered in relation to the specific guidance in Table 1 (see paragraph 3.10) and generally in **PS 2, Ethics, competency, objectivity and disclosures**.

3.3 Retype reports can be categorised as either:

- a copy report – a duplicate copy of a previous report stating exactly the same facts with an *inspection* date, *valuation date* and valuation figure the same as for the original report or

- a transcription report – the transcription of data, which was presented in a previous report, to another report format stating the same facts with an *inspection* date, *valuation date* and valuation figure.

3.4 There may be minor amendments to meet lender requirements for additional data that can be presented in the transcription report if it was collected during the original *inspection*. Where additional data is requested that would require another visit to the site, the valuer should negotiate the appropriate fee for the additional work.

3.5 Where the valuer is aware that the value of the property has reduced to a level materially below the valuation at the original *inspection* date, the valuer should initially decline instructions. In the absence of a contract or agreement to provide a copy report stating both the original and current valuation figures, the valuer should offer to provide a revaluation at an appropriate fee.

3.6 Where the lender's requirements are for a valuation based on a different valuation definition from the original, the instructions should be declined. The valuer should then offer to provide a revaluation at an appropriate fee.

Retype reports in Scotland

3.7 After the introduction of the Home Report there is the option for the surveyor to provide a generic mortgage valuation report (MVR) in addition to the Single Survey. Buyers will be in the same position as before in having this prior to making an offer. A lender may request a valuation for mortgage purposes on its own report forms. This can be provided prior to purchase provided that:

- the valuer is an approved panel member for the lender
- the valuation in the MVR is replicated exactly in the retyped lender valuation and
- no additional information other than that which is in the Single Survey and MVR is provided.

3.8 If the valuer is unable to comply with these requirements, the instruction should be declined and the lender will be required to source a valuation from another panel member. However, if the valuation in the MVR is seen to be inappropriate at the date of the retype request due to changing market circumstances or the level of the offer from the prospective buyer, the valuer may seek the vendor's permission to 'refresh' the Single Survey and MVR. This creates an updated version to be put into the public domain and then provides the opportunity for the valuer to provide a valuation to the lender. If the vendor does not give permission, the lender will need to source another valuation from a different panel member.

3.9 Where a lender requires a valuation for mortgage purposes after the applicant has made a commitment to purchase then the valuer, provided he or she is an approved panel member for the lender, can provide additional information, if appropriate, to the lender without the need to 'refresh' the Single Survey and the MVR. If the valuation is seen to be inappropriate at the date of the retype request and a refreshed Single Survey is not instructed, the lender would be required to source another valuation from a different panel member.

3.10 Table 1 provides an indication of the circumstances under which a request for a retype report may give rise to a conflict of interest. Further guidance on conflicts of interest is given in **PS 2 paragraph 4, Independence, objectivity and conflict of interest**.

Table 1

Instruction source	Acceptable	Not acceptable (not applicable in Scotland)	Acceptable subject to conditions
Lender	*Different lender, same applicant*: acceptable, as this is an accepted industry practice *Same lender, different applicant*: acceptable, as most likely to be a full revaluation	*Different lender, different applicant*: not acceptable, as previous applicant and lender case may still be live	*Same lender, different applicant*: acceptable if applicant 'related' to previous applicant and change is administrative
Intermediary	*Same or different lender, same applicant*: acceptable, as this is an accepted industry practice	*Different lender, different applicant, or same lender, different applicant*: not acceptable, as there's no proof that original applicant has ceased interest, so potential conflict	*Different intermediary, different lender, same applicant*: can proceed
Applicant	*Same applicant, different lender*: acceptable, as applicant has instructed the transfer of information, therefore it is implicit that the valuer has the personal details. It should be stated within the report that the applicant has instructed the valuer.		

4 Further advances

4.1 Where a property is already in mortgage to a lending institution, the lender may sometimes wish to consider whether a further advance, usually of a specified sum, can be made on the security of the property or the repayment of a loan rescheduled. The valuation may be of the property as it stands and/or with works proposed to it. The lender is expected to provide the valuer with the original report, or a copy, wherever possible.

4.2 The valuer's remit is to provide a report on all of the following:

- the current *market value* of the property in its existing state
- the current *market value* in its future state, where defined works are contemplated on the *special assumption* that they have been satisfactorily completed
- where previously provided, a revised estimate obtained for insurance purposes
- any factors likely to affect its value materially and

- changes in the accommodation or its amenities since the previous *inspection* report.

5 Buy to let

5.1 Buy-to-let valuations will encompass a number of different categories. The main three are:

Category 1: a single individual residential unit let to a single household on a single assured shorthold tenancy (AST) where it neither forms, nor is intended to form, part of a portfolio

Category 2: a single residential unit let on a single AST, but to individuals on a sharing basis up to a maximum of four individuals and

Category 3: licensable houses in multiple occupations (HMOs) and multiple units held on a single title. They will include categories of properties not capable of being valued on an *assumption* of owner occupation and/or by adopting a traditional comparable methodology. These will be valued only after confirmation of direct *terms of engagement* with the instructing lender and referring to the lender's specific guidance.

5.2 The following comments apply to **all** categories:

(a) The valuer must be sufficiently experienced in the residential investment market and have a sound knowledge of the rentals in the locality.

(b) The valuer should be aware of the impact of rental incentives in respect of properties suitable for buy-to-let investment. Guaranteed rents that are above *market rent* and cashbacks in lieu of rental income for a number of years may have an effect on price. The valuer should consider these impacts and report accordingly.

(c) The lender may use either or both the *market rent* and the *market value* to determine the size and type of loan to be extended to the borrower. The *market rent* figure may therefore be critical in the underwriting of the loan and should not be viewed just as a guide or confirmation of the current or future rent passing.

(d) The valuer should fully research, document and retain comparable rental evidence and either decline to provide a *market rent* figure or clearly state limitations as to accuracy if there is insufficient or limited evidence.

(e) If the property is likely to incur higher than average maintenance costs due to its age/type, existing condition or intensity of occupation, this should be identified within the report, as the proportion of rent required for reinvestment will exceed normal levels and reduce net income accordingly. Excessive service charges and/or ground rents should also be considered in this regard, as they will similarly affect net income.

(f) Where the lender advises the valuer that the borrower intends to let a vacant property for residential purposes, the lender should also instruct on whether the valuer is to value the property:

(i) with vacant possession

(ii) subject to an AST at *market rent* or

(iii) subject to such other terms as the lender advises.

5.3 Where *market rent* is to be provided it shall comply with **VPS 4 paragraph 1.3, Market rent**, on the *special assumption* that it is an unfurnished, six-month AST. This should be a sustainable rent and not one distorted by temporary factors of high demand, such as seasonal workers, holiday lets, asylum seekers or other special cases. A simple adoption of the current rent passing (if known) will not be appropriate where market conditions have changed since commencement of the existing tenancy.

5.4 Comparable evidence for *market rent* should be as robust as that obtained for *market value*.

5.5 The following paragraphs provide comments that apply to the specified categories.

Category 1: Single assured shorthold tenancy

5.6 Individual residential properties that fall into category 1 may be purchased with a view to the owner letting them as investments. Many lenders have specific loans designed for this buy-to-let market. As the security offered is essentially a property that would be in the residential owner-occupier market, it is appropriate that the valuation is in accordance with that market.

5.7 The valuer should be aware of the impact of incentives in respect of properties suitable for buy-to-let investment. Guaranteed rents that are above *market rent* and cashbacks in lieu of rental income for a number of years may affect the price. The valuer should consider these impacts and report accordingly. In some cases the lender may specifically request the valuer to give an opinion of the *market rent* on an AST under item f(ii) in paragraph 5.2.

5.8 In the case of item f(i) in paragraph 5.2, the valuer must include in the report a sentence stating that the lender has advised that the property is to be let and that this may adversely affect the valuation reported (if the valuer believes this to be the case). In the case of item f(ii) or (iii) in paragraph 5.2, the valuer must state in the report that a *special assumption* has been made that the property has been let on an AST on market terms, or such other stated terms as advised by the lender.

5.9 Many lenders use a standard pro-forma report for buy-to-let valuations. Where this is the case, the valuer does not need to comment on:

(a) the letting *assumptions* made and/or

(b) the possible adverse effect on the capital value of letting.

This applies where the pro-forma, lender's *terms of engagement* or lender's guidance manuals (or equivalent) already state the *assumptions* and/or *special assumptions* that the lender wishes the valuer to make in the preparation of the report.

5.10 In the event that the property is already let and is to be conveyed subject to the letting, the lender may request that a *special assumption* be made that the property is vacant. The current rent passing should not necessarily be confirmed as

the current *market rent*. The current *market rent* should be the figure that the valuer considers is the true value irrespective of whether the current rent passing is higher or lower.

5.11 Where the lender requires the valuation of more than one category 1 property for the same borrower, the valuation is to be on an 'individual property basis' and not as a parcel or portfolio of properties, unless otherwise instructed. In such case this specification does not apply, and the valuer should refer to VPGA 2, Valuations for secured lending, and VPGA 8, Valuations of portfolios, collections and groups of properties, unless covered in the following paragraphs.

Category 2: Shared houses

5.12 Where a property has been let to a group of tenants, typically a shared student house or as individual rooms, the *market value* may be assessed on a comparable basis. However, these properties may be located in areas comprising a high concentration of similar rented accommodation and limited owner occupation. In this situation, the comparables used to determine the valuation may come principally from transactions of other similar *investment property* (rather than owner-occupied property) in the locality.

5.13 The rental value assessment should only be provided at a 'higher' shared occupancy rate, where there is a proven sustainable demand in the area for this type of letting arrangement and the property is suitable for this form of letting.

Category 3: Houses in multiple occupation/multi-unit properties

5.14 For this specialist area of valuation, the valuer must have knowledge of, and experience in, the valuation of the more complex residential *investment property* in the particular locality.

5.15 Houses in multiple occupations (HMOs) comprise individual units that cannot be sold separately and have at least some shared facilities. If the property appears to be compliant with legislation/safety requirements having regard to the provisions of the *Housing Act* 2004, then it is reasonable to adopt the *income approach* method of valuation, assuming there is a continuing rental demand for this type of accommodation in the area. The valuation obtained should be logic checked against the tone of values for similar *investment property* in the vicinity.

5.16 The valuer should identify whether the property is subject to mandatory HMO licensing and if a copy of the licence has been seen.

5.17 The additional considerations for the category 3 scenarios include:

(a) management regulations for HMO

(b) potential mandatory or discretionary licensing schemes

(c) condition/fitness requirements, that is, Housing Health and Safety Rating System (HHSRS) and

(d) the possibility that planning consent will be required for the HMO usage, in addition to the usual local authority consents for the current property form and layout.

6 Valuations without internal inspection

6.1 The valuer may be asked for a valuation without the benefit of an internal *inspection*, and with or without the benefit of an earlier report. This may be called a 'desk-top', 'drive-by' or 'pavement' valuation, or an 'external appraisal', and may include reference to automated valuation models (AVM).

6.2 When an opinion is provided on this basis, it must be confirmed in writing, and the manner of valuation and the restrictions under which it is given clearly stated (see VPS 1.9(g), Extent of investigation). The lender must be informed that the value stated in such a fashion must not be disclosed to the borrower or any other party, unless required to do so by the FCA rules in Mortgages and home finance: conduct of business sourcebook (MCOB).

6.3 Many lenders use a standard pro-forma report for valuations without an internal *inspection*. Where this is the case, the valuer does not need to comment on:

- the manner of valuation
- the restrictions under which it is given
- the non-disclosure to the borrower and/or other *third parties* or
- where the pro-forma, lender's *terms of engagement* or lender's guidance manuals (or equivalent) already state the *assumptions*, restrictions and terms under which the valuer should prepare the report.

6.4 Where a desk-top opinion is sought without any form of *inspection* of the property itself, the valuer should exercise additional caution particularly as to the intended use of the valuation. It is likely to be used for a preliminary assessment prior to a more detailed investigation at a later date (and section 7 below may also apply). The valuer should ensure that the source of information and the rationale used in arriving at the desk-top valuation are documented and retained, given that there will be no site notes.

7 Retrospective valuations

7.1 A valuation may be provided at any historical date. However, a lender may be seeking a retrospective valuation as part of an internal process of reviewing a specific loan. It is therefore important that the valuer establishes the reason for the request before accepting the instruction.

7.2 Where an instruction is accepted, the *terms of engagement* must incorporate the following statements:

- The valuation will be in accordance with the residential mortgage specification as at the *valuation date*. Previous specifications are available from the RICS Library.
- Where *inspection* is not possible, or is expressly forbidden, a statement to that effect will be made.
- Because the valuation is based on restricted information, it is provided solely for the internal use of the lender. It is not to be used in any proceedings without the valuer's consent, as the opinion may change if the valuer is later required to give evidence in formal proceedings.

- Where the lender decides to institute formal proceedings the valuer must be instructed to act as an expert witness and will follow the RICS mandatory standard, *Surveyors acting as expert witnesses* (2014).

UK appendix 12 RICS Scotland advice on issuing terms of engagement

1 Introduction

1.1 This appendix reproduces the advice issued by RICS Scotland in January 2006.

1.2 The advice in this appendix does not apply to the provision of services as part of a Home Report in Scotland. In such cases UKVS 3.6 will apply.

1.3 Paragraph 1.1 of the RICS Scotland advice refers to the Rules of Conduct and those standards that were applicable in 2006. As the Rules of Conduct 2007 do not refer to *terms of engagement* and the references in these standards have changed, this paragraph should be read as follows:

> '1.1 This advice should be read in conjunction with the *RICS Valuation – Professional Standards*, 2014. PS 2.7, Terms of engagement, requires the *terms of engagement* to be brought to the client's attention and appropriately documented prior to the issue of the report.'

1.4 Similarly, all references to various 'practice statements', now termed professional standards, valuation practice statements or valuation standards, should be checked against their new numbering and location in this edition of the Red Book.

RICS Scotland advice on issuing terms of engagement (SRF/01/06)
1 Introduction
1.1 This advice should be read in conjunction with the Royal Institution of Chartered Surveyors (RICS) Appraisal and Valuation Standards (Fifth edition) (Red Book) Chapter 2 (Agreement of terms of engagement), PS 2.1 – *Confirmation of terms of engagement*.
RICS Code of Conduct, Rule 8, provides that terms of engagement shall be sent promptly.
1.2 This advice reflects that due to time restrictions sometimes created by the traditional and accepted procedures for buying residential property in Scotland, it is often difficult to issue Terms of Engagement to clients, or those acting for clients, prior to the issuing of a valuation or survey report. The guidance contained in this advice aims to reflect best endeavours on behalf of the Chartered Surveyor, in their firm.

2 Best endeavours

2.1 Where it is possible, and reasonable time permits, these Terms of Engagement shall be issued to clients in accordance with the Red Book PS 2.1 – *Confirmation of terms of engagement*. Where this is not possible then the Chartered Surveyor, or their firm shall adhere to at least one of the following guiding principles:

2.1.1 A written copy of the standard Terms of Engagement shall be sent to the client, or their representative, within 24 hours of receipt of the instruction.

2.1.2 Where a Chartered Surveyor, or their firm, has a website openly accessible to the public, then their standard Terms of Engagement shall be posted therein and the client, or their representative, shall be directed to view the terms on the website.

2.1.3 Where practicable, the Terms of Engagement shall be emailed to the client, or their representative, within 24 hours of receipt of the instruction.

2.1.4 Where practicable, the Terms of Engagement shall be sent by fax to the client, or their representative, within 24 hours of receipt of the instruction.

2.1.5 It shall be deemed to be good practice for the Chartered Surveyor, or their firm, to furnish their standard Terms of Engagement with referring parties (e.g. local solicitors, lenders, etc., with their valuation commissions once received). A note of receipt of these terms should ideally be sought.

3 This advice is approved by the RICS Appraisal and Valuation Standards Board and RICS Scottish Residential Faculty Board.

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UK appendix 13 Valuation of registered social housing providers' stock for secured lending purposes

1 Introduction

1.1 This appendix provides guidance on the additional matters that should be taken into account by valuers undertaking valuations for registered social housing providers' stock for secured lending purposes. Its provisions also apply to valuations of their interests in property in shared ownership.

1.2 In this appendix references to the 'client' are to the lender, which will normally issue any valuation instructions. However, the provisions apply equally if a registered social housing provider requests a valuation for secured lending.

2 Identifying the property

2.1 The valuer first needs to agree with the client whether the stock is to be valued as a single portfolio, or in lots, which could be individual dwellings. If the stock is not to be valued as a single portfolio, the client must be made aware that the aggregate of the valuations provided may differ from the price that could be achieved if some or all of the properties were sold either as a portfolio, or if a large number were placed on the market concurrently for sale individually (see also VPGA 8, Valuations of portfolios, collections and groups of properties).

2.2 Particular care is necessary to establish the nature of the housing provider's interest(s) to be valued. Restrictions and encumbrances (for example, Section 106 agreements, right to buy and nomination rights) are common. Planning consents may include restrictions on occupation or tenure. Obviously the valuation must reflect the terms of any shared ownership leases.

3 Extent of inspection

3.1 Where the stock to be valued comprises a large number of similar properties, or a number of estates or blocks, each of which comprises similar properties, the valuer must agree with the client whether every property will be inspected or, as is more usual, whether sample *inspections* should be completed. In such case, the valuer will assume that these are representative of those properties that have not been

inspected. The extent of each sample *inspection* (for example, internal and external, external only or front elevation only) must also be agreed.

3.2 Where the *inspection* is to be of a sample only, the extent of the sampling and the method of its selection must be agreed with the client. If the valuer subsequently considers that the extent of the *inspection* is not adequate for the purpose of the service, the client must be advised accordingly and further instructions agreed before reporting.

4 Basis of value

4.1 *Market value* will be subject to existing tenancies. Unless the client specifies to the contrary, a *special assumption* should not be made that dwellings vacant at the *valuation date* have been re-let to tenants in the registered social housing provider's target group. Instead, they should be valued with vacant possession.

4.2 A valuation on the basis of *market value* should reflect any intention that the valuer considers a prospective purchaser would have to raise the rents. If the valuer expects to make this *assumption*, the potential impact of this on the value of the security should be drawn to the client's attention.

4.3 Existing use value for social housing (EUV–SH) is defined in UKVS 1.13, Valuations for registered social housing providers. Its use is appropriate in secured lending valuations, as it assumes that the properties will continue to be let as social housing and that any vacant dwellings will be re-let to tenants in the registered social housing provider's target group.

5 Calculations of worth

5.1 The client may also require the valuer to provide a calculation of *worth* on the *assumption* that the lender was in control of the security, following default by the borrower. In this case the client's potential rights (for example, whether it will be entitled to sell vacant dwellings, or where tenants' rights to buy exist), along with its willingness and ability to raise rents and sell dwellings that become vacant, will be relevant.

5.2 The client may also be interested in receiving, and hence will specify, a return that is to be adopted through the discount rate used in the calculation of *worth*. *Special assumptions* such as this must be stated in the report.

5.3 Where a calculation of *worth* is provided, an opinion of value on *market value* or EUV-SH should be provided concurrently.

6 Developments

6.1 Where the security of a proposed development (or a development in the course of construction) is being considered for lending purposes, it will normally be appropriate to provide both a valuation of the property in its current condition, and a further valuation on the *special assumption* that the development will be completed in accordance with the plans and specification provided. In establishing the current

value the valuer will need to determine what information is available on the anticipated development costs, and the extent to which these may be relied on by the valuer.

7 Reporting

7.1 The report should contain, in addition to those matters listed in **VPS 3, Valuation reports**, as many of the following additional matters as seem appropriate in the circumstances:

- a statement of the average rents being charged for each dwelling and tenancy type, and a comparison of these with the valuer's assessment of the level of rents that could be obtained if the properties were let unfurnished on the open market
- a statement as to the existence of nomination rights
- an explanation if there is an exceptionally high number of vacant dwellings
- an appreciation of the strength of demand for the dwellings, both let at the level of rents charged, or to be charged, by the registered social housing provider and if offered for sale with vacant possession, along with any known factors likely to significantly affect these strengths
- a statement where the valuation(s) reported has been affected by the existence of an unimplemented planning permission for change of use or other development, or by the prospect of such consent(s) being available, with advice as to the amount(s) of the increase reported in consequence
- an opinion as to whether, over the period contemplated for the loan, material changes in the necessary level of expenditure, in real terms, are likely to be required
- the valuer's opinion of the property as a lending security, including implications relating to the ability to realise the security in the event of default, bearing in mind the length (which will be stated) of the term of the loan contemplated by the client, and assuming that the borrower will maintain the property in a reasonable state of repair and
- a statement as to the valuation method(s) adopted, and an indication of the extent to which the valuer has been able to have regard to comparable market transactions. The yield, the principal inputs (where a discounted cash flow method is used), *assumptions* and the discount rate adopted must be stated.

8 Liaison with lenders

8.1 The British Bankers' Association, the Council of Mortgage Lenders and RICS regard it as important that the lender and the valuer develop a close working relationship in respect of valuation and appraisal, especially in more complex cases, to ensure that the service provided by the valuer reflects the lender's needs and that the lender fully understands the advice that is being given.

UK appendix 14 Affordable rent and market rent

1 Introduction

1.1 This appendix provides background information on the regulatory system in England related to affordable rent and guidance to the valuer on the application of the basis of *market rent* for this type of property. The additional requirements set out in paragraphs 3 to 5 are of mandatory application.

2 Background

2.1 Affordable rent is designed to:

- maximise the delivery of new social housing by making the best possible use of constrained public subsidy and the existing social housing stock and
- provide an offer that is more diverse for the range of people accessing social housing and an alternative to traditional social rent.

2.2 Affordable rent falls within the definition of social housing in section 68 of the *Housing and Regeneration Act* 2008 (and, in particular, the definition of low cost rental accommodation in section 69 of the Act). Affordable rent properties will therefore be subject to regulation by the Homes and Communities Agency (previously known as the Tenant Services Authority (TSA)) where they are provided by a registered provider. Current HCA regulations and archived TSA regulations are available on www.homesandcommunities.co.uk

3 Status of the valuer

3.1 The regulations neither specify that the valuer should be professionally qualified, nor require the valuation to be made by a valuer independent from the landlord. However, where the valuer is a *member* of RICS, attention is drawn to **PS 1 paragraph 1, Mandatory application**, where a written valuation is provided. Where the valuer is an employee of, or is in any way associated with, the registered provider, then details of such relationship are to be clearly stated in the report to comply with **VPS 3 paragraph 7(a) Identification and status of valuer**.

4 Basis of value and assumed tenancy terms

4.1 The regulations refer to 'gross market value'. This term is taken to be the same as *market rent* as defined in **VPS 4 paragraph 1.3**, having regard to the following assumed tenancy terms:

- The tenancy is assumed to be a 12-month assured shorthold tenancy on market terms, unfurnished but with appliances, carpets and curtains, with an expected right for the tenant to 'hold over' or renew the tenancy.
- The rent is inclusive of any service charges (the *assumption* being that these are paid by the landlord). If this is not the case the rationale should be explained.
- As long as they do not conflict with the aforementioned *assumptions* the general tenancy terms should reflect those usually applied in the private sector.
- The condition of the property is only taken into account in so far as it impacts the rental value.

5 The property

5.1 The extent of the property being valued should be clearly stated.

5.2 Where the valuation is for a proposed new development, reference to the plans should be clearly stated within the report. The *assumptions* on the quality of specification, and compliance with planning approvals and development control requirements, should also be disclosed.

5.3 Where an existing property is being valued, a summary of the condition of the property should be included within the report to the extent that it impacts the rental value.

5.4 All *assumptions* about the property should be stated.

6 Method of valuation

6.1 The comparison method of valuation evidence is expected to be the most likely approach to be adopted, with evidence obtained from the private rented sector. Where other methods are adopted they are to be specified in the *terms of engagement*, together with confirmation that the client has no objection.

6.2 The method of valuation and justification for its use should be stated within the report.

6.3 Where the landlord owns a large number of properties, it is acceptable to provide valuations on a sample, or beacon, basis. In such cases the valuer must clearly identify the types of property within each sample or beacon.

7 Analysis of comparable market evidence

7.1 Details of comparable evidence should be included in the report, together with the evidence drawn from these cases.

7.2 Some market information is publicly available, but published and website database information must be used with caution and with the full knowledge of how and from where it is derived. While databases may be useful in providing a general background to values, they may not be sufficiently comprehensive by themselves to provide enough data for an accurate valuation.

7.3 Details of all comparable evidence, including any adjustments made to reflect the differences between the terms of letting and the valuation requirements, should be kept on file and sources of comparables noted in the valuation report.

7.4 The HCA's comment on the difficulty in identifying comparables in certain circumstances is stated in the 2011–2015 Affordable Homes – Framework at paragraph 3.5:

> 'Housing for vulnerable and older people often includes a range of services to support the particular needs of the client group. When setting an Affordable Rent, the gross market rent comparables should be based on similar types and models of service provision. Where there are insufficient comparables for similar types of provision in the local area, valuers should be requested to identify comparables from other areas, and extrapolate their best view of the gross market rent that would be applicable in the location in which the property is situated.'

7.5 Where rental evidence of comparable types of property is not available from within the immediate locality, then a wider market area should be used. The valuer will need to use professional knowledge and judgment in order to apply the evidence to the subject property. Comment should be made on similarities and variations in the comparable market and how they affect the valuation. Sometimes evidence may be completely lacking, in which case the valuer may be forced to consider an alternative method of valuation, such as *investment value* or the rental relationship to the capital value.

7.6 Comparables may be more difficult to identify in rural areas, or for specialist supported housing being provided for a particular client group. They may also require a wider market area of comparables, or an alternative supporting method of valuation adopted to determine the market rental value with details provided within the valuation report.

7.7 Output from an automated valuation model (AVM) may also be considered. However, care should be taken to understand how that output relates to the valuation requirements. Guidance on AVM is being developed and once published will be available on www.rics.org/standards

7.8 Further guidance on comparable evidence can be found in the RICS information paper, *Comparable evidence in property valuation* (2012).

5 RICS UK guidance notes

UKGN 1 Land and buildings apportionments for lease classification under IFRS

1 Introduction: the accounting principles

1.1 The purpose of this *guidance note* is to provide assistance to valuers on the various matters that arise from the application of IAS 17, *Leases*.

1.2 This guidance is written with specific reference to UK leasing practice and markets.

1.3 This *guidance note* was originally published as Valuation Information Paper 9 in 2006. Apart from revising the commentary on the classification of the land element of leases that arises from an amendment of IAS 17 in January 2010, there have been no fundamental changes to the original text.

1.4 It is common for items of property, plant and equipment used by a business to be leased rather than purchased outright, as this gives the entity (the term used for the business preparing the *financial statements*) lower entry costs and potentially greater flexibility. Leased assets are generally treated as belonging to the lessor, and therefore do not appear on the balance sheet of the lessee.

1.5 In some cases, however, the rent payable under a lease can be seen simply as payment by instalments for the purchase of the leased asset, including an interest charge. Such a lease is termed as a 'finance lease'. In this situation, the underlying asset is classified as belonging to the lessee and appears on the balance sheet of the lessee as an asset, with the corresponding rent outgoings capitalised and shown as a liability.

1.6 Leases that are more of a temporary arrangement, where the rents can be best seen as a payment for a short term right to use the asset, are recognised as 'operating leases'. These are accounted for as assets on the balance sheet of the lessor, and the lessee merely presents the periodic rental charge in the profit and loss statement, with future rent liabilities disclosed in the notes to the accounts.

1.7 This *guidance note* does not address in detail the accounting treatment of finance and operating leases. However, under an operating lease the annual rent charge is shown in the profit and loss statement. Under a finance lease, the rent is divided between an interest charge (shown in the profit and loss statement) and a

charge for the repayment of the capital. The lessee's accounts will also usually show an annual depreciation charge on the asset.

1.8 IFRS requires all leases to be accounted for in accordance with IAS 17, which is not just concerned with land and buildings, but with all leased items such as plant and equipment. The difficulties raised by leases of land and buildings are recognised, and some guidance is given in the standard on how to deal with these asset types.

1.9 Land and buildings are usually traded in the market as a single unit – the land supports the buildings and the buildings cannot be used independently of the land. Leases in the UK are drawn up on this basis, and the valuation process does not differentiate between the two elements. Nevertheless, IFRS treats these elements as 'separable' and a separate accounting treatment may be required. This might lead to a requirement for separate valuations of the two elements and, more directly, an apportionment of the rent payable between them.

1.10 A split of rentals is required for two reasons. First, it will help determine the classification of the lease (as it relates to each element) as either a finance lease or an operating lease. Where it has been classified as a finance lease, the split of rentals will be used to calculate the amounts to be included in various parts of the *financial statements*.

Table 1: Lease classification

Party	Operating lease	Finance lease
Lessor *financial statements*	The asset will be held on the balance sheet as (usually) an investment property.	A financial asset is recognised on the balance sheet as representing the right to receive lease payments and the entity's interest in the residual value of the property.
	Rental income is recognised in the income statement over the lease term, and depreciation may be charged against the asset.	Rental payments are allocated between the repayment of the financial asset and interest income (which is recognised in the income statement).
Lessee *financial statements*	The asset is not recognised on the balance sheet.	The asset is recognised on the balance sheet initially at an amount equal to the lower of its *fair value* or the present value of the minimum lease payments. A liability to make future payments, equal to the lower of the *fair value* of the asset or the present value of the minimum lease payments, is recognised on the balance sheet.
	Lease payments paid are recognised in the income statement over the lease term.	The asset will be depreciated. Interest expense is recognised in the income statement.

1.11 It is the responsibility of company directors to determine lease classification, in consultation with their accounting advisers. The directors may ask valuers for advice ranging from advising on elements of the classification routines described in this *guidance note* to undertaking a full detailed quantitative test for lease classification, including the calculation of the amounts to be included in the *financial statements*. Valuers are advised only to provide these services if they have an adequate understanding of the accounting concepts involved.

1.12 As illustrated in Table 1, the classification of a lease for an asset (which would either be the land or the buildings in the case of real estate) can have a significant impact on what is presented in the *financial statements*.

2 Accounting guidance

2.1 IAS 17 requires all leases to be classified as either a finance lease or an operating lease, depending on the substance of the transaction, and not by its legal form. A finance lease is defined as 'a lease that transfers substantially all the risks and rewards incidental to ownership' of the leased asset to the lessee (IAS 17, paragraph 4). An operating lease 'is a lease other than a finance lease'.

2.2 When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance lease or an operating lease by applying the tests outlined in paragraphs 2.6 and 2.7.

2.3 In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life. Consequently, most leases of land are normally classified as operating leases, unless the practical effect of the lease is to transfer the risks and rewards. This would apply if, for example, the lease is longer than 99 years or the lessee is expected to acquire title to the land (because it can be bought at a favourable price). In addition, if the land value is insignificant, there is no need to account for the land and buildings assets separately and the classification of the buildings will be paramount.

2.4 Therefore, under IAS 17 unless title to the land is expected to pass to the lessee, the lessee is not considered to receive 'substantially all the risks and rewards of ownership' of the land. This is a clear instruction within the standard, despite the fact that substantially all the value of the land might pass to the lessee at the inception of a long lease.

2.5 The classification of the buildings element is often less straightforward. However, in many cases it is possible to determine that the lease of the building is an operating lease at a qualitative level without performing detailed calculations. The underlying test is not financial (IAS 17 does not state any threshold apportionments of value), but depends on the transfer of risks and rewards having regard to the substance of the transaction, rather than the form of the lease contract.

2.6 IAS 17, paragraph 10, provides examples of situations that 'would normally' indicate that a lease is a finance lease. These are (in the order in which they appear in the standard):

> (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
> (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
> (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
> (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
> (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.
>
> IAS 17, paragraph 10
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2.7 In addition, the following circumstances are described as situations that could also indicate a finance lease:

> (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
> (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
> (c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
>
> IAS 17, paragraph 11
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2.8 Paragraph 12 of IAS 17 states that the examples and indicators in paragraphs 10 and 11 (see paragraphs 2.6 and 2.7 above) are not always conclusive. 'If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease.'

2.9 Most of these tests are primarily factual and objective, and should not be difficult to apply. The exceptions are 2.6(c) and (d).

2.10 With regard to 2.6(c), there is no definition of what is meant by 'the major part of the asset's economic life'. Some auditors interpret this to mean a lease term that is at least 75% of the asset's remaining economic life at the inception of the lease, but the standard offers no further guidance. Building lives are a matter of judgment, so this test is unlikely to be conclusive in isolation. An appropriate test might be to ask whether the building would be redeveloped or re-let today if it currently was at

the age and in the condition predicted for the end of the lease term. If a refurbishment might be envisaged (perhaps retaining the structure and frame, but rebuilding the walls, roof and services), then the residual value should be estimated taking into account which elements are retained.

2.11 Under 2.6(d) there is similarly no definition of what is meant by 'substantially all' of the *fair value*. The company directors and their accounting advisers will need to interpret this test in the context of the advice provided to them by the valuer. In due course a certain percentage might become established practice. Certainly, if the value of the lease interest in the buildings comes close to 90% of the freehold value or more, then the lease would likely be classified as a finance lease, unless there is persuasive evidence to the contrary.

2.12 If the qualitative tests (excluding 2.6 (d), which is quantitative) indicate an operating lease and a preliminary (non-detailed) consideration of 2.6 (d) does not suggest otherwise, then no further analysis is required. If the qualitative tests are not conclusive, then separate valuations of the land and buildings under the lease, and an apportionment of the rent, will be required in order to carry out the test under 2.6(d) and to determine the figures to be included in the *financial statements*. The remainder of this *guidance note* will focus on this subject matter.

3 Definitions

3.1 Certain terms are used in IAS 17 for which definitions are not provided. Phrases that may seem familiar to valuers may have different meanings than expected. The following expressions (defined in IAS 17, paragraph 4, and reproduced in quotes) are used with the meanings provided in the following paragraphs. Valuers should refer to IAS 17 for the full list of definitions.

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3.2 ***Fair value*** is 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'. In the context of IAS 17, the *fair value* of the leased asset or interest will normally be its *market value* as defined in **VPS 4 paragraph 1.2, Market value**.

3.3 **Asset** normally refers to the property out of which the lease is created. In valuation terms, this would be the freehold in the land or the buildings. It is also referred to as the **leased asset** (which is not defined).

3.4 A **lease** is an 'agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time'. It is the substance of the agreement that is important, not its legal form. An agreement can be a lease in accounting terms that would, however, not be considered a lease under UK law.

3.5 The **inception of the lease** is the 'earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease'.

This would usually be the date when the heads of terms are agreed or the date of the lease. The inception of the lease and the commencement of the lease term refer to the original lessor and lessee's situation, not that of the current parties if the lease has been assigned. There may be practical difficulties in ascertaining some dates that are many years after the event, but the date of the lease and the stated commencement date are usually sufficient for lease analysis.

3.6 The **commencement of the lease term** is the 'date from which the lessee is entitled to exercise its right to use the leased asset'.

3.7 The **lease term** is the 'non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option'.

3.8 Contingent rent is the 'portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time' (for example, future changes in market rents, percentage of future sales, amount of future use, future price indices, future market rates of interest).

3.9 Minimum lease payments are 'the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) for a lessee, any amounts guaranteed by the lessee or any party related to the lessee [for example, another group company]; or

(b) for a lessor, any [amounts] guaranteed to the lessor by:

   (i) the lessee;

   (ii) a party related to the lessee; or

   (iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.'

In addition, if the lessee has an option to purchase the asset at a price that makes it reasonably certain at the inception of the lease that the option will be exercised, then the minimum lease payments will be the rent payable up to the date when the option can be exercised, plus the option payment. The 'minimum lease payments' include any premium paid as consideration for the granting of the lease.

3.10 Residual value is the term used in IFRS for the value the asset will have at the end of its useful life. Useful life is the period over which the entity currently holding the asset expects to use it, which can be contrasted with economic life (see paragraph 3.11). For valuations undertaken in the context of IAS 17, residual value is considered to be the discounted reversion value of the leased asset – that is, the estimated value of the leased asset at the end of the lease term discounted back to the inception of the lease. (The terms 'residual value' and 'reversion value' are virtually synonymous in the context of IAS 17. Where this *guidance note* refers to a specific concept within IAS 17, the term 'residual value' is used. Where the discussion is on more general valuation issues, the term 'reversion' is used.)

3.11 Economic life is (for land and buildings) 'the period over which an asset is expected to be economically usable by one or more users'. This is not necessarily

the same as the physical life, as it can take into account when a building is likely to be redeveloped due to changing economic circumstances, or because of technical obsolescence.

3.12 The **interest rate implicit in the lease** is

'the discount rate that, at the inception of the lease, causes the aggregate present value of:

(a) the minimum lease payments and

(b) the unguaranteed residual value to be equal to the sum of

(i) the fair value of the leased asset and

(ii) any initial direct costs of the lessor.'

Residual value here refers to the leased asset, which is usually the buildings element of the freehold reversion value. The *fair value* of the leased asset would normally mean its *market value*.

3.13 The **lessee's incremental borrowing rate of interest** is 'the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.'

3.14 The terms **land** and **buildings** are not defined in IAS 17. These are familiar terms to valuers, but when used in an accounting context should not be interpreted too literally. IAS 17 assumes that all the features and qualities of a parcel of *real property* that contribute to its value can be grouped under two categories: 'land' and 'buildings'. Further, there is the implicit *assumption* that the sum of the values of these categories equals the value of the parcel of *real property*. Value might be affected by many features, such as location, architectural merit, lease structure, covenant and sunk finance costs.

3.15 It is possible to construct arguments that value relies on matters other than 'land' and 'buildings', and that the sum of the parts does not necessarily add up to the whole, but they are not relevant to this discussion. IAS 17 instructs valuers to apportion the value of a leased asset into two parts, labelled 'land' and 'buildings', and therefore by definition the two combined will equate to the whole.

3.16 The 'land' category is best defined as those elements that contribute to the value of *real property* and do not depreciate or reduce in a systematic way over time or usage. 'Buildings' is best defined as everything else. 'Land' therefore has an indefinite value, while 'buildings' needs to be accounted for as a wasting asset. In practice, 'buildings' will include, for example, the physical structures on the land, plus the sunk finance costs, developer's profit and perhaps the lease value, all of which will depreciate to zero if the land is cleared of all built structures. 'Land' will include the location factors, as well as the physical ability and the legal right to use and construct improvements on the site.

4 The process of lease classification

4.1 Land and buildings are considered separately for lease classification. Financial calculations are only required to assist in the classification process for borderline

leases. Subsequently, these calculations are used for producing the various figures required for reporting purposes if the lease of either element is determined to be a finance lease.

4.2 The lessor and lessee do not have to classify the lease in the same way. For example, if the lessor had the benefit of a guaranteed residual value from a party unrelated to the lessee, then this would affect the lessor's lease classification, but not the lessee's.

4.3 In terms of IFRS, the value of an asset comprising land and buildings that have been leased has four elements:

- the value within the lease of the buildings
- the value within the lease of the land
- the residual value of the buildings and
- the residual value of the land.

4.4 Although most UK leases are drawn up on the *assumption* that the buildings will be yielded up to the landlord at the end of the term in good repair and ready for re-letting, the reality is that some buildings are redeveloped rather then re-let. In financial terms, the lessor may not be concerned with the value of the buildings (as opposed to the value of the land as a development site) at the end of the term when agreeing to grant a lease. If the reversionary value of the buildings is not important at the inception of the lease, many accountants will consider that the buildings have been 'bought' by the lessee. This would create a finance lease, whatever the form of the lease and covenants.

4.5 Where there are rent reviews during the non-cancellable term and these rent reviews are expected to take effect, it might be perceived that the benefits of an increase in the value of the asset during the term still accrue to the lessor, indicating an operating lease. However, if the rent reviews are upwards only and the initial rent is set at a high enough figure and lasts for a long enough term, such that these rent payments alone could 'pay for' the buildings regardless of the contingent element, this would indicate a finance lease.

4.6 The valuer may be asked to carry out classification appraisals on long lease terms without unusual review provisions, where the economic life test might be passed and the effects of declaring a finance lease need to be considered.

4.7 The following information is needed from the valuer by those who prepare accounts regarding leases of land and buildings for classification under the test in paragraph 2.6(d), and to determine the asset and liability figures to be shown in the accounts:

- the freehold value of the asset that has been leased, split between the buildings and the land
- the value contained within the lease, again split between the buildings and the land
- the allocation of the minimum lease payments under the lease between the buildings and the land and
- the calculation of the interest rate implicit in the lease.

4.8 Table 2 illustrates the main steps the valuer will need to take. The figures are drawn from Example 1, section 13. Although this is not a finance lease, it is used to illustrate the method and how the calculations would be carried out as if it was a finance lease.

Table 2

Process	Description	Land element	Buildings element	Total	Commentary
1. Assess the freehold value of the land and buildings				2,500,000	Carry out a valuation of the investment See section 5
2. Apportion the freehold value between the value within the lease and the residual (reversion) value	Lease value			1,843,000	Deduct the present value of the freehold reversionary interest See section 6
	Residual value			657,000	
	Total			2,500,000	
3. Apportion the freehold value between the land and buildings		550,000	1,950,000	2,500,000	Deduct land value or buildings (DRC) value See section 7
4. Apportion the value of the buildings element between the residual value and the value within the lease	Within lease		1,640,000		Estimate the buildings residual value using expected depreciation, or from the current value of older buildings See section 8
	Residual value		310,000		
	Total		1,950,000		
5. Apportion the values under the lease		203,000	1,640,000	1,843,000	Deduct the value of the buildings within the lease
6. Apportion the minimum lease payments between the land and buildings		19,300	155,700	175,000	Apportionment in the ratio of step 5 values See section 10
(Alternative approach) Sinking fund		32,700	116,000 + 26,300	175,000	Apportion in the ratio of step 3 values, but allowing for the depreciating nature of the buildings
7. Calculate the interest rate implicit in the lease	Freehold value		1,950,000		Work out the discount rate that, when applied to both the lease payments and the residual value, gives the present value of the leased asset See section 11
	Residual value		310,000		
	Minimum lease payments		155,700		
	Implicit interest rate		6.99%		

5 The value of the freehold interest

5.1 The value of the freehold interest is the *market value* of the property (land and buildings combined) as an investment, determined in the normal manner in accordance with **VPS 4 paragraph 1.2, Market value**.

5.2 Most leases will have been agreed as arm's length transactions, and therefore the *market value* of the asset at the inception of the lease can be readily determined. If a premium has been paid for a lease, this is to be included as part of the minimum lease payments. However, the valuer may consider that the *investment value* arising out of the lease is not the same as the *market value* (i.e. *fair value*) of the leased asset. If so, the valuer is advised to assess the true *fair value* of the asset so that the difference between the created *investment value*, or actual sale price, and the underlying *fair value* can be accounted for separately in the accounts. This might occur when, for example, there is a clear case of a *special purchaser* or through a sale and leaseback transaction that is known to be at a non-*market rent*.

5.3 This is borne out by the particular rules that apply to sale and leasebacks (IAS 17, paragraphs 58 to 66). Clearly these allow for the possibility that the money paid by the investor/lessee under a sale and leaseback may be in excess of the normal *market value* of the leased asset. In these cases, where there is a clear indication that a non-market price has been reached as a result of a sale and leaseback, the valuer will have to carry out the test outlined previously in paragraph 2.6(d). For this test, the valuer compares the sale and leaseback lease payments with the true *market value* of the asset, assuming a normal lease (having regard to the market at the time) and a *market rent*. When defining the difference between the sale and leaseback price and the true *market value*, the valuer might consider the following factors:

- **Yield**: sale and leasebacks may be arranged across a number of properties at the same time, giving the investor greater security by spreading the property risk. The yield may also be determined by the financial strength of the vendor/lessee. Either of these factors might alter the price paid above or below the true underlying asset value, especially if the price paid is an apportionment of a larger transaction. The valuer should apply a market yield having regard to the normal covenant expected for properties of a similar nature.
- **Rent**: the rent paid under a sale and leaseback transaction might be related to affordability rather than current *market rents*. The *market rent* is to be used when estimating the true *market value* of the asset.
- **Lease terms**: if the lease term is unusually long, or other covenants have been written into the lease that would not be considered normal in the marketplace and which have affected the price paid, then the price paid may need adjustment to reflect 'normal' lease terms in the prevailing market. For example, there might be a rent escalator provision linked to a financial index as opposed to *market rents*.
- **Lease incentives**: the *investment value* of a property at the inception of the lease might be affected by a rent-free period or other incentives that have been granted to the lessor. Such provisions would not usually apply to a sale and leaseback transaction, meaning the price paid might be raised.

5.4 The valuer needs to be sure that any atypical lease terms that have been identified have affected the price paid. Otherwise, there is no need to use an

alternative *market value* in the test outlined in paragraph 2.6(d). While the 'true' *market value* is required for lease classification, once the lease is classified this value is only used again if the lease is an operating lease. If a finance lease results, then the asset is not deemed to have changed hands and any excess amount of the sale proceeds over the carrying amount of the asset is deferred and amortised over the period of the lease (IAS 17, paragraph 59). Under an operating lease, any amounts above or below *fair value* (as opposed to carrying amount) have to be identified because these are treated separately in the accounts.

6 Residual value

6.1 The residual value of the property (the land and buildings combined) for the purposes of lease classification can be estimated using the freehold value of the property in the condition anticipated at the end of the lease term, but in the market prevalent at the inception of the lease, and then deferring this over the term certain of the lease. This will be the shorter of the lease term or the period to the first break (unless it is reasonably certain the break will not be exercised).

6.2 The suggested means of doing this is to apply the single rate years purchase (YP) for the lease term at the valuation yield to the minimum lease payments (usually the current rent payable), and deduct this from the freehold value. Mathematically what is left will be the part of the freehold value that is not dependent on the contractual rents payable under the lease.

6.3 Care is required if the current buildings are known to be a sub-optimum use of the land, so that the land reversion is inflated by the expectation of redevelopment. The valuer should make sure that all of this element of value is included in the residual, thus diminishing the value within the lease. These circumstances are unlikely at the inception of the lease and, in any event, suggest that the buildings will be held under a finance lease (see Example 8 in section 13).

6.4 Normally this residual value is split between the land and buildings elements at this stage, as shown in Table 2 (see paragraph 4.8). The lessor of a finance lease of buildings will show in its balance sheet a financial asset equal to the net investment in the lease (the discounted value of the lease payments plus the unguaranteed residual value). The land and buildings components of the residual value will therefore appear as different assets, and the valuer must distinguish between them accordingly. This apportionment is also required in order to calculate the interest rate implicit in the lease for the buildings element.

6.5 This apportionment could be done in one of two ways. The first is to estimate the remaining economic life of the buildings at the end of the lease term, and then apply this as a ratio to the current *depreciated replacement cost (DRC)*. This is a simple and robust method that can be easily understood by the reader of the valuer's report. An alternative is to estimate what the building might be worth if it was already at the age and in the condition expected at the end of the lease, but using the market conditions as at the lease inception date. For example, if the lease of a new property was for 40 years, the value of a comparable 40-year-old building today and the redevelopment value should be considered. Any margin between those two elements would become the residual value of the buildings.

7 Apportioning the values between land and buildings

7.1 All calculations are carried out as at the inception of the lease, as defined previously in section 3, Definitions.

7.2 The apportionment can be done by finding the value of the land and treating the remaining value as attributable to the buildings, or vice versa.

7.3 If the buildings are valued as the remainder after deducting the known value or a development appraisal (see paragraph 7.4) of the land, this presents few problems for the valuer. Frequently, however, evidence of land values is not available, but the situation will vary depending on local market practice and conditions.

7.4 If a development appraisal of the land is carried out using the existing development, in effect the calculation is the same as using the *DRC* of the buildings (see paragraphs 7.6 to 7.9). If the freehold value would be affected by a different development in highest and best use, this development value could be used provided it is treated only as part of the residual value (see paragraph 6.3). Again, the same result might be obtained more easily by taking the current development cost of the buildings and depreciating it heavily to reflect the expected redevelopment at the end of the lease term.

7.5 If the buildings have to be valued, this is usually done based on their *DRC*, which is not the same as the fire insurance reinstatement cost. Instead, the value required represents the remaining utility value of the buildings, having regard to their age and condition at the inception of the lease and current construction techniques, not simply their reinstatement cost. However, the initial stage of the process is similar.

7.6 The valuer first estimates the gross rebuilding cost of the buildings. As the valuer is concerned with value and utility rather than reinstatement, the costs should be for a modern equivalent structure of the same utility, rather than the reproduction costs. The value should take into account factors that add to the prestige and attractiveness of the building and therefore its value, but not necessarily seek to reproduce every feature in a like-for-like manner.

7.7 Professional and carrying (finance) costs should be added to the building costs and any non-recoverable tax. This is because these costs would have to be incurred when constructing the buildings and the value of these costs is lost once the building reaches the end of its economic life. They therefore attach to, and depreciate with, the buildings. Costs that need to be considered include:

- professional fees
- developer's profit (see paragraph 7.8)
- interest charges
- VAT and
- acquisition costs.

7.8 The developer's profit is judgmental. It is believed that this item should be allowed for if, under the normal scheme of procurement for the asset, this cost would be incurred in the market at the inception of the lease. For example, if the asset is the supermarket unit in a shopping centre, it is not possible to construct this unit except as part of a larger scheme. This would involve a developer who would need a

return. In contrast, an owner-occupied and self-constructed building on leased land might not involve any *third party* developer. However, even in this situation there may have been internal costs that should be correctly capitalised to arrive at the true cost of procuring the building.

7.9 The gross building costs then need to be depreciated having regard to the situation and condition of the buildings at the inception of the lease. This should also reflect the difference between the modern equivalent building that has been costed and the remaining utility of the existing structures. A new building might not require any depreciation, while older buildings are usually depreciated having regard to their original estimated economic life, adjusted for maintenance and repairs, compared with their estimated remaining economic life.

8 Land and buildings residual values

8.1 This is the part of the process that is most likely to cause difficulties for valuers and their clients.

8.2 It might be assumed that if a direct valuation of the land is used, the same value could be used as the end of lease value and discounted to the inception of the lease. In practice, this is unlikely to produce the right figure because the yield rates used in valuations are growth implicit, and most of that growth will apply to the land, not the buildings. Therefore, at the end of the lease the land will have a value that reflects the then optimum development of the site, involving issues such as technological development, changing tenant requirements and revised planning restrictions. It is impossible to predict these changes, and so mathematically there is a good reason to adopt a lower discount rate for the land element if the current land value is used to calculate the residual value of the land at lease expiry, as compared with the buildings. Implicitly, the discount rate on the land would be lower than the valuation yield for the whole property. The difficulty is that there is unlikely to be any objective basis by which this revised discount rate can be calculated.

8.3 It is therefore simpler to estimate the residual value of the buildings by applying a depreciation adjustment to the value of the buildings at the inception of the lease, than to estimate the land residual value. While it might not be clear how long the economic life of the buildings might be, at least a reasoned estimate can be made, thus making the adopted figure more transparent and reliable.

8.4 The buildings residual value (in current market prices, as required by IAS 17) can be estimated using a straight-line deprecation over the expected economic life, and applying a depreciation factor proportionately to the relative durations of the lease term and the economic life. Alternatively, if the current value of an older building is known, the amount of depreciation can be calculated if it is assumed that all of the fall in value as the building ages should be attributed to the buildings.

8.5 In section 13, Examples 2 and 3 show how these calculations might be carried out.

9 Minimum lease payments

9.1 Minimum lease payments include only those rent payments that can be quantified absolutely at the inception of the lease, as well as any premiums or capital sums payable as part of the agreement.

9.2 Any increase in the rent payable following a review to market rental value is a contingent element and not included in the minimum lease payments. If the rent cannot reduce on review, then the initial rent is included until the end of the lease term or earlier expected date of determination. If there is an upward or downward review, then the entire rent after the review date is treated as contingent and is not included in the minimum lease payments. In practice, a lease with regular upward or downward rent reviews cannot be a finance lease because the lessor retains the risk of rental value changes. Minimum lease payments would not extend beyond a break clause unless it was reasonably certain the break would not be exercised.

10 Apportioning the minimum lease payments

10.1 IAS 17 states that 'the minimum lease payments … are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and the buildings element' (paragraph 16). The allocation of the minimum lease payments, simply by reference to the relative *fair values* of the land and buildings, would not reflect the fact that land often has an indefinite economic life and therefore would be expected to maintain its value beyond the lease term.

10.2 In contrast, the future economic benefits of a building are likely to be used up, at least to some extent, over the lease term. Therefore, it would be reasonable to expect that the lease payments relating to the building would be set at a level that would enable the lessor not only to make a return on initial investment, but also to recoup the value of the building used up over the term of the lease. IAS 17 confirms that the allocation of the minimum lease payments should be weighted to reflect their role in compensating the lessor, and not mechanically by reference to the relative *fair values* of the land and buildings (see IAS 17, 'Basis for Conclusions', BC9 to BC11).

10.3 The simplest way of achieving this weighted allocation of the minimum lease payments is to apportion the rent. This should not be done by reference to the freehold relativity of the land and buildings values, but by the ratio of the values within the lease. As the net present value of the buildings residual value has been reduced by applying a depreciation factor before discounting it, the result is that the buildings element in the lease has been increased, as compared with the proportion of the freehold value attributed to the buildings. Therefore, applying the leasehold value apportionment to the rent produces a realistic weighting to reflect the depreciating nature of the buildings.

10.4 Alternatively, the rent could be apportioned simply by reference to the ratio of the freehold values of the land and buildings, and then adding a sinking fund element to the buildings allocation that would explicitly allow for the wasting nature of the leased buildings. The term used would be to the expected lease termination date (either the full term or an earlier break date, if this is expected to be exercised). The sinking fund would be calculated to replace that element of the buildings value used up during the lease term. This would be the difference between the buildings freehold value at the inception of the lease and the undiscounted residual (reversion) value at the end of the term.

11 Discount rate (interest rate implicit in the lease)

11.1 The implicit interest rate can be calculated using discounted cash flow (DCF) techniques or by a formula in spreadsheet applications. The discount rate needs to be applied to both the minimum lease payments allocated to the buildings and the buildings residual value, such that the net present value of both elements equals the freehold value of the buildings at the inception of the lease.

11.2 IAS 17, paragraph 16, implies that the interest rate implicit in the lease (or the lessee's incremental borrowing rate) can be applied to the allocated minimum lease payments to test whether the net present value equates to 'substantially all' of the *fair value* of the leased asset. These calculations reveal a certain circularity in the lease classification process because for leases of land and buildings (unless the lessee's incremental borrowing rate is used), the interest rate will depend on the prior calculation of the residual value.

11.3 For high land value locations, such as a high street, the minimum lease payments could possibly equate to the freehold value of the buildings over relatively short terms, if a high enough proportion of the payments is allocated to the buildings (see Example 5 in section 13). In these situations, it is worth considering the payments apportioned to the land element to decide whether they, in fact, give a realistic return on the land element. If the land return is similar to the buildings return (see Examples 4 and 6 in section 13), then it is more likely that the buildings should be classified as held under a finance lease.

11.4 Once all the aforementioned values have been obtained, the company will decide on the lease classification and, if a finance lease is determined, on the allocation of the rent between the interest charge (in the profit and loss account) and the payment for the leased asset.

12 Listed buildings

12.1 UK planning law dictates that certain buildings are protected from development or substantial alteration through having a historic or architectural significance. There is a presumption in law that these buildings will be maintained and will effectively have an indefinite economic life. However, there are circumstances under which redevelopment is permitted.

12.2 Certain listed buildings (those of the greatest importance) can be treated as if they will never be redeveloped, and therefore a lease of such buildings, or part of them, will qualify as an operating lease. This applies for the same reason that the land element is usually an operating lease: the lease term is a temporary arrangement when compared with the economic life of the building.

12.3 Even when the listed building is considered not to be of particular importance, such that at least a partial redevelopment might be envisaged at some time in the future, it would be appropriate to assume a long remaining economic life at the inception of the lease that is at least the length of a new modern building. Only longer lease terms would pass the economic life test in paragraph 2.6(c).

12.4 When calculating the construction cost of listed buildings, the valuer should take into account the features of the building that gave rise to its listed status and

presume that those features and the materials used would have to be identical to the existing structure. It would not be appropriate to cost a modern equivalent building with the same utility. The depreciation factor applied will need careful consideration, and guidance can be found in UKGN 2, Depreciated replacement cost method of valuation for financial reporting.

12.5 Listed buildings where the features that gave rise to the listing are relatively unimportant in relation to the building as a whole (for example, the facade or certain rooms within the structure) are often redeveloped around these features. In these cases, it may not be appropriate to make significant changes to the lease classification considerations because the building is listed, especially if development work has already been carried out on the structure.

13 Examples

13.1 The following examples are intended to illustrate how the calculations might be performed and to address difficulties that might arise. All calculations for these examples are given together at the end of this *guidance note*.

13.2 Example 1

13.2.1 This is a provincial office building that is newly constructed and let under a 20-year upwards only, full repairing and insuring (FRI) lease. It was leased at £175,000 per annum with no rent-free period. The rent has been treated as the expected market rental value, and therefore the freehold value is calculated at £2.5 million using a standard YP approach. The buildings have an estimated rebuilding cost of £1,950,000, which includes fees and profit. While there is little doubt that this is not a finance lease under the economic life test, this example serves to illustrate the judgments that the valuer will be required to make.

13.2.2 In this example it is assumed that there are no readily available comparables that give a direct land value for the analysis, so the *DRC* of the buildings has been used to apportion the value between the land and buildings.

13.2.3 The building costs include fees, unrecoverable VAT and the developer's profit. It is considered normal in the particular location for this property for developers or property companies to carry out developments and then sell them into the market. Although a company could self-develop a property, it is most unlikely for them to do this unless they have a particular property expertise. In that event, it might be appropriate to consider capitalising internal costs such as managers' time, so the final figure might not be very different.

13.2.4 The residual value of the buildings at the end of the lease term has been estimated using simple straight-line depreciation.

13.2.5 The results show that even though the lease term is only for 20 years, 84% of the present value of the buildings element is included in the value of the lease. Using undiscounted values, this figure falls to 40%, reflecting the 30 years of continued economic life after expiry of the lease term anticipated at the inception of the lease.

13.2.6 The rent has then been apportioned in the same ratio as the land and buildings values under the lease, with 89% of the rent allocated to the buildings.

When compared with the freehold values, this gives a return of 8% on the freehold value of the buildings, but only 3.5% on the land. The discrepancy and relatively low returns again suggest this is an operating lease.

13.2.7 The interest rate implicit in the lease has been calculated to be exactly the same as the property yield (7%). This is as expected, because the calculations have all been predicated on the yield and no external adjustments (such as applying a known land value) have been made.

13.2.8 The alternative calculation shows the effect of using the freehold relativities for the rent apportionment, and then applying a sinking fund to recover the buildings value consumed over the term of the lease (£770,000). The calculations do not give quite the same figure, as the freehold analysis inevitably applies a higher land value and the calculation is sensitive to the sinking fund accrual rate. The discrepancy between the two approaches diminishes for longer lease terms (see Examples 4 and 6).

13.3 Example 2

13.3.1 This example is exactly the same as Example 1, but with the residual value taken from market evidence of the value of older buildings. The difference between the value of the new property and the 20-year-old property is £830,000. For the sake of simplicity, it is assumed that this entire diminution applies to the buildings. Therefore if the cost of construction today is £1,950,000 (including fees, profit and interest), then the value of the 20-year-old building will be £1,120,000 at today's prices. The rest of the calculation is much the same as for Example 1.

13.4 Example 3

13.4.1 Again, this is very similar to Example 1, but with a known land value applied to calculate the buildings value at the inception of the lease. Therefore, there is no need to calculate the building costs, but the residual value of the land and buildings is still most easily calculated by applying a depreciation factor to the buildings value. The alternative is to use the estimated land value at the end of the lease term and discount this. However, this calculation is difficult because investments in land are purchased in the expectation of capital value growth in the land over the lease term. Therefore, either a rate of growth has to be assumed in the land value over the lease term, or the discount rate has to be reduced to reflect this. This leads to subjective adjustments that are best avoided.

13.5 Example 4

13.5.1 This is the same as Example 1, but with a much longer lease term. The rental return on the lease values is much higher than in Example 1 (especially on the land) and much closer to the implied return on the freehold values, but the interest rate implicit in the lease has not changed.

13.5.2 This example might be considered to create a finance lease on the buildings element because of the length of the lease term. However, if the lessee's increment borrowing rate is applied and is higher than 7%, then the allocated minimum lease payments would not equate to 'substantially all' of the *fair value* of the buildings.

13.6 Example 5

13.6.1 This property is a high street shop, where the buildings cost is relatively low compared to the value of the freehold land and buildings. The relative returns on the land and buildings are similar to Example 4, despite the lease term being only 20 years. Mathematically, therefore, the value test in paragraph 2.6(d) will be 'passed' much earlier than for properties with a lower relative land value, leading to the possibility of a finance lease with shorter lease terms.

13.7 Example 6

13.7.1 This is the same as Example 5, but with a longer lease term. The implicit interest rate is again unchanged, but the return on the land and buildings elements has converged, as with Example 4.

13.8 Example 7

13.8.1 This is a detached restaurant in an edge-of-town retail and leisure park. It is a simple single-storey structure that can be built cheaply, but uncertainty over future rental movements means that the lessee has agreed to a compounded fixed rent escalator of 3.5% per annum.

13.8.2 As this is a fixed rent increase, these additional payments form part of the minimum lease payments for classification analysis. This has two notable effects:

- the interest rate implicit in the lease is much higher than in the earlier examples, which is a strong indication that the buildings lease could be classified as a finance lease
- the interest charges are implicitly higher than the rent payable for the early years of occupation.

13.8.3 This is an example of an atypical lease structure, which means the lessee does assume the risk of variations in the value of the leased asset. The rent does not change if the value of the property changes over the lease term. Therefore, provided the lease term is long enough, a finance lease is indicated for the buildings.

13.9 Example 8

13.9.1 This example is for an older industrial property already midway through its expected economic life and let for 20 years at £50,000. The rebuilding cost is similar to the current value of the building, but after allowing for depreciation at 50%, there is still a significant value on the land.

13.9.2 The remaining estimated economic life of the building at the inception of the lease is equal to the lease term, even though it is only for 20 years. The values and implicit interest rates also suggest that a finance lease has been created for the buildings. While this might appear illogical for an FRI lease, the original lessor and lessee are anticipating (at the inception of the lease) that the buildings will be redeveloped at the end of the lease term. Even though this might not happen, it would be reasonable to assume that the lessor is not relying on the buildings element having a significant residual value.

Example 1: DRC on buildings cost, using expected life of buildings

Description Detached office building in provincial town

Tenure	Lease date	21-Jan-00	*inception of the lease*
	Term commencement	21-Oct-99	
	Term	20.00	years
	Lease expiry date	21-Oct-19	
	Rent review date(s)	21-Oct-04	and every 5 years
	Basis of rent review	Market Rent	
	Rent passing	£175,000	
	Effective term	19.75	years
Valuation	Rent passing	175,000	
	Yield	7.00%	
	Years purchase	14.29	
		2,500,000	(rounded)

Usually at this stage, purchaser's costs would be deducted to arrive at a 'price' in exchange.
However, as 'fair value' includes these costs, this step can be omitted.

Residual Value	Freehold Value	2,500,000	
	Value within the Lease	(1,843,000)	The PV of £175,000 pa for 19.75 years, at 7%
	The residual value	657,000	for both land and buildings

Depreciated Replacement Cost of Building (used when no land values are available)

Gross internal area		1,050.00	
Effective value construction cost		1,200.00	£/m²
Building cost		1,260,000	
Add fees	12.50%	158,000	
Developer's profit	20.00%	284,000	
Acquisition fees	2.00%	34,000	
Capitalised interest	7.5% for 6 months	65,000	
Non-recoverable VAT		151,900	
Total Building cost (rounded)		1,950,000	
Depreciation		0.00%	assuming new building
Effective value of buildings		1,950,000	

Calculation of Buildings Residual Value (using interest rate implicit in the lease)

Depreciated Replacement Cost		
Current construction cost (as above)	1,950,000	
Remaining economic life	49.75	years, being 50 years from completion
Less lease term	(19.75)	
Remaining life at end of lease	30.00	
Buildings residual value (straight line approach)	1,180,000	being £1,950,000 x (30/49.75)
Present value multiplier at IR implicit in lease	0.2632	rounded 6.9932% for 19.75 years
Present value of buildings residual value, say	310,000	
Value under the lease	1,640,000	being £1,950,000 less £310,000
residual value as % of total	*15.90%*	*using net present value*
	60.51%	*using undiscounted figures*

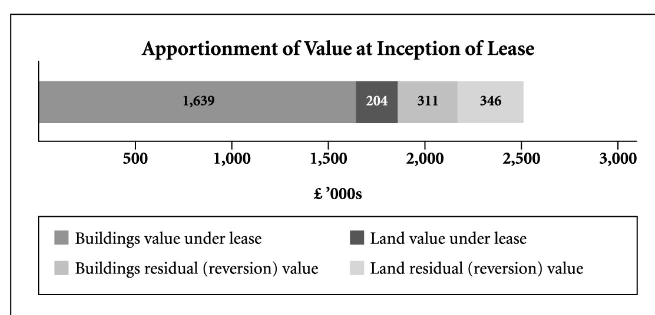
	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	1,640,000	88.99%	155,700	7.98%
Land element	203,000	11.01%	19,300	3.51%
	1,843,000		175,000	

Implicit interest rate (buildings lease) **6.9990%**

Example 1: DRC on buildings cost, using expected life of buildings (continued)

Breakdown of Net Present Values

Buildings value under lease	1,640,000
Land value under lease	203,000
Buildings residual (reversion) value	310,000
Land residual (reversion) value	347,000
	2,500,000



Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	1,950,000	
Undiscounted buildings value at end of term	(1,180,000)	
Buildings value consumed during term	770,000	39.49%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	26,300	

	Fair Value of Leasehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	1,950,000	136,500	116,000	7.30%
Buildings sinking fund			26,300	
Land element	550,000	38,500	32,700	5.95%
	2,500,000	175,000	175,000	
Implicit interest rate (buildings lease)			**6.2270%**	

Table of Components

	Total	Land	Buildings
Value of Whole Leased Asset (including costs)	2,500,000	550,000	1,950,000
LESS Residual Value	(657,000)	(347,000)	(310,000)
Value of the Lease Elements	1,843,000	203,000	1,640,000
Rent allocation, using values within the lease	175,000	19,400	155,700
Interest Rate Implicit in the Buildings Lease			7.00%
Rental allocation, using FH values with sinking fund	175,000	32,700	116,000
Buildings sinking fund			26,300
			142,300
Interest Rate Implicit in the Buildings Lease			6.23%

Example 2: DRC on buildings cost, using evidence of value for older buildings

Description	Detached office building in provincial town		
Tenure	As per example 1		
Valuation	As per example 1	2,500,000	
Residual Value	As per example 1	657,000	

Value of Old Asset Today

Market rent	125,000	
Yield	7.50%	
	13.33	
	1,670,000	(rounded)
Diminution in Value	830,000	(assumed to be buildings)

Depreciated Replacement Cost of Building

As per Example 1	1,950,000	
LESS diminution in value of 20 year old building	(830,000)	
Effective value of building at end of lease	1,120,000	
Depreciation	42.56%	
Implied straight line life	46.99	years

Calculation of Buildings Residual Value (using interest rate implicit in the lease)

Depreciated Replacement Cost		
Current construction cost (as above)	1,950,000	
LESS diminution in value	(830,000)	
Buildings residual value	1,120,000	
PV multiplier at IR implicit in lease	0.2631	6.9933% for 19.75 years
Present value of buildings residual value	295,000	
Value under the lease	1,655,000	being £1,950,000 less £295,000

	Fair Value of Leasehold Assets	**Percentage Split**	**Rent Allocation**	**Income Rate of Return on FH Value**
Buildings element	1,655,000	89.80%	157,100	8.06%
Land element	188,000	10.20%	17,900	3.25%
	1,843,000		175,000	

Implicit interest rate (buildings lease) **6.9934%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value consumed during term	830,000	42.56%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	28,400	

	Fair Value of Freehold Assets	**Direct Rent Allocation**	**Include Sinking Fund**	**Income Rate of Return on FH Value**
Buildings element	1,950,000	136,500	114,300	7.32%
Buildings sinking fund			28,400	
Land element	550,000	38,500	32,300	5.87%
	2,500,000	175,000	175,000	

Implicit interest rate (buildings lease) **6.1553%**

Example 3: Using current land values

Description	Detached office building in provincial town		
Tenure	As per example 1		
Valuation	As per example 1	2,500,000	
Residual Value	As per example 1	657,000	
Land and Building Values			
	Land area	0.04	hectares
	Price	13,750,000	per hectare
		550,000	value of land within freehold
		1,950,000	value of buildings within freehold

Having derived the buildings element in the freehold value, the calculations proceed as per example 1 – Calculation of Buildings Residual Value

Example 4: Long lease with upwards only rent reviews

Description	Detached office building in provincial town		
Tenure	As per example 1		
	Rent passing	£175,000	
	but with an effective term of	44.75	years
Valuation	As per example 1	2,500,000	
Residual Value	Freehold Value	2,500,000	
	Value within the Lease	(2,379,000)	The PV of £175,000 pa for 44.75 years, at 7%
	The residual value	121,000	for both land and buildings

Depreciated Replacement Cost of Building (as before)

Effective value of buildings	1,950,000	as per example 1

Calculation of Buildings Residual Value

Current buildings value	1,950,000	
Remaining economic life	49.75	years, being 50 years from completion
Less lease term	(44.75)	
Remaining life at end of lease	5.00	
Buildings residual value (straight line approach)	200,000	being £1,950,000 x (5/49.75), rounded
PV multiplier at IR implicit in lease	0.0485	6.998% for 44.75 years
Present value of buildings residual value	10,000	
Value under the lease	1,940,000	being £1,950,000 less £10,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	1,940,000	81.55%	142,700	7.32%
Land element	439,000	18.45%	32,300	5.87%
	2,379,000		175,000	

Implicit interest rate (buildings lease) **6.9981%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	1,950,000	
Undiscounted buildings value at end of term	(200,000)	
Buildings value consumed during term	1,750,000	89.74%
Accumulation rate	4.00%	
Effective Term	44.75	
Sinking Fund (rounded)	14,600	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	1,950,000	136,500	125,100	7.16%
Buildings sinking fund			14,600	
Land element	550,000	38,500	35,300	6.42%
	2,500,000	175,000	175,000	

Implicit interest rate (buildings lease) **6.8277%**

Example 5: Retail unit on institutional lease

Description High street shop with upper parts in provincial town

Tenure	As per example 1, except		
	Rent passing	£100,000	
	Effective term still	19.75	years
Valuation	Rent passing	100,000	
	Yield	6.00%	
	Years purchase	16.67	
		1,670,000	(rounded)
Residual Value	Freehold Value	1,670,000	
	Value within the Lease	(1,139,000)	The PV of £100,000 pa for 19.75 years, at 6%
	The residual value	531,000	for both land and buildings

Depreciated Replacement Cost of Building

Gross internal area		400.00	
Effective value construction cost		1,000	£/m²
Building cost		400,000	
Add fees	12.50%	50,000	
Developer's profit	20.00%	90,000	
Acquisition fees	2.00%	11,000	
Capitalised interest	7.5% for 6 months	21,000	
Non-recoverable VAT		48,213	
Total Building cost (rounded)		620,000	
Depreciation		0.00%	assuming new building
Effective value of buildings		620,000	

Calculation of Buildings Residual Value

Current buildings value	620,000	
Remaining economic life, say	49.75	years, being 50 years from completion
Less lease term	(19.75)	
Remaining life at end of lease	30.00	
Buildings residual value	370,000	being £620,000 x (30/49.75), rounded.
PV multiplier at IR implicit value	0.3158	6.0106% for 19.75 years
Present value of buildings residual value	117,000	
Value under the lease	503,000	being £620,000 less £117,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	503,000	44.16%	44,200	7.13%
Land element	636,000	55.84%	55,800	5.31%
	1,139,000		100,000	

Implicit interest rate (buildings lease) **6.0106%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	620,000	
Undiscounted buildings value at end of term	(370,000)	
Buildings value consumed during term	250,000	40.32%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	8,500	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	620,000	37,126	34,000	6.85%
Buildings sinking fund			8,500	
Land element	1,050,000	62,874	57,500	5.48%
	1,670,000	100,000	100,000	

Implicit interest rate (buildings lease) **5.6990%**

Example 6: Retail unit on long lease

Description	High street shop with upper parts in provincial town		
Tenure	As per example 5		
	Rent passing	£100,000	
	but with and effective term of	44.75	years
Valuation	As per example 5	1,670,000	
Residual	Freehold Value	1,670,000	
Value	Value within the Lease	(1,544,000)	The PV of £100,000 pa for 44.75 years, at 6%,
	The residual value	126,000	rounded for both land and buildings

Depreciated Replacement Cost of Building

As per example 5	620,000	

Calculation of Buildings Residual Value

Current buildings value	620,000	
Remaining economic life	49.75	years
Less lease term	(44.75)	
Remaining life at end lease	5.00	
Buildings residual value	60,000	being £620,000 x (5/49.75),
PV multiplier at IR implicit in lease	0.0736	rounded 6.0047% for 44.75 years
Present value of buildings residual value	4,000	
Value under the lease	616,000	being £620,000 less £4,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	616,000	39.90%	39,900	6.44%
Land element	928,000	60.10%	60,100	5.72%
	1,544,000		100,000	

Implicit interest rate (buildings lease) **6.0048%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	620,000	
Undiscounted buildings value at end of term	(60,000)	
Buildings value consumed during term	560,000	90.32%
Accumulation rate	4.00%	
Effective Term	44.75	
Sinking Fund (rounded)	4,700	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	620,000	37,126	35,400	6.47%
Buildings sinking fund			4,700	
Land element	1,050,000	62,874	59,900	5.70%
	1,670,000	100,000	100,000	

Implicit interest rate (buildings lease) **6.0416%**

Example 7: Long lease with fixed uplifts

Description Detached single storey unit in retail park

Tenure	Lease date	21-Jan-00	inception of the lease
	Term commencement	21-Oct-99	
	Term	35.00	years
	Lease expiry date	21-Oct-34	
	Rent review date(s)	21-Oct-04	and every 5 years
	Basis of rent review	3.5% per annum	compounded
	Rent passing	£100,000	
	Effective term	34.75	years
Valuation	Rent passing	100,000	
	Yield	6.00%	
	Years purchase	16.67	
		1,670,000	(rounded)
Residual Value	Freehold Value	1,670,000	
	Value within the Lease	(1,447,000)	The PV of £100,000 pa for 34.75 years, at 6%
	The residual value	223,000	for both land and buildings

Average Contractual Rent (minimum lease payments)

Period	Rent	PV at 8.3321%	NPV
0.75	75,000	0.94	70,631
1.75	100,000	0.87	86,931
2.75	100,000	0.80	80,245
3.75	100,000	0.74	74,073
4.75	100,000	0.68	68,376
5.75	115,927	0.63	73,170
6.75	115.927	0.58	67,542
7.75	115,927	0.54	62,384
8.75	115,927	0.50	57,552
9.75	115,927	0.46	53,126
10.75	134,392	0.42	56,850
11.75	134,392	0.39	52,478
12.75	134,392	0.36	48,442
13.75	134,392	0.33	44,716
14.75	134,392	0.31	41,277
15.75	155,797	0.28	44,171
16.75	155,797	0.26	40,774
17.75	155,797	0.24	37,638
18.75	155,797	0.22	34,743
19.75	155,797	0.21	32,071
20.75	180,611	0.19	34,319
21.75	180,611	0.18	31,680
22.75	180,611	0.16	29,243
23.75	180,611	0.15	26,994
24.75	180,611	0.14	24,918
25.75	209,378	0.13	26,665
26.75	209,378	0.12	24,614
27.75	209,378	0.11	22,721
28.75	209,378	0.10	20,973
29.75	209,378	0.09	19,360
30.75	242,726	0.09	20,718
31.75	242,726	0.08	19,124
32.75	242,726	0.07	17,653
33.75	242,726	0.07	16,295
34.75	242,726	0.06	15,042
Average		0.3286	42,213
Implied rental equivalent			**128,469**

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Example 7: Long lease with fixed uplifts (continued)

Depreciated Replacement Cost of Building (used when no land values are available)

Gross internal area		750.00	
Effective value construction cost		800.00	£/m²
Building cost		600,000	
Add fees	12.50%	75,000	
Developer's profit	20.00%	135,000	
Acquisition fees	2.00%	16,000	
Capitalised interest	7.5% for 6 months	31,000	
Non-recoverable VAT		72,275	
Total building cost (rounded)		930,000	
Depreciation		0.00%	assuming a new building
Effective value of building		930,000	

Calculation of Buildings Residual Value (using interest rate implicit in the lease)

Depreciated Replacement Cost		
Current construction cost (as above)	930,000	
Remaining economic life	40.00	years
Less lease term	(34.75)	
Remaining life at end of lease	5.25	
Buildings residual value (straight line approach)	120,000	being £930,000 x (5.25/40),
Present value multiplier at IR implicit in lease	0.0620	rounded 8.332% for 34.75 years
Present value of buildings residual value, say	7,000	
Value under the lease	923,000	being £930,000 less £7,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	923,000	63.79%	81,947	8.81%
Land element	524,000	36.21%	46,522	6.29%
	1,447,000		128,469	

Implicit interest rate (buildings lease) **8.3321%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	930,000	
Undiscounted buildings value at end of term	(120,000)	
Buildings value consumed during term	810,000	87.10%
Accumulation rate	4.00%	
Effective Term	34.75	
Sinking Fund (rounded)	11,100	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	930,000	71,543	65,400	8.23%
Buildings sinking fund			11,100	
Land element	740,000	56,926	51,969	7.02%
	1,670,000	128,469	128,469	

Implicit interest rate (buildings lease) **7.6711%**

Example 8: Old industrial building

Description Ageing single storey industrial unit

Tenure	Lease terms as per example 1		
	Rent passing	£50,000	
	Effective term	19.75	years
Valuation	Rent passing	50,000	
	Yield	8.00%	
	Years purchase	12.50	
		630,000	(rounded)
Value from above		630,000	
	Value within the Lease	(488,000)	The PV of £50,000 pa for 19.75 years, at 8%
	The residual value	142,000	for both land and buildings

Depreciated Replacement Cost of Buildings

Gross internal area		1,000.00	
Effective value construction cost		350.00	£/m²
Building cost		350,000	
Add fees	12.50%	44,000	
Developer's profit	20.00%	79,000	
Acquisition fees	2.00%	9,000	
Capitalised interest	7.5% for 6 months	18,000	
Non-recoverable VAT		42,175	
Total building cost (rounded)		540,000	
Depreciation		50.00%	
Effective value of building		270,000	

Calculation of Buildings Residual Value

Current buildings value	270,000	
Remaining economic life	25.00	years, being 50 years from completion
Less lease term	(19.75)	
Remaining life at end of lease	5.25	
Buildings residual value	60,000	being £270,000 x (5.25/25),
PV multiplier at IR implicit in lease	0.2188	rounded 7.9985% for 19.75 years
Present value of buildings residual value	13,000	
Value under the lease	257,000	being £270,000 less £13,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	257,000	52.66%	26,300	9.74%
Land element	231,000	47.34%	23,700	6.58%
	488,000		50,000	

Implicit interest rate (buildings lease) **7.9986%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	270,000	
Undiscounted buildings value at end of term	(60,000)	
Buildings value consumed during term	210,000	77.78%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	7,200	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	270,000	21,429	18,300	6.78%
Buildings sinking fund			7,200	
Land element	360,000	28,571	24,500	6.81%
	630,000	50,000	50,000	

Implicit interest rate (buildings lease) **7.6313%**

RICS UK guidance notes

UKGN 2 Depreciated replacement cost method of valuation for financial reporting

1 Introduction

1.1 The purpose of this *guidance note* is to provide information on the use of the *depreciated replacement cost (DRC)* approach. The '*cost approach*' and *DRC* are regarded as synonymous terms; both are in common use around the world to describe a method of valuation of all types of assets. This *guidance note* also highlights the reporting requirements outlined in these *valuation standards* that are particularly relevant when the *DRC* method has been used.

1.2 It is important to understand that the word 'depreciation' is used in a different context for valuation than for financial reporting. In a *DRC* valuation, 'depreciation' refers to the reduction, or writing down, of the cost of a modern equivalent asset to reflect the obsolescence and relative disabilities affecting the actual asset. In financial reporting, 'depreciation' accounting refers to a charge made against an entity's income to reflect the consumption of an asset over a particular accounting period. These are distinct usages of the word, and there is no direct correlation between the methods used to assess depreciation in each case.

1.3 The intention of this guidance is to provide guidelines that better ensure:

- client involvement and understanding
- that valuations are appropriate to the needs of both public and private sector clients
- transparency and
- year-on-year consistency in asset valuation approach, including where there is a change of valuer.

1.4 Section 13 contains a list that will assist the valuer in checking that all the matters to be considered within this guidance have been addressed.

1.5 Where *DRC* is used for valuations in the public sector, there may be specific requirements within the rules governing those valuations that amend specific parts of this guidance, for instance, the date at which the building is assumed to be available. Such specific requirements take precedence over this *guidance note*.

2 Definition of depreciated replacement cost

2.1 There are three principal valuation approaches that are generally recognised internationally:

- direct market comparison
- *income approach* and
- *cost approach*.

These approaches may all be used to assess different *bases of value*, including *market value*.

2.2 This *guidance note* focuses on the use of *DRC* to derive *market value*. When used to assess *market value* the objective is to establish the price that would be paid between a willing buyer and willing seller acting at arm's length. Therefore when considering comparative costs and depreciation adjustments, the valuer must have regard to the evidence of the market (in so far as is practicable), not only the circumstances of the current owner.

2.3 *DRC* is a form of *cost approach* that is defined in the Glossary as:

> the current cost of replacing an asset with its modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation.

2.4 The *DRC* approach is based on the economic theory of substitution. Like the other valuation approaches listed in paragraph 2.1, it involves comparing the asset being valued with another. However, *DRC* is normally used in situations where there is no directly comparable alternative. The comparison therefore has to be made with a hypothetical substitute, also described as the modern equivalent asset. The underlying theory is that the potential buyer (described in the *market value* definition) in the exchange would not pay any more to acquire the asset being valued than the cost of acquiring an equivalent new one. The technique involves assessing all the costs of providing a modern equivalent asset using pricing at the *valuation date*.

2.5 In order to assess the price that the buyer would bid for the actual asset, depreciation adjustments have to be made to the gross replacement cost to reflect the differences between it and the modern equivalent. These differences can reflect factors such as the comparative age or remaining economic life, the comparative running costs and the comparative efficiency and functionality of the actual asset.

2.6 This *guidance note* discusses factors that may need to be taken into account in assessing both the cost of a modern equivalent asset and the depreciation adjustments applied to the actual asset.

3 When depreciated replacement cost is used

3.1 *DRC* is used where there is no active market for the asset being valued – that is, where there is no useful or relevant evidence of recent sales transactions due to the specialised nature of the asset.

3.2 Although the *DRC* method may be used for the valuation of different types of specialised asset, particular complications arise when applying the *DRC* method to *specialised property*, which is defined in the Glossary 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.

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 is no relevant or reliable evidence of sales involving similar property.

3.3 However, *DRC* is often referred to as a method of last resort and is only to be relied on if it is impractical to produce a reliable valuation using other methods. The classification of an asset as specialised should not automatically lead to the conclusion that a *DRC* valuation must be adopted. If sufficient direct market evidence exists, it still may be possible to undertake a valuation of the *specialised property* using the sales comparison and/or the income capitalisation approach.

3.4 For certain types of specialised asset that are associated with an identifiable and dedicated cash flow, the income (or 'profits test') approach may be more appropriate. The use of *DRC* may not be preferred but may be used as a cross-check to establish whether the return on capital is realistic.

3.5 The market for assets will change over time. Assets that might previously have been classified as having no market may have an active market that has recently emerged. For example, within the healthcare and leisure sectors, evidence of market transactions is growing. Therefore, before adopting the *DRC* method the valuer will need to be satisfied that there are no transactions involving similar buildings in similar use that could provide sufficient evidence to use a sales comparison approach.

3.6 The value of a *specialised property* (or a specialised plant and equipment asset) is intrinsically linked to its use. If there is no demand in the market for the use for which the property is designed, then the specialised features will either be of no value or will have a detrimental effect on value as they represent an encumbrance. It is therefore important to establish the entity's intentions when valuing for inclusion in a *financial statement*. If the *specialised property* is not to be retained for the delivery of a product or service because there is no longer demand for it, it follows that the use of *DRC* would be inappropriate. No hypothetical buyer would consider procuring a modern equivalent asset if this would immediately be redundant. Such surplus property is valued having regard to its potential for alternative use, with due allowance for any costs associated in achieving that alternative use.

3.7 Some buildings (or specialised plant and equipment assets) 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 or extensive adaptations designed to meet the requirements of the actual occupier. Typical examples, which may be purpose built or adapted, include an office building with enhanced security features such as thickened walls, toughened glazing and extra stand-off land, or an industrial building with structural alterations to accommodate a particular production process.

3.8 Where the entity has significantly adapted an existing asset to its requirements, it may elect to treat the cost of specialised adaptations as a separate item in its *financial statements*. In such a case, the valuer would need to value the interest in the asset on the *special assumption* that the adaptations do not exist. If detrimental

to value it may also be appropriate to state that no account has been taken of the costs associated with their removal and reinstatement.

3.9 If the entity does not treat the costs of specialised adaptations separately, the latter will then be valued as part of the property interest. The valuer will have to decide whether the adaptations are sufficiently extensive for the property to meet the definition of a *specialised property*. The valuer will also have to decide whether there is no other reliable method of assessing the *market value* plus adaptation, before using the *DRC* method. In respect of *real property* this decision will reflect the market in the locality. In one location there may be sales evidence of other similarly adapted buildings, thus using the *DRC* method would be inappropriate. However, the same building in another location may properly be valued using the *DRC* method because there is no remotely comparable property bought and sold in that location.

3.10 The *DRC* method is not suitable for use in valuations of *real property* for loan security. This is due to the specialised nature of assets that are normally valued using *DRC*, and because the method assumes that there is a continuing demand for the use of the asset. Exceptionally, in rare cases, it may be used to support a valuation for loan security arrived at using a different approach.

4 Valuer qualifications

4.1 It is fundamental that *DRC* is recognised as a valuation to which the *valuation standards* apply, and not a cost estimation exercise. Each valuation to which the standards apply must be prepared by, or under the supervision of, an appropriately qualified valuer.

4.2 The valuer's task includes consideration of the key elements of a market transaction involving the specialised asset. The specialised knowledge required in order to properly undertake a *DRC* valuation includes:

- an understanding of the asset, its function and its environment
- knowledge of the specification that would be required for an equivalent asset in the current market, and the cost of acquiring or procuring that asset
- sufficient knowledge of the asset and its marketplace to determine the remaining physical and economic life of the asset and
- sufficient knowledge of the sector in question to assess functional, technical or economic obsolescence.

4.3 Although a single valuer may not have all the knowledge or skills required, the *valuation standards* accept that these can be met in aggregate by more than one valuer. **PS 2 paragraph 3, Member qualification**, requires that if the valuer proposes to employ another *firm* to provide valuation advice, as opposed to providing information to assist the valuer in preparing his or her own valuation, the client's approval must be obtained.

5 Settling the terms of engagement

5.1 The discussion of the *terms of engagement* provides an essential link between the valuer and the client that will help to establish whether the use of the *DRC* method is appropriate.

5.2 VPS 1, Minimum terms of engagement, stipulates certain matters that must be addressed by the *terms of engagement*. The following particular points may need more detailed attention:

- the subject of the valuation
- the interest to be valued
- the type of property and how it is used, or classified, by the client
- the extent of the valuer's investigations and
- the nature and source of information to be relied upon by the valuer.

5.3 If the asset is specialised it may be necessary to define what is to be included in the valuation. The identification of assets that are classified as part of the property interest and those that are classified as plant and equipment is often unclear in a *specialised property*. Many specialised assets comprise separately identifiable components, and the valuer will need to discuss with the client whether it is appropriate to value these as separate items, or to what degree it would be appropriate to regard them as aggregated into a single asset, and valued accordingly. The entity's accounting policies may influence this decision.

5.4 The valuer will need to establish how the entity uses the asset and confirm that there is an intention to continue that use. For a *specialised property* it may be necessary to establish the extent of the land occupied by the specialised improvements and distinguish this from land that is properly classified as either surplus or in conventional use.

5.5 With specialised assets the valuer may have to place greater reliance on information provided by the client, or its other advisers, than would be the case with more conventional assets. This information can include information of the cost, design features and performance of the asset. Since the asset is specialised it follows that detailed knowledge of these matters may be outside the knowledge and expertise that could normally be expected of a valuer in that sector. It may be important to discuss and agree the extent to which the valuer may rely on such information provided by the client or, if further specialist input is to be obtained by the valuer, the source and cost of that further advice.

5.6 Where the valuer has not provided an earlier valuation it is recommended that the client be asked to provide a copy of any previous report. The information in that report will enable the valuer to establish the approach taken and assist the client in reconciling any significant valuation differences that may arise.

5.7 It is essential that the valuer maintains accurate and comprehensive records of discussions with the client and the reasons for the conclusions reached.

6 Assessing replacement cost

6.1 The general principle is that the costs reflect those of a modern equivalent asset. Although the actual or estimated cost of reproducing the actual asset may be relevant in this assessment, there will be many cases, especially with old or obsolete assets, where this information is irrelevant.

6.2 The principle can be illustrated by considering the value of an item of machinery that is a few years old. If technological advances mean that the same output can

now be achieved with a smaller and more efficient machine, the actual machine would not be replaced. The modern equivalent is defined by its comparative performance and output, not its physical characteristics.

6.3 In assessing the cost of the replacement asset, due account has to be taken of all the costs that would be incurred by a potential buyer on the *valuation date*. These could include the costs of delivery, transportation, installation, commissioning and any unrecoverable duties or taxes. Quite often a specialised asset will have to be especially commissioned, so design and other fees may also be incurred.

6.4 When considering *specialised property*, the current gross replacement cost of the asset is assessed. This comprises the cost of replacing the land plus the cost of replacing the improvements to the land. For the latter, the approach is to assess the cost of their replacement with a modern equivalent and then make depreciation adjustments to reflect the differences between it and the actual asset when compared with a modern equivalent. Costs that may be expected to be incurred in replacing the asset include:

- setting up costs, where appropriate, such as planning fees and site preparation works
- professional fees related to the project
- a contingency allowance, if appropriate and
- finance costs, taking into account the likely pattern of payment.

Once the gross replacement cost has been derived, the depreciation factors are applied as a further and separate calculation.

6.5 The asset being valued may take a considerable period, often years, to replace. In assessing the replacement cost of the modern equivalent asset, based on current prices, the prospect for cost fluctuation and related issues that may occur over such a prolonged period may be taken into account.

7 The site value of a specialised property

7.1 Although the ultimate objective of the *DRC* method is to produce a valuation of the actual property in its actual location, the initial stage of estimating the gross replacement cost has to reflect the cost of a site suitable for a modern equivalent facility. Often this will be a site of a similar size and in a similar location to the actual site. However, if the actual site is clearly one that a prudent buyer would no longer consider appropriate because it would be commercially wasteful or would be an inappropriate use of resources, the modern equivalent site is assumed to have the appropriate characteristics. The fundamental principle is that the hypothetical buyer for a modern equivalent asset would purchase the least expensive site that would be suitable and appropriate for its proposed operations.

7.2 The property being valued may be located in a situation that would now be considered unnecessarily expensive. This may be due to changes in the way in which the service provided is delivered, or to changes in the market for the product it produces. An example could be a hospital that was originally constructed in the centre of a city that might now be better situated in the suburbs because of changes in the transport infrastructure or the migration of the population it served. Another

example could be where a specialised industrial facility was originally located close to a source of raw materials that are now imported, thus rendering the original location irrelevant.

7.3 Other factors need to be considered in addition to establishing the location of the modern equivalent site. The modern equivalent asset may not require a site as extensive as the actual site. In this respect land is no different to any other asset. If 2 hectares are now sufficient to provide the same service, the modern equivalent site will be 2 hectares, even if the actual site is 4 hectares.

7.4 There may also be geographical limitations on where the modern equivalent site might be located, imposed by physical or practical considerations. For example, a specialist industrial operation may require a site located next or close to a dock if material has to be imported by sea. A local authority may have an obligation to provide a service within a particular geographical locality, even though cheaper sites may be available elsewhere.

7.5 Sites of *specialised properties* often include areas of vacant land. This may be held for possible future expansion, as a safety or security cordon, or may simply be surplus. The valuer will need to enquire as to the purpose of any vacant land at the actual property in order to assess whether this would be a necessary feature of the notional replacement site. If not then it is not reflected in the *DRC* calculation, although its value would need to be considered separately. Surplus land is normally reported as a separate asset as it needs to be identified and treated separately in the *financial statements*.

7.6 Once the extent and location of the site that would be necessary to create the modern equivalent asset has been identified, the next step is to estimate what it would cost to acquire that site in the market at the *valuation date*. Because many *specialised properties* will be *sui generis* uses under planning legislation, there can be practical difficulties in determining from what planning use it is appropriate to draw the sales comparison. In the case of a specialised industrial property, it would usually be appropriate to assume that land with an industrial planning consent (or where such permission could be anticipated) would provide the best comparable evidence. Likewise for the site of a specialised administration building in a town centre, sites for office use would provide the most appropriate comparables.

7.7 The actual use of the property may be so specialised that it may be impossible to categorise it in general market terms. In such cases the valuer has to determine what other uses the property can offer to a buyer of an alternative site for the specialised use to make it competitive in the market. This may be a range of uses that prevail in the locality of the actual site, but for the reasons discussed earlier, this may not be appropriate if the modern equivalent site would be located elsewhere. In that case, it is the range of uses in that locality that would be considered.

7.8 In the public sector, particular issues can arise with *specialised property* that provides a service to a defined local community, such as schools, libraries and health centres. One characteristic of such property is that the service requirement may be attached to a tightly defined geographical area, which limits the availability of alternative sites.

7.9 The valuer may need to decide and agree with the entity on the possible locations for the current defined service requirement. This might mean competing against other users, but where land could be made available by using statutory

powers, this might indicate the appropriate approach to the valuation. The overriding objective is for the valuer to establish the lowest amount that a prudent purchaser would pay to acquire a site for an equivalent development in a relevant location at the *valuation date*.

7.10 A particular problem that arises with schools, within either the public or private sector, is when they have playing fields within the curtilage. This land will be considered separately from the land on which the buildings are constructed, as no prudent purchaser would buy land with consent for residential or commercial development for use as a playing field. The potential on the existing site is not relevant in the *DRC* calculation, as the purchaser of the equivalent asset would acquire land for which playing field use would be the only permitted form of development. There are many examples of schools, universities and private businesses that have their main facilities within a town, but have their associated playing fields in an out-of-town location that is outside the permitted development boundary.

7.11 In some circumstances the actual site may be leasehold. The consideration of the land value will therefore reflect the terms of the existing lease.

7.12 Incidental costs, such as fees and carrying costs, are restricted to those costs associated with the normal acquisition and development of land.

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

8.1 When valuing a *specialised property* it is often difficult to distinguish between what may be classified as a building or structure and what may be classified as plant. In the specialised industrial sector, many structures effectively only provide support and weather protection for process plant – if the plant was removed then the 'building' would not exist. In such cases there has to be discussion with the entity as to whether a distinction needs to be made between buildings and plant and, if so, what items fall under each heading.

8.2 Because of the diverse nature of the buildings, structures and plant that may form part of a *specialised property*, the term 'site improvement' refers to all additions to the land. These are buildings, structures or some modifications to land of a permanent nature, involving expenditures of labour and capital, and they are intended to enhance the value or utility of the property. Improvements have differing patterns of use and economic lives.

8.3 Site improvements will include all site works associated with the development, including services, fencing, paving and any other items of a permanent nature that support the specialised use. The following paragraphs provide guidance on calculating the cost of buildings and site improvements. Although they refer specifically to buildings, the same principles apply to all improvements.

8.4 In order to assess the cost of a modern equivalent building, the valuer needs first to establish the size and specification that the hypothetical buyer would ideally require at the *valuation date* in order to provide the same level of productive output or an equivalent service. If the actual building is old, it will usually be the case that a new building could be smaller but still provide the same level of service. For

example, a modern building will often be able to offer more efficient space, as it can provide open plan or clear span areas that have a greater capacity than an older building with fragmented accommodation and a poor net to gross floor area.

8.5 Having established the size of the notional building to be costed, the valuer may need to determine an appropriate specification for the building. It cannot be assumed that this would be the same as the actual building, especially if it is not new. The design and construction of a modern equivalent may differ from the existing building because features of the latter are now unsuitable or just irrelevant for the needs of the entity. In other cases, the existing materials may still be suitable but are simply unavailable, or only available at a cost that would be uneconomic. Care has to be taken to consider the service that is being provided within the building, and to price for a specification that would be compatible with the service potential of the subject building.

8.6 For example, the specification that would be appropriate for a high security government department (for example, a defence weapons establishment) will be different from that appropriate for a specialised, but not security-sensitive, use. Similarly the specification required for a general care, private sector hospital will be different from that for a specialised, high-dependency unit within public sector provision.

Historic buildings

8.7 Historic buildings can present particular valuation difficulties. The principle that the cost is based on a modern equivalent asset still applies, but there may be situations where the only way that a replacement asset could provide equivalent service potential would be if it reproduced the actual building. However, reproduction will be very rare. In most cases the fact that the entity currently occupies a historic building is incidental to the service provided and would be totally irrelevant when specifying a modern equivalent.

8.8 Only where the historic nature of the building itself creates an intrinsic part of the benefit or service potential of the asset would it be correct to reflect the cost of reproducing the actual asset in the cost of the modern equivalent. An example could be an art gallery housed in a building that itself is as important as the exhibits it contains in attracting visitors. Another example provided in International Public Sector Accounting Standard 17 (IPSAS 17, *Property, Plant, and Equipment*, paragraph 47), published by the International Federation of Accountants (IFAC), is of a parliament building that may be reproduced rather than replaced with an alternative because of its significance to the community. In cases where it would not be possible to reproduce the actual building, it may be appropriate to assess the cost of constructing a building with a similarly distinctive design and high specification.

8.9 Some historic or heritage assets may be impossible to replace because a modern reproduction could never recreate the historic significance of the asset. The decision of whether or not a historic asset is to be capitalised is a matter for the entity, although the valuer may be asked to comment upon the practicability or otherwise of valuing the asset.

Sources of cost information

8.10 Having determined the nature, size and specification of the modern equivalent building and all other necessary improvements, the cost of providing these may be assessed by reference to published building cost data. However, published construction price data may be of limited assistance where the replacement building or structure is highly specialised. Instead, the valuer may have to rely on actual costs involved in the creation of the current asset, or discuss with the entity the need to commission specialist cost advice.

8.11 If the valuer has access to the actual costs incurred in constructing the asset, those costs may need adjustment to reflect differences between these costs and those that would be incurred in constructing the modern equivalent.

8.12 The most obvious of these differences is the date on which the price is fixed. The cost of the modern equivalent will reflect the cost that would be incurred if the works were commissioned on the *valuation date*. Various cost indices are published for construction and engineering work that show typical historic price fluctuations, and they can be used to adjust historic cost data to the *valuation date*.

8.13 Other factors that may result in the cost of creating the actual asset to differ from that of a notional replacement include:

- **Site preparation**: work may have been undertaken to prepare the actual site for development that would not be necessary for the assumed equivalent site. For example, costs actually incurred in levelling a site or providing services to the site boundary may already be reflected in the cost of acquiring an equivalent site in the market if the available evidence was for level, serviced land.
- **Phasing of work**: a large site may have been developed in phases, whereas the cost of the modern equivalent reflects the cost that would be incurred in replacing the whole asset at the *valuation date* let as a single contract. This could create economies of scale and reduce contract overheads, for example, on preliminaries work.
- **Optimal working conditions**: if the cost of the equivalent site is based on a site that is assumed to be free of any difficulties or constraints on development, then any additional costs incurred because of abnormal conditions on the actual site are ignored.
- **Contract variations**: any additional costs incurred in constructing the actual building caused by design or specification changes during the progress of the contract are ignored.
- **Planning changes**: when the actual asset was constructed it may have had deemed planning consent. As the planning legislation has changed, the cost of obtaining consent for a modern equivalent may need to be taken into account.

Two other related factors are the additional cost of footings for heavy machinery (where specialised plant and equipment is required) and additional costs arising from extending an existing property.

8.14 Incidental costs, such as fees and carrying costs, are to be restricted to those costs associated with the assumed procurement of the building. Allowance for VAT is made only where this is an irrecoverable cost. Although it would not normally be

appropriate to make an addition to the cost to reflect developer's profit (because the purchaser is deemed to be procuring the building for owner occupation), it may be appropriate to add for management time if this were a significant cost that would be incurred in constructing a modern equivalent.

8.15 The entity may require the valuer to provide an estimate of the cost of components within the actual building for depreciation accounting as part of the valuation instruction (see paragraph 1.4). These costs are not to be confused with the cost of creating an equivalent component in the modern equivalent building, but are intended to reflect a realistic allocation of the end value attributed to the building in exactly the same way as if the asset had been valued using a sales comparison or *income approach*.

9 Assessing depreciation

9.1 Having established the replacement cost of a modern equivalent asset, it is then necessary to adjust or depreciate it to reflect differences between this modern equivalent and the actual asset being valued. The underlying principle is that the hypothetical buyer has the option of procuring either the modern equivalent or the actual asset. If the modern equivalent provides the ideal facility for the buyer, the price paid for the actual asset is expected to reflect all the disadvantages that it suffers in comparison.

9.2 Applying depreciation is primarily a process of replicating how the market would view the asset. Depreciation rates and estimates of the future economic life of an asset are influenced by market trends and/or the entity's intentions. The valuer is recommended to identify these trends and intentions, and to be capable of using them to support the depreciation rates applied. The application of *DRC* should replicate the deductive process of a potential buyer with a limited market for reference.

9.3 Three principal types of depreciation allowance, or obsolescence, may be identified as:

- physical deterioration
- functional obsolescence and
- external obsolescence.

Physical deterioration

9.4 This is the result of wear and tear over the years, which may be combined with a lack of maintenance. The valuer compares the decline in value of an asset of a similar age with the value of new assets in the same market.

9.5 The asset is valued in its existing condition, with the valuer fully taking into account any physical deterioration arising from a lack of maintenance or other causes, and the recognition that a lack of adequate maintenance can accelerate the rate of depreciation. Thus, depreciation caused by inadequate maintenance is to be reflected in the allowance made, just as a deduction for disrepair would be made from a valuation based on sales comparison. Physical deterioration is frequently measured by reference to the anticipated physical life of the asset.

9.6 The physical deterioration of the asset is to be viewed not in absolute terms, but within context. In some markets and for some types of asset, a degree of physical deterioration will not adversely affect the value, while in other cases it will. It would be inappropriate to determine the effect of physical deterioration on value depreciation only in purely mechanistic terms.

Functional obsolescence

9.7 Functional obsolescence arises where the design or specification of the asset no longer fulfils the function for which it was originally designed. An example would be a building that was designed with specific features to accommodate a process that is no longer carried out. In some cases functional obsolescence is absolute, i.e. the asset is no longer fit for purpose. In other cases the asset will still be capable of use, but at a lower level of efficiency than the modern equivalent, or may be capable of modification to bring it up to a current specification. The depreciation adjustment will reflect either the cost of upgrading or, if this is not possible, the financial consequences of the reduced efficiency compared with the modern equivalent.

9.8 Functional obsolescence may also arise because of advances in technology. A machine may be capable of replacement with a smaller, cheaper equivalent that provides a similar output, or a modern building may be more efficient because of superior insulation and modern services.

9.9 The modern equivalent asset may be cheaper to recreate than the current asset, and so the replacement cost already reflects that of an 'optimised' asset, thus making further adjustment under this heading unnecessary. An example would be where the modern equivalent reflects a smaller building because there is no need for it to reflect historic or redundant features that exist in the actual building. Further depreciation to account for these features would be double counting.

9.10 There will be situations where the asset being valued is too small, as technological advances now make it possible to achieve economies of scale. An example would be an aircraft terminal, designed to cater for a maximum number of passengers per plane, which is now too small to handle larger modern planes.

9.11 Another cause of functional obsolescence is legislative change. In the industrial sector an existing plant may be incapable of meeting current environmental regulations, or in some cases the product it was built to produce is now illegal. In the service sector, the need for occupiers to comply with current regulations on health and safety or disabled access may also give rise to differing degrees of functional obsolescence.

Economic obsolescence

9.12 This arises from the impact of changing economic conditions on the demand for goods or services produced by the asset. However, care has to be taken to distinguish these factors that are due to economic conditions, from factors that are specific to the entity. Any writing down of a valuation derived solely from the *DRC* approach to reflect the profitability of the business is a matter for the occupier.

9.13 A common example of economic obsolescence is where over-capacity in a particular market reduces the demand and therefore value for the actual asset, regardless of how modern or efficient it may be. In the industrial sector, falling

commodity prices have seen periods when excess market capacity has made the production of commodities such as oil or steel uneconomic. During such periods, this would have had a significant impact on the demand and therefore on the value of specialised facilities used to produce these products. In these particular examples, the cyclical nature of the markets might mean that a purchaser might be willing to buy and hold the facility in anticipation of a return to profitability, but the price would need to reflect the risks involved.

Measuring obsolescence

9.14 The three principal categories of obsolescence identified are not the only reasons why it may be necessary to adjust the cost of the modern equivalent asset in order to establish the value of the actual asset. Depreciation rates may be all encompassing or analysed separately. The three main headings simply illustrate common reasons for the actual asset being worth less than the modern equivalent. Frequently it will be not be possible to identify a separate adjustment under each category; in other cases, the distinction between the categories may be blurred. It is important to ensure that separate consideration of depreciation under each heading does not result in double counting.

9.15 There will be cases where obsolescence is total. Examples include:

- **Physical obsolescence**: if the cost of repairing, reconditioning or refurbishing the actual asset to render it useable has exceeded the cost of a modern equivalent, the asset would have no value.
- **Functional obsolescence**: the introduction of new technology may render obsolete a relatively new asset with an otherwise long anticipated life, with the result that there would be no demand for it other than any value for salvage or an alternative use.
- **Economic obsolescence**: if demand for the product or service provided by the asset has collapsed and is not expected to recover, there would be no demand for the asset other than for any salvage value or alternative use.

9.16 Total obsolescence is often clear from the outset of the instruction, and the asset in question is classified accordingly as surplus or redundant by the entity. However, if the valuer concludes that an asset is completely obsolete during the course of the valuation exercise, this matter should be discussed with the entity before proceeding, as reclassification as surplus will indicate that a different valuation approach is required.

9.17 It follows that the *DRC* method is normally used where obsolescence is only partial. Although the actual asset may not be in the same condition, as efficient or as technically advanced as a modern equivalent, it may still have a useful remaining life and will therefore have a value for that use. Assessing the remaining life of the asset is therefore an important aspect of the *DRC* method.

Asset life

9.18 The depreciation that will affect an asset when compared with its modern equivalent will depend on its anticipated remaining life. An asset that is expected to have a remaining life of 20 years will be worth a higher percentage of a new replacement than one with an expected life of five years. The remaining life can

depend on physical or economic factors, or a combination of both. The physical life is how long the asset could be used for any purpose, ignoring any potential for refurbishment or reconstruction. The economic life is how long a succession of owners could use the asset for its designed purpose. The remaining life for valuation purposes will be the lower of the physical life and economic life where these do not coincide.

9.19 The life of the asset (and its pattern of depreciation) determined as part of the *DRC* valuation is not necessarily based on the same criteria as the estimate of the 'useful life' or 'future useful economic life', or in the public sector 'service delivery lifespan' and attendant depreciation, which has to be determined by the entity for depreciation accounting (the latter two tasks are not to be confused).

9.20 In assessing the remaining life, it may be assumed that routine servicing and repairs are undertaken, but the possibility of materially extending the life of the asset by significant refurbishment or the replacement of components is disregarded.

9.21 For some classes of asset a regular pattern of depreciation can be determined over the whole life of an asset, although the value will reflect the remaining life available at the *valuation date*. Where this is the case, the percentage of the current replacement cost remaining at the *valuation date* may be estimated using a 'straight-line', 'reducing balance' or an 'S-curve' method. These are described in the following paragraphs.

9.22 It will be helpful to discuss with the client how the entity deals with depreciation in its *financial statements* and how the valuer's approach may differ.

Straight-line

9.23 The straight-line basis tends to be the most commonly adopted method for calculating depreciation of buildings because of its simplicity and relative ease of application. Straight-line depreciation assumes the same amount is allocated for depreciation for each year of the estimated life.

9.24 The weakness of this method is the very simplistic assumption of the uniform erosion of the asset's value over its total life, compared with the equivalent replacement asset. The assumption is clearly correct at two points in the life – the beginning and the end – but it would be entirely fortuitous if it were correct at any intermediate point, which is when a valuation is most likely to take place. However, this effect may be mitigated by frequent valuations.

Reducing balance

9.25 The reducing balance method of depreciation assumes a constant percentage rate of depreciation from the reducing base. The reduction of the balance at the end of each period by a fixed proportion of itself creates a sagging depreciating value curve over the life of the asset. This method effectively 'compounds' the total depreciation. This may match reasonable expectations of declining value over time better than the straight-line method.

S-curve

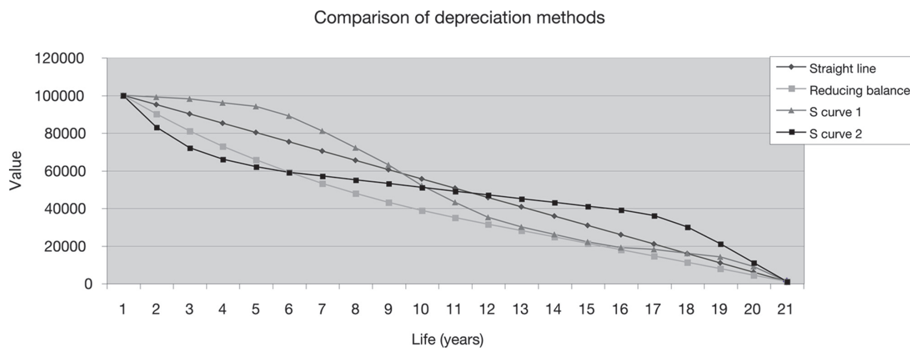
9.26 The S-curve is recommended where sufficient data is available for the valuer to be confident that the curve represents the likely reality. In some cases it presents

the most realistic representation of an asset's depreciation by assuming that depreciation is at a low rate in the early years, then accelerates in the middle years and reduces again in the final years. However, some assets, such as plant, may have a different depreciation pattern (high at first rather than low).

9.27 Although it is normally accepted that the S-curve realistically represents the pattern of depreciation over the life of most assets, the percentage for any given year will depend on decisions made as to the rates of depreciation at different times and when these change. In the absence of empirical evidence in support of these inputs, the exact pattern of the curve may depend on subjective inputs and may be no more relevant than the other methods discussed.

9.28 The chart in Figure 1 compares the patterns of each of the methods where it is assumed that an asset has an original cost of £100,000, which reduces to a value of £1,000 over 20 years. Two types of S-curve are shown to illustrate the possible range of differences, as it is recognised that the pattern of depreciation will differ between, for example, buildings and plant and equipment.

Figure 1



9.29 The three methods outlined are all in common use. Of these, the straight-line approach has the advantage of simplicity. However, it does not represent the way in which asset values are normally reflected in the marketplace. The reducing balance method may also be open to similar criticism that it does not reflect market perceptions. The S-curve attempts a surrogate for market behaviour and is appropriate where there is empirical evidence available.

9.30 Other forms of depreciation curves are available, and where they are used by a particular market the valuer is expected to reflect them. In making adjustments for depreciation and obsolescence the valuer is advised to rely on professional knowledge, judgment and market experience, and to take due account of the nature of the asset and the type of use to which it is put.

10 Other considerations

10.1 It is not normally appropriate to make any deduction for depreciation from the cost of acquiring a modern equivalent site in the market, because freehold land rarely depreciates. When valuing *specialised property* the normal practice is to

assess the cost of the improvements separately, assess the appropriate depreciation and then add this to the cost of replacing the land in order to arrive at the final valuation.

10.2 Where a *specialised property* has many buildings or structures, some may have a longer anticipated life than others. Although it may be appropriate to adopt different rates of depreciation for different structures in making the valuation, care has to be taken not to lose sight of the objective of the exercise, which is to establish the value of the whole of the defined *specialised property*. It would therefore be inappropriate to assign a substantially longer life to an individual building or component than the anticipated life of the whole of the defined property.

10.3 If individual buildings are identified as having potential for an alternative use beyond the anticipated life of the overall *specialised property*, this may be separately reported and based on a different valuation method, but should not be reflected in the *DRC* calculations. The objective of the *DRC* approach is to establish how valuable the *specialised property* is in comparison with a modern equivalent. The modern equivalent cannot be assumed to be exactly alike with the same alternative potential; it is purely the utility of the asset for the current use that is being assessed as part of the *DRC* calculation.

10.4 There will be situations where the valuer can readily identify that the site of a *specialised property* could be redeveloped for an alternative, and more valuable, use if the current use was to be discontinued. In assessing the cost of the equivalent replacement site as part of the *DRC* calculation, this potential has to be disregarded for the simple reason that the hypothetical buyer would not buy a site to construct the specialised facilities if it had to compete with more valuable uses. In most cases, the potential of the actual site will have been identified using a sales comparison, not a *DRC* approach. However, the fact that this potential is irrelevant to the *DRC* process does not mean that it is irrelevant to the entity. In these circumstances UKVS 1.15.3 requires the valuer to report the value based on the alternative use. Further discussion on this can be found in section 9.

11 Final reconciliation

11.1 The *DRC* calculation usually involves the consideration of many separate elements, and an essential final step is for the valuer to ensure that the resulting mathematical conclusion is consistent with the underlying valuation objective – that is, to establish the price that would be paid in an exchange between a willing seller and willing buyer in an arm's length transaction.

11.2 The valuer is advised to 'stand back and look' at the overall conclusion, taking particular care to check that the process of adjusting for depreciation has not resulted in any factor being either double counted or ignored. An attribute of the actual asset may be identified that has not been reflected in the process of depreciating by comparison with the hypothetical modern equivalent. In the case of a *specialised property* this could include an adjustment for any additional value in the land in its current location, which could lead to a buyer of the specialised facility for its continued use to bid more for this property than it would for a modern equivalent with no such potential.

12 Reporting

12.1 The report must comply with **VPS 3, Valuation reports**. The matters that have to be covered in all valuation reports are listed in **VPS 3 paragraph 7, Report content**, while UKVS 1.15.1 and UKVS 1.15.2 impose additional requirements when the *DRC* approach is used. A summary is given in the following paragraphs.

12.2 A statement that the *DRC* method has been used is necessary (see VPS 3.7(l)). If the valuation is being undertaken for inclusion in accounts prepared under International Financial Reporting Standards (IFRS) or UK Generally Accepted Accounting Principles (UK GAAP), the value is reported as being on the basis of *fair value*. However, in order to comply with VPS 3.7(l), a statement is required explaining that because of the specialised nature of property, the value is estimated using a *DRC* method and is not based on the evidence of sales of similar assets in the market. This statement matches a requirement in International Accounting Standards (IAS) 16 and Financial Reporting Standard (FRS) 102 for the entity to include a similar statement in the published accounts.

12.3 For assets held in the private sector, to comply with UKVS 1.15.1, a statement that the valuation is subject to the adequate profitability of the business paying due regard to the total assets employed must be included.

12.4 For assets held in the public sector, to comply with UKVS 1.15.2, a statement that the valuation is subject to the prospect and viability of the continued occupation and use must be included. If the valuer was readily able to identify that the asset has a higher value for an alternative use, this must be reported in accordance with UKVS 1.15.3(a) as the *fair value*, together with a statement that the value for alternative use takes no account of matters such as business closure or disruption and any associated costs that would be incurred. This is most likely to arise in connection with a *specialised property*, where the land may have a higher value for redevelopment than the *DRC* value.

12.5 If the valuer considers that the value of the asset would be materially lower if the business ceased, the report must also contain a statement to this effect (see UKVS 1.15.3(b). The *valuation standards* do not require the valuer to provide an actual figure for this purpose. If the entity wishes to establish the impact of possible closure of a specialised facility on the value of the assets employed, it may commission valuations to reflect the 'break-up', salvage or alternative use value of the asset. This would be a separate exercise and not part of the *DRC* valuation for inclusion in the *financial statements*. Any valuations provided would need to be on the *special assumption* that the entity had ceased operations (see **VPS 4 paragraph 3, Special assumptions**).

13 Checklist

This checklist is intended to provide the valuer with a simple way of confirming that all the matters discussed in this *guidance note* have been considered.

Where large numbers of properties are to be valued it may be helpful for a separate list and a schedule to be prepared for groups of properties. The schedule could indicate against each entry the matters that have been discussed and agreed.

It may be helpful to attach such a schedule to the report so that any reader will be fully aware of the approach taken. This will also help ensure that consistency is achieved when a revaluation is undertaken.

Item for consideration	Ref. in GN	Comments
1 Appropriate to use *DRC*	3.1–3.10	
2 Qualification of the valuer (a) Specialist assistance	4.1–4.2 4.3	
3 *Terms of engagement* settled	5.1–5.2	
4 Assessing replacement cost (a) Site value (b) Actual (c) Modern equivalent	 6.1–6.5 7.1–7.12	
5 Building and site improvements (a) Plant identified (b) Infrastructure works (c) Size of modern equivalent (d) Specification of modern equivalent	8.1–8.6	
6 Consideration of historic buildings	8.7–8.9	
7 Sources of cost information	8.10–8.15	
8 Assessment of depreciation (a) Physical deterioration (b) Functional or technical obsolescence (c) Economic obsolescence (d) Asset life	9.1–9.2 9.4–9.6 9.7–9.11 9.12–9.13 9.18–9.22	
9 Depreciation method (a) Straight line (b) Reducing balance (c) S-curve	9.23–9.30 9.23–9.24 9.25 9.26–9.28	
10 Other considerations	10.1–10.4	
11 Final reconciliation	11.1–11.2	
12 Reporting (a) All items under VPS 3.7 (b) Statement that *DRC* used (c) UKVS 1.16.1 (private sector) (d) UKVS 1.16.2 (public sector) (e) UKVS 1.16.3 (alternative values) (f) Alternative value statements	12.1–12.5	

Ensure file contains all relevant information on the decisions taken during the *DRC* process.

UKGN 3 Valuations for capital gains tax, inheritance tax and stamp duty land tax

1 Introduction

1.1 Valuations for capital gains tax (CGT), inheritance tax (IHT) and stamp duty land tax (SDLT) purposes are based on a statutory definition of 'market value', which is similar to the definition used in these standards. However, the statutory definition has been the subject of interpretation by the Upper Tribunal (Lands Chamber). *Members* should be aware of these differences between the definitions, so that HM Revenue and Customs (HMRC) will not be able to challenge their valuations as being made on an incorrect basis.

1.2 This *guidance note* deals solely with the statutory basis of 'market value' for CGT (including corporation tax on capital gains), IHT and SDLT, and does not cover valuations that may be required for income tax or corporation tax (such as capital allowances). The valuation approach in this *guidance note* is the one that would likely be adopted by HMRC for VAT purposes.

1.3 CGT, IHT and SDLT are complex taxes and *members* should take care to understand the background to the event triggering a potential tax liability before proceeding.

1.4 Further information is available on the HMRC website (www.hmrc.gov.uk), which gives access to the HMRC's internal guidance manuals, and the Valuation Office Agency (VOA) website (www.voa.gov.uk), which gives access to the instructions to district valuers.

1.5 Valuations, which will include apportionments in appropriate cases, for tax purposes are based on the concept of a hypothetical sale for which a statutory definition is required. The statutory definition and interpretation of market value for tax purposes is not exactly the same as the definition of *market value* used in these standards. While the differences are not always significant, difficulties arise frequently enough to warrant some basic introduction for general practitioners who may encounter such issues only on rare occasions.

1.6 This *guidance note* is based on interpretations arising from cases that have been determined by the Upper Tribunal (Lands Chamber) or higher courts on appeals made by taxpayers against tax assessments based on the value of property. It is recognised that there may be circumstances where the client wishes to challenge an aspect of the tax calculation, including the interpretation of the statutory basis or the method of valuation. If the valuer is instructed to give valuations on specified *assumptions* that differ from those in this *guidance note*, the procedures in **VPS 3 paragraph 7(i), Assumptions and special assumptions** must be followed.

2 Background

2.1 CGT, IHT and SDLT are included in self-assessment procedures where the taxpayer is responsible for calculating the appropriate amount of tax based on the valuations provided by the valuer.

2.2 In the case of individual taxpayers, partnerships and trusts, any CGT calculation will be included in the tax return for the tax year in which the transaction requiring the tax application took place.

2.3 Large companies, on the other hand, pay their corporation tax on any capital gains in advance, by quarterly instalments based on a prediction of their results for that tax year. A large company is one that does not fall in the category of a small or medium sized enterprise (SME) as defined by the European Commission. Its definition of an SME is an enterprise that employs fewer than 250 persons and either a turnover of less than €50 million or a balance sheet total of less than €43 million.

2.4 Special provisions apply for groups of companies. Any large company taxpayer with a significant property portfolio is faced with the problem that property transactions may generate large gains or losses that can distort a tax charge. The exact amount of those gains or losses may be dependent on the valuation provided.

2.5 In IHT cases the personal representatives are required to submit an IHT account that identifies all 'appropriate' property and its value.

2.6 The valuations used by taxpayers in their tax computations are subject to examination by district valuers on behalf of the HMRC. It is therefore imperative that any valuation used in those tax calculations has been calculated on the statutory basis using best practice.

2.7 If, following discussion with a district valuer, a different valuation or apportionment is agreed or determined and results in a materially different tax bill, a taxpayer could be faced with a claim for interest and, in some cases, additional penalties. Where the taxpayer has paid too much tax, the HMRC may pay interest, although the taxpayer is still worse off because the interest rates are less favourable than commercial rates.

2.8 It is therefore of great importance, when preparing a valuation for taxation purposes, to apply the statutory rules appropriately and to have a proper understanding of the basis of market value for taxation purposes.

3 Basis of value

3.1 Definitions for the *basis of value* for CGT can be found in section 272, *Taxation of Chargeable Gains Act* 1992, for IHT in section 160, *Inheritance Tax Act* 1984, and for SDLT in section 118, *Finance Act* 2003.

3.2 These definitions are written in similar terms and broadly define market value as:

> 'the price which the property might reasonably be expected to fetch if sold in the open market at that time, but that price must not be assumed to be reduced on the grounds that the whole property is to be placed on the market at one and the same time.'

3.3 The current statutory definitions for CGT, IHT and SDLT are similar to those used in earlier tax acts. Over the years, case law has established that, in arriving at market value, the following *assumptions* must be made:

- the sale is a hypothetical sale
- the vendor is a hypothetical, prudent and willing party to the transaction
- the purchaser is a hypothetical, prudent and willing party to the transaction (unless considered a *special purchaser*)
- for the purposes of the hypothetical sale, the vendor would divide the property to be valued into whatever natural lots would achieve the best overall price
- all preliminary arrangements necessary for the sale to take place have been carried out prior to the *valuation date*
- the property is offered for sale on the open market by whichever method of sale will achieve the best price
- there is adequate publicity or advertisement before the sale takes place so that it is brought to the attention of all likely purchasers and
- the valuation should reflect the bid of any *special purchaser* in the market (provided that purchaser is willing and able to purchase).

3.4 Clients will often request a valuation for 'probate purposes', when they actually need a valuation for IHT purposes. When confirming instructions and in the report, the valuer must make it clear that although the valuation is required as part of the procedure for obtaining a 'grant of probate', the *basis of value* will be in accordance with the statutory definition. Valuers should therefore avoid using the term 'probate value'.

4 Analysis of the definition

4.1 The definition of open market value for the *basis of value* for CGT or for tax purposes may be broken up into elements that have been defined in case law.

'The price …'

4.2 In *Duke of Buccleuch v IRC* (1967) the price that the property might reasonably be expected to fetch was defined as the gross sale price for the property without deducting any selling costs.

4.3 Furthermore, in *Ellesmere v IRC* (1918) the price was held to mean the best possible price that would be obtainable in the open market, if the property was sold in such a manner (and subject to such conditions) as might reasonably be calculated to obtain for the vendor the best price for the property.

4.4 However, it should not be assumed that the best price is automatically the highest possible price that could be achieved. What is required, in valuation terms, is an estimate of the price that could be realised under the reasonably competitive conditions of an open market on a particular date.

'… **the property** …'

4.5 In *Duke of Buccleuch v IRC* it was held that the reference to 'the property' was not a reference to the whole estate being valued, but meant any part of the estate that was proper to treat as a unit for valuation purposes. Similarly, in *Ellesmere v*

IRC, it was held that the market price was a price based on the separate values of the various parts. It was also indicated that the price must be estimated on the basis that the properties were sold in whatever lot(s) would realise the best price.

4.6 In *IRC v Gray (Executor of Lady Fox decd.)* (1994) it was held that the property must be valued as it actually existed, even if, in reality, a vendor would most likely have made some changes or improvements before putting it on the market. Although this case referred to variations in the way in which the property was held by the parties (rather than physical works), it identified the general principle of valuing the property as it stands at the *valuation date*.

4.7 As a consequence, in preparing any taxation valuation, it is important to have proper regard to the most viable lotting of the property (or properties) to be valued, in order to maximise the overall price. This is effectively a notional marketing exercise, commonly referred to as 'prudent lotting'.

'… **if sold** …'

4.8 The statutory definitions of market value are concerned with a hypothetical sale, not an actual one. As originally held in *IRC v Crossman* (1937), and confirmed unanimously in *Duke of Buccleuch v IRC* and in *Lynall v IRC* (1972), in arriving at the value, it is irrelevant to consider what would have been the circumstances attending an actual sale.

4.9 The price that the property would have actually realised in the open market, or the potential impossibility of putting the property on the market at the *valuation date*, is also irrelevant. In other words, one does not have to assume that the property actually had to be sold, as a hypothetical market must be assumed, as at the *valuation date*.

4.10 In *IRC v Gray (Executor of Lady Fox decd.)* it was said that the property must be assumed to have been capable of sale in the open market, even if it was in fact inherently unassignable or held subject to restrictions on sale. The relevant question is what a purchaser would have paid to enjoy whatever rights were attached to the property at the relevant date, assuming a hypothetical sale.

'… **in the open market** …'

4.11 In *Lynall v IRC* it was held that the property must be valued on the basis of a hypothetical sale between a hypothetical willing vendor (not the actual owner of the property in question) and a hypothetical willing purchaser. The hypothesis used was that potentially no one was excluded from buying (the hypothetical purchaser thus potentially including even the actual owner).

4.12 The statutory definitions refer to 'the open market' and not 'an open market'. This has been interpreted to mean a real market made up of real people. In *Lynall v IRC* the open market was regarded as a blend of reality and hypothesis. It was held that the conditions under which the hypothetical sale is deemed to take place should be built on a foundation of reality as far as is possible. However, it was deemed even more important not to defeat the intentions of statute by an undue concern for reality in what is essentially a hypothetical situation.

4.13 Case law has further refined the components of the open market definition and, in particular, those parties assumed to be active in it. In *Lynall v IRC* it was held that the statute implied that there had been adequate publicity or advertisement

before the sale, and that steps had been taken (before the sale) to enable a variety of persons, institutions or financial groups to consider what offers they would be prepared to make.

4.14 However, in *IRC v Gray (Executor of Lady Fox decd.)* it was said that it could not be emphasised too strongly that although the sale is hypothetical, there is nothing hypothetical about the open market in which it is supposed to have taken place. The hypothetical sale envisaged (in order to ascertain the market value for taxation purposes) presupposes a willing vendor and a willing purchaser.

'… **at that time** …'

4.15 This is defined by statute for the purposes of the valuation exercise in question (for example, in a CGT case it might be 31 March 1982). The *assumption* regarding the definition of the date is that all the preliminary arrangements have been made prior to the *valuation date* so that a hypothetical sale can take place at the statutory point in time. The objective is to ascertain the value of the asset at the prescribed time (and not at any other time), and this can only be achieved by assuming that all preliminary arrangements have been made beforehand.

5 Further interpretation

5.1 As part of the consideration of the definition of market value for tax purposes, the courts have also given guidance on other terms which, although not appearing in the statutory definition, are used in the interpretation.

5.2 A **willing vendor** or **willing seller** is one who is prepared to sell, provided that a fair price is obtained. It does not mean a vendor who is prepared to sell at any price and on any terms. In short, the hypothetical vendor is assumed to be a reasonable and prudent person.

5.3 A **willing purchaser** presupposes that the open market includes everyone who has the will and the money to buy. It has been said that the buyer, like the vendor or seller in paragraph 5.2, must be a person of reasonable prudence.

5.4 A ***special purchaser*** is one who has a particular interest in acquiring a property. The case of *IRC v Clay* (1914) effectively established that where there is a known purchaser in the market who is willing to buy at a considerably higher price than anyone else, then the value of the asset for tax purposes is represented by the higher price the *special purchaser* is willing to pay, or by a close approximation to this.

5.5 In *Walton v IRC* (1995) it was held that it was a question of fact – to be decided by evidence – whether or not there were any *special purchasers* in the market and what price they would be prepared to pay.

6 Methods of valuation

6.1 Methods of valuation are not predetermined by statute or by case law. Transaction evidence may reflect the application of a variety of valuation methods, but that does not affect the comparability of the price realised in each case. In practical terms, property assets are valued or appraised by whichever 'method' is most appropriate. Special classes and categories of asset will be valued in different

ways because of how 'the market' values them. A presumption of the *Lynall* case is that the vendor, when advertising the property, makes such information available to purchasers of that type of asset as they would expect to receive, or to be able to access, in a normal market transaction.

7 Special cases

7.1 Special situations, such as the valuation for taxation purposes of interests in land that are rarely (undivided shares) or never (unassignable agricultural tenancies) sold in the real world, or apportionments for part-disposal calculations, are beyond the scope of this *guidance note*. Those involved in such matters should study the relevant HMRC and VOA manuals and other guidance. Further help may be obtained from the RICS Valuation Professional Group (valuation@rics.org).

8 Case references

8.1 The relevant cases referred to in this *guidance note* are:

- *Duke of Buccleuch v IRC* [1967] 1 AC 506
- *Ellesmere v IRC* [1918] 2 KB 735
- *IRC v Clay* [1914] 3 KB 466
- *IRC v Crossman* [1937] AC 26
- *IRC v Gray (Executor of Lady Fox decd.)* [1994] STC 360
- *Lynall v IRC* [1972] AC 680, HL (This case was heard in a range of courts between 1969 and 1972); see also *Attorney-General for Ireland v Jameson* [1905] 2 IR 218
- *Walton v IRC* [1996] STC 68.

UKGN 4 Inspections and material considerations

1 Introduction

1.1 VPS 2, Inspections and investigations, paragraph 3 refers to settling the *terms of engagement* and notes that 'the degree of on-site investigation that is appropriate will vary, depending on the nature of the property, the purpose of the valuation and the *terms of engagement* agreed with the client.'

1.2 Unless expressly stated to the contrary in the *terms of engagement,* the valuer has an obligation to investigate, consider and report on any material feature that affects a property or its surroundings and could have an impact on value, even if it is not included in this *guidance note*.

1.3 Although many issues affect the value of a property interest, the degree to which these matters may be addressed by the valuer will often depend on the purpose of the valuation and the extent of enquiries that would normally be associated with such a valuation. It is acceptable for the valuer to agree with the client that either no investigation of these matters will be undertaken, or that specific *assumptions* can be made, providing that this takes account of **VPS 1 paragraph 2(g), Extent of investigation**.

1.4 The topics referred to, and the information sources provided, are for guidance only. They should not be regarded as a comprehensive list of all matters that may need to be investigated or reflected in every situation.

1.5 While many information sources are property specific, others are not and only give generalised information relating to a wider area. The valuer will need to take care in considering the potential impact on the specific property and, where appropriate, make clear the limitations of the information relied on in the report.

1.6 Increasingly under UK legislation, a risk assessment is to be undertaken by a designated competent person who will identify the appropriate action to be taken to counter a potential property hazard. Valuers are not expected to be competent to assess these risks, but are recommended to familiarise themselves with those matters that commonly affect value in the sector or locality in which they practise. Where these are likely to be a factor, valuers will need to discuss with clients whether the matters identified should be subject to an investigation by appropriate specialists, or whether the value is to be reported on the basis of a specific *assumption* about the level of risk.

1.7 In most cases the risk arising from a particular hazard reflects a combination of the physical features of the property and the manner in which the property is used by the occupier. Care is to be taken to distinguish between any work that may be required because of the specific way in which a particular occupier uses a property and work that would have to be undertaken by any potential buyer in the market.

1.8 Where expert reports have been obtained, the valuer is to consider their effect on the valuation. It is important that the valuer does not offer any explanation or interpretation of such reports in the absence of any personal expertise in the subject.

2 Contamination and environmental matters

2.1 Depending on the scope and purpose of the valuation the valuer will agree, in the *terms of engagement*, the extent to which contamination and environmental matters are to be investigated or commented on in the report (see **VPS 1 paragraph 2(g), Extent of investigation**, and **VPS 2, Inspections and investigations**).

2.2 The RICS *guidance note*, *Contamination, the environment and sustainability: their implications for chartered surveyors* (2010), contains detailed guidance on various issues related to environmental and sustainability. The use of the relevant property observation checklist provided in that *guidance note* is recommended.

3 Hazardous or deleterious materials

3.1 It is estimated that asbestos, in some form, is present in 1.5 million buildings in the UK, as its use was common until the mid-1980s.

3.2 The *Control of Asbestos Regulations* 2012 require non-domestic property to have management plans in place. In any building where asbestos is present, the cost of maintenance, alteration and repair can be significantly increased because of the need to take appropriate precautions under the regulations, and this can affect value. It is therefore recommended that all valuers develop an awareness of the types of buildings and construction likely to contain asbestos.

3.3 Depending on the purpose of the valuation, the valuer may have to alert the client of the need to identify or discover:

- the dutyholder
- the asbestos register and
- if any management plan is in place, following any specialist asbestos survey.

Valuers are not qualified to interpret or validate the content of any asbestos register, or asbestos management plan, unless they have been specially trained, for example, accredited by National Individual Asbestos Certification Scheme (NIACS).

3.4 The RICS *guidance note*, *Asbestos and its implications for members and their clients* (2011), has been especially prepared for non-specialist surveyors. Its purpose is to assist them in identifying potential problems and knowing when to recommend the appointment of an expert.

3.5 There may be various materials used in the construction of buildings that may be deleterious, for instance, high alumina concrete and calcium chloride cement and, in Devon and Cornwall, mundic. The identification of these requires specialist knowledge, but for more information *members* are referred to the following RICS *guidance notes*, available to RICS *members* on www.rics.org:

- *Building surveys and technical due diligence of commercial property* (2010)
- *Surveys of residential property* (2013)

- *The mundic problem* (2015).

4 Disability discrimination

4.1 The *Equality Act* 2010, which came into effect 1 October 2010, largely replaced the *Disability Discrimination Act* 2005 as well as consolidated numerous other anti-discriminatory laws. With regard to disability, the Act imposes a duty on employers and businesses offering a service to the public to make reasonable changes to practices and procedures to enable disabled people to do their jobs. In addition, employers and businesses must remove or alter any feature that makes it impossible, or unreasonably difficult, for a disabled person to make use of the services provided.

4.2 Disability has a wide definition; valuers should be aware of the potential liability on building owners or occupiers to comply with the Act and its possible impact on the value of the property interest. However, the duty of compliance rests with the occupier. Although physical changes to a property may enable a particular occupier to comply with the Act, so may changes in the way it conducts its business. For further information, the Department for Work and Pensions provides extensive advice on the application of the legislation (visit www.dwp.gov.uk).

5 Fire safety law

5.1 The *Regulatory Reform (Fire Safety) Order* 2005 (SI 2005/1541) requires the 'responsible person' to make a suitable and sufficient assessment of the risks, and to identify the fire precautions required to comply with the Order. The Order applies to all non-domestic property.

5.2 Such fire precautions may include adaptation of the building and installation of fire safety equipment, but in all cases they must include: signage, fire safety action plans, staff training, identifying dutyholders and routine maintenance/monitoring via signed and dated checklists.

5.3 For further information the RICS publication, *The New Fire Safety Legislation 2006: A Practical Guide* (2007), written for construction and property management professionals, outlines their duties under fire safety legislation. Detailed information on the regulations and fire safety in general is available from www.fire.org.uk

6 Energy Performance Certificates

6.1 In England and Wales the government has implemented the European Energy Performance of Buildings Directive requiring Energy Performance Certificates (EPC) to be made available for all properties, residential and commercial, when bought sold or rented.

6.2 For commercial properties the duty was introduced progressively from 6 April 2008, according to the floor area of the building. From 1 October 2008 an EPC must be made available by the 'relevant person' whenever a non-domestic building is constructed, sold or rented out, subject to certain exemptions. EPCs are valid for ten years.

6.3 The valuer should be aware that the 'relevant person' (such as a prospective landlord or a tenant making an assignment of, or subletting, a non-domestic building) is responsible for making an EPC available free of charge to the prospective buyer, tenant or assignee. Landlords are required to cooperate in providing an EPC if their tenant decides to assign or sublet the premises that are subject to common heating or air conditioning services. More information can be found on the Communities and Local Government website at www.gov.uk/government/policies/improving-the-energy-efficiency-of-buildings-and-using-planning-to-protect-the-environment

6.4 In Scotland the Scottish government via the Scottish Building Standards (SBS) Agency is responsible for the implementation of the directive. Generally, all public buildings over 1000m^2 will need to display an EPC, even if they are not being sold or leased. The implementation date for non-domestic EPCs in Scotland when leased or sold was 4 January 2009.

6.5 Domestic (residential) properties that are marketed for sale in Scotland after 1 December 2008 are required to provide an energy report as part of the Home Report (this will generate an EPC). All rented dwellings are also required to have an EPC from 4 January 2009 when they change occupants, although existing tenancies are not affected. An EPC will be valid for ten years. More information can be found on the Scottish government website at www.scotland.gov.uk/Topics/Built-Environment/Building/Building-standards

UKGN 5 Local authority disposal of land for less than best consideration

1 Introduction

1.1 This *guidance note* applies only to local authorities in England and Wales.

1.2 Local authorities have wide land disposal powers under sections 123 and 127 of the *Local Government Act* 1972 and section 233 of the *Town and Country Planning Act* 1990. However, they are required to seek specific consent from the secretary of state where the consideration is less than the best that can reasonably be obtained.

1.3 In England, the *Local Government Act 1972: General Disposal Consent (England) 2003* removes the requirement for authorities to seek specific consent from the secretary of state for any disposal of land where the difference between the unrestricted value of the interest to be disposed of, and the consideration accepted (the 'undervalue'), is £2 million or less.

1.4 The detailed valuation requirements are set out in the Technical Appendix to the Consent, which specifically incorporates this *guidance note* and the definition of *market value* in **VPS 4 paragraph 1.2, Market value**.

1.5 In Wales, the *Local Government Act 1972: General Disposal Consent (Wales) 2003* removes the requirement for authorities to seek specific consent from the National Assembly for Wales for any disposal of land where the difference between the unrestricted value of the interest to be disposed of, and the consideration accepted (the 'undervalue'), is £2 million or less.

1.6 The circular accompanying the 2003 Consent provides that the valuer shall have regard to the guidance on local authority disposals of land at an undervalue in these standards.

1.7 The local authority decides whether any proposed disposal requires specific consent, as the secretary of state and the National Assembly for Wales have no statutory powers to advise in any particular case. The valuer may be asked to provide a valuation so that the local authority may consider whether or not an application for consent is necessary, or to support a submission for a specific consent. For either request, valuation must be provided in England following the advice in the Technical Appendix and in Wales following the advice in paragraph 4 of the circular.

1.8 In Scotland, the consent regime is provided by section 74 of the *Local Government (Scotland) Act* 1973. However, this section was amended by section 11 of the *Local Government in Scotland Act* 2003, so that the current ministerial consent regime can be replaced by regulations issued by Scottish ministers. No regulations have yet been made.

2 Bases of valuation

2.1 The consent requires the valuer to provide the following figures (details of which are given in the proceeding paragraphs):

- unrestricted value
- restricted value and
- the value of voluntary conditions.

2.2 Unrestricted value

2.2.1 This is the best price that is reasonably obtainable for the property. It is the *market value* of the land, as defined in **VPS 4 paragraph 1.2, Market value**, except that it should take into account any additional amount that is, or might reasonably be expected to be, available from a purchaser with a special interest. It should also ignore the reduction in value caused by any voluntary condition imposed by the local authority.

2.2.2 In general terms, unrestricted value is intended to be the amount that would be received for disposal of the property where the principal aim was to maximise the value of the receipt. Apart from the inclusion of bids from a purchaser with a special interest, it is defined in the same way as *market value*. For example, the valuer must take account of any uses that might be permitted by the local planning authority if these would be reflected by the market, and not only a use (or uses) intended by the parties to the proposed disposal.

2.2.3 The valuer should assume that the freehold disposal is made, or the lease is granted, on terms that are intended to maximise the consideration. For example, where unrestricted value is based on the hypothetical grant of a lease, at a rack rent or ground rent, with or without a premium, the valuer should assume that the lease would contain those covenants normally included in such a lease by a prudent landlord. The valuer should also assume that the lease would not include unusual or onerous covenants that would reduce the consideration, unless these had to be included as a matter of law.

2.3 Restricted value

2.3.1 This is the *market value* of the property having regard to the terms of the proposed transaction. It is defined in the same way as unrestricted value, except that it should take into account the effect on value of any voluntary condition.

2.3.2 Where the local authority has invited tenders and is comparing bids, the restricted value is normally the amount offered by the local authority's preferred transferee. Otherwise it is normally the proposed purchase price.

2.4 The value of any voluntary conditions

2.4.1 Sales may be subject to voluntary conditions. These are any term or condition of the proposed transaction that the local authority chooses to impose. Voluntary conditions do not include any term or condition that the local authority is obliged to impose, for example, as a matter of statute or a condition that runs with the land.

They also do not include any term or condition relating to a matter that is a discretionary, rather than a statutory, duty of the local authority.

2.4.2 Their value is the total of the capital values of voluntary conditions imposed by the local authority as terms of the disposal, or under agreements linked to the disposal, that produce a direct or indirect benefit to the local authority that can be assessed in monetary terms. It is not the reduction in value (if any) caused by the imposition of voluntary conditions, and any adverse effect these may have on value must not be included in this figure.

2.4.3 The proposed disposal, or an agreement linked with it, may give rise to non-property benefits to the local authority. For example, these might include operational savings, or income generated as a result of the transaction where the local authority has an associated statutory duty. The monetary value of these benefits to the local authority should be included in the value of voluntary conditions in the valuer's report.

2.4.4 The valuer will often be able to assess the value of a voluntary condition of disposal to the local authority. However, there may be cases where a question arises about the status, in law, of such value (whether or not it is capable of forming part of the consideration). In such cases, the local authority may need to seek legal advice as to whether the value of the voluntary condition is such that it may form part, or all, of the consideration the local authority proposes to accept. Conversely, there may also be cases where a term or condition of disposal is, in law, capable of forming part, or all, of the proposed consideration, but it has no quantifiable value to the local authority, or its value is nil.

2.4.5 Where the valuer is not qualified to assess the value of any benefits (for example, of share options) the report should make clear the extent to which the valuer accepts liability for the figures. Where the valuer does not accept full responsibility, the report should make clear who was responsible for assessment of the remainder, and copies of any valuations or advice received from accountants or other professional advisers should be annexed.

3 Leasehold disposals

3.1 The valuer is required to assess the unrestricted value in capital terms. The unrestricted value should be assessed by valuing the authority's interest after the lease had been granted, plus any premium payable for its grant. In other words, it will be the value of the right to receive the rent and any other payments under the lease, plus the value of the reversion when the lease expires.

4 Options

4.1 Where a disposal involves the grant of an option, the valuer must consider both the payment for the option and the consideration that might be received, were it to be exercised as either, neither or both may involve a discount. Paragraphs 19 to 21 of the technical appendix to the Consent provide more detailed guidance on the treatment of options.

5 Discount

5.1 This is the amount by which the value of the actual consideration is less than that of the best consideration reasonably obtainable. It is given by the formula:

unrestricted value – (restricted value + value of conditions).

Otherwise, where the value of the consideration for the disposal differs from the restricted value, it is given by this formula:

unrestricted value – (value of consideration + value of conditions).

5.2 The secretary of state must be aware of cases where the proposed consideration is more or less than the value of the interest to be disposed of, subject to the proposed voluntary conditions, so that this can be taken into account when reaching the decision. Accordingly, where the value of the consideration differs from the restricted value, both figures must be given.

6 Purpose of the valuation

6.1 Along with stating the purpose of the valuation, the valuer must provide a summary of the proposed transaction, noting the key terms and any restrictions to be imposed by the local authority. Where the local authority proposes to grant a lease, a copy of the draft lease should be attached to the report. Where this is impracticable, a copy of any heads of terms agreed or a summary of the key terms of the proposed lease should be provided.

7 Assumptions as to planning

7.1 Where there is no detailed scheme, the valuer should make reasonable *assumptions* about the form of the development. This should include a note of the existing use(s), current planning consents and use(s) likely to be permitted with regard to the development plan. Where the unrestricted value has been based on an assumed planning use other than that for which the property has been sold, a detailed explanation of the planning *assumptions* made is required.

8 Tenure

8.1 This must include a note identifying the local authority's tenure and giving details of the purpose(s) for which the land is held (which is normally for the purposes of the power under which it was acquired, or taken on lease, unless it has since been formally appropriated). It must also include a summary of the details of any leases, or encumbrances such as easements, to which the land is subject.

9 Valuations

9.1 The unrestricted and restricted values, together with the value of conditions, should be given. Where any of these is nil this should be expressly stated.

9.2 Where the value of a scheme is less than the development cost (that is, there is 'negative development value'), the advice in paragraph 23 of the technical appendix to the Consent should be followed.

9.3 Where the value of land may be affected by the availability of grants, the advice in paragraph 24 of the technical appendix to the Consent should be followed.

9.4 The *valuation date* should not be more than six months before the submission of the application to the secretary of state.

10 Description

10.1 The report must include a written description of the site and buildings, the location and surroundings. A plan, to which the secretary of state will refer if giving consent and which is sufficiently accurate to identify the land, is also to be provided.

11 Existence of a special purchaser

11.1 The effect on value of the existence of a purchaser with a special interest should be described.

12 The report

12.1 The report must be signed by a 'qualified valuer' (a *member* of RICS).

UKGN 6 Analysis of commercial lease transactions

1 Introduction

1.1 In the period before the major commercial property crash in 1990 in the UK, rental valuation was relatively straightforward. The vast majority of institutional grade properties were let on 20 or 25-year terms, had upwards only market rent reviews and were let on Full Repairing and Insuring (FRI) terms. Hence, defining and assessing rental values was relatively straightforward using the comparable method underpinned with a good supply of comparable property lettings on standard lease terms. Rental value variations were largely based on location and physical differences, although differences between rents provable at a third party rent determination and those achievable in new lettings were being monitored by some market participants.

1.2 The situation changed in the period after the 1990 property market crash. Successive reports by the University of Reading in relation to monitoring the *Commercial Leases Code of Practice* (DETR, 2000; ODPM, 2005), supported in the last 10 years by the *BPF/IPD Annual Lease Review* (e.g. BPF/IPD, 2012), detail the increasing variation in lease terms in the UK and the increasing importance since 1990 of incentives within new lettings, such as rent-free periods and capital contributions by landlords. It is these developments that have created additional difficulties in assessing rental levels. In essence, the inclusion of incentives within a letting means that the rent negotiated between the parties cannot be taken at face value as a signal of the rental value of the subject property. This, in turn, causes issues for asset valuation in general and for two specific major applications of valuation method; rent review and property performance measurement.

1.3 Whatever the purpose, the valuer may be required to establish the *market rent* of the subject property. *Market rent* is defined in **VPS 4 paragraph 1.3, Market rent**. This definition suggests that the *market rent* should be assessed as the current letting value of the vacant property based 'on appropriate lease terms'. The supporting text is more specific:

> 'Valuers must therefore take care to set out clearly the principal lease terms that are assumed when providing an opinion of *market rent*. If it is the market norm for lettings to include a payment or concession by one party to the other as an incentive to enter into a lease, and this is reflected in the general level of rents agreed, the *market rent* should also be expressed on this basis. The nature of the incentive assumed must be stated by the valuer, along with the assumed lease terms.'

1.4 The definition suggests that, where it is normal in a particular market environment to grant incentives to tenants, the *market rent* is subject to these

incentives and so the *market rent* to be identified under the RICS definition is a headline, face or contract rental value. Headline, face or contract rent is defined below but, in summary, represents the rental value that is paid, or would be paid, subject to a stated or assumed set of lease incentives.

1.5 However, in the case of a rent review, the rent review clause usually contains its own definition, which takes precedence over the *market rent* definition in **VPS 4 paragraph 1.3, Market rent**. In the case of lease renewals under the *Landlord and Tenant Act* 1954, the Act and case law will also take precedence over this definition. In UK practice, occasionally this will be the headline rental value, but in many cases an effective rental value will be required at a rent review.

1.6 This *guidance note* addresses the valuation issues that have arisen from these recent market changes and provides some guidance to valuers on the analysis of transactions subject to lease incentives. It describes the different incentives and explains some of the different approaches that can be used to help determine the effective rental value. This is the rent that the property would have let at in the market place had no incentives to let been given to the tenant. Although the best evidence of rental levels in the market is new lettings, they are most likely to include incentives. This *guidance note* explores some of the factors that the valuer may need to consider when assessing the impact of such incentives on the rent agreed and its analysis.

1.7 One of the major factors in any market is market knowledge. Openness, transparency and a willingness to share information benefit the market as a whole and are to be encouraged. However, due to commercial sensitivities, lettings of commercial property can be subject to confidentiality clauses, meaning that the available information may be limited. As assumptions may have to be made, it is very important that valuers are closely involved with, and aware of, the workings of the particular market and use their experience of the market when approaching comparable transactions. They should consider the circumstances of these types of transaction, understand the transaction being analysed and identify the true incentive, before adopting a mathematical approach.

1.8 There is no single correct approach to analysis and, as illustrated in the examples (see section 7 below), no 'right' answer. Methods may vary depending on the circumstances of individual cases and market practices in different areas and sectors. Changing markets may mean that the approach adopted previously may not be appropriate several years later. Different approaches may also be suitable for the different reasons why an effective rent is being sought; for example consistency of approach through time may be an important element where effective rental values are being used to construct a rental value index for performance measurement approaches. However, whatever the purpose, the underlying principles are the same.

1.9 The following terms are used in this *guidance note*:

- **Incentive**: this term embraces any form of incentive, inducement or concession made by either party. The most common examples are capital payments and rent-free periods (subject to paragraph 4.1.3 for fitting-out periods).
- **Headline rent**: this is the actual contracted periodic rental payment under the lease that becomes payable after all the initial incentives or concessions in the letting have ended. It is sometimes referred to as the 'face rent' or 'contract rent'.

- **Effective rent**: this is the rent that would be agreed between the parties for a letting of the premises on the relevant terms and conditions, but without incentives forming part of the transaction. In some circumstances, such as where a large premium has been paid to secure the property and part of it is considered to be a rental equivalent, the effective rent could be higher than the headline rent. The effective rent is sometimes referred to as the equivalent rent'.

2 Motivation of the parties

2.1 The terms upon which prospective landlords and tenants will enter into a commercial lease are influenced by the general and local state of the market at the time that the terms are negotiated.

2.2 The parties may also be influenced by their respective individual objectives, economic circumstances, accounting practices or tax positions even though these are not directly related to the value of the property.

2.3 The motivations for parties offering or accepting incentives will differ with each transaction. A tenant accepting an incentive may have different motivations from the landlord offering them. Moreover, the two parties to a transaction may put different interpretations on their agreement.

2.4 Aside from market conditions and the negotiating strength of the parties, the reasons for, and influences upon, the agreement of incentives include, among others, the following:

- Investor landlords generally seek to hold the property for a combination of rental income and capital growth. They will seek to maintain or achieve a given level of rent and/or length of lease to secure an income stream from a good tenant covenant for a period that will maximise capital value.
- Incentives may be given to facilitate funding, possibly at a more favourable funding rate. The achievement of higher headline rents may be an important factor.
- If the lessor is itself a tenant, its motivation may be different from an investor landlord as it will normally be aiming to mitigate or eliminate its continuing liabilities rather than maximising capital value.
- The taxation, grant and capital allowance positions of the parties may be factors.
- The strength or weakness of the tenant's covenant may be a consideration.
- The actual terms, frequency and nature of rent reviews and the assumptions made at future rent reviews may have an impact.
- They may ease cash flow for either party. For the tenant, a rent-free period, coupled with a higher subsequent rent, is effectively an unsecured loan from the landlord.

3 Impact of break clauses, rent reviews and lease length on write-off period

3.1 In certain markets the amount of an incentive is directly proportionate to the length of tenant commitment, with larger incentives being payable if the tenant

commits to a longer lease. There may also be variations in the preferences of landlords and tenants as to the length of leases. The length of the lease, the timing and type of any rent review and the presence of break clauses all impact on the length of time that the incentive impacts on the lease income.

3.2 Break clauses may have a critical impact on any analysis depending on whether there is a reasonable possibility that they will be exercised and the terms on which they are capable of being exercised. Break clauses may have a bearing upon any write-off period with the assumption that, if a headline rent is above the effective rent at the time of the break, the break may be more likely to be exercised.

3.3 However, not all break clauses are exercised in these circumstances so it is not necessarily correct to assume that all tenants might be expected to operate a break clause (especially if there is a penalty for its operation). Exercising the break changes the period for the write-off of fitting-out costs to a shorter one than initially envisaged, which may in turn have to be reflected in an adjustment to the tenant's accounts. The effect of the notice period and the tenant's need to secure alternative premises may also be factors. If alternative premises are secured first, there could be an element of double overheads. Landlord's break clauses, on the other hand, are unlikely to be operated if the rent passing still exceeds the effective rent, unless other pressures dictate. However, a break may be capable of being used by the tenant to negotiate a downward review, so extinguishing the impact of any incentive over the later part of the lease.

3.4 This explains the importance of the rent review to any consideration of the length of time that any incentive has an impact. A rent review clause that allows a downward review to an effective rental value automatically extinguishes the impact of any incentive at that point. In these circumstances, the rent at review would be the same regardless of whether a headline rent or an effective rent had been agreed at the beginning of the lease. If, however, an upwards only rent review to effective rental value is in place, the impact of the review will only have been extinguished if the level of effective rental value had grown to or above the level of headline rent at the date of the review. The same test applies for any subsequent reviews in the lease. For any given package of lease incentives, it is only possible to determine the write-off period by assuming a future level of rental growth over the lease period. Therefore, a logical decision on write-off period can only be made in the context of an explicit cash flow analysis. If a conventional valuation approach is applied, there is no fundamental basis for that decision.

3.5 However, in the context of UK rent review negotiations, this decision has been based in the motivation of the parties within a conventional valuation framework. A write-off period to the end of the lease is preferred by landlords as it produces a higher effective rental value level from any headline rent and incentives package than if that same headline rent and package is written off to the first review only. The lower effective rental value determined when the incentives are written off to the first review only is obviously preferred by tenants (see section 5, Analysing the transaction). If a rent review negotiation cannot be resolved between the parties, third party determination is used and each of the parties can object to any particular arbitrator or expert. Arbitrator/experts would tend to adopt a compromise position, which is for the incentives to be written off over a compromise period between the first rent review and the lease term.

3.6 The more rational argument for the determination of write-off period is that, if a very low effective rent is determined by writing off to the first review, it is less likely to

be able to grow to headline rent by the first review; which means it does last beyond the first review. Conversely, if a high effective rent is determined by writing it off over the whole length of the lease, it is much more likely to grow to the headline rent over the period to the first review; suggesting the impact does not extend past the rent review. Unless the incentives packages are small in the case of tenants or the anticipated growth over the whole term of the lease is very low in the case of landlords, both extreme positions tend to be self-defeating. Only in an explicit cash flow context can the write-off period be modelled effectively.

4 Types of incentives

4.1 Rent-free periods

4.1.1 A rent-free period may occur at the beginning of the lease or at any time during the currency of the lease term. Occasionally, the tenant is required to pay rent for an initial period as evidence of its commitment to the lease, with the free period commencing at some future date.

4.1.2 Rent-free periods may reflect:

- the time required to fit out the property to suit the tenant's needs
- agreement by the tenant to carry out repairs, or improve the property, which may benefit the landlord
- commitment from the tenant to pay a higher rent so the landlord maintains rental levels as high as possible or
- acceptance of specific liabilities or restrictions under the lease.

4.1.3 The principle of granting a rent-free period to reflect the time required for fitting out the property to suit the tenant's reasonable needs is common practice in many markets. Therefore it may not normally be regarded as an incentive. It represents a balance between the landlord's need to secure an income from as early a date as possible and the tenant's need not to have a rent liability until the property can be occupied.

4.1.4 What is considered a reasonable length of time for the fitting out will vary according to the extent of the works, the size of the property in question and local market practice. Where specialist fitting out is involved, the time taken may go beyond a normal fitting-out period and an element may not be considered to be part of the reasonable fitting-out period.

4.1.5 In some circumstances, usually by the grant of a licence or following an agreement for a lease, the fitting-out period may begin before the formal commencement of the lease.

4.1.6 Assistance by the landlord with the costs of fitting out (in contrast to the rent-free period to reflect the time taken for the works) may take the form of capital payments to the tenant, or the provision of physical works by the landlord.

4.1.7 When fitting-out works or improvements are carried out as a condition of the grant of the lease, they are effectively a premium payable by the tenant. It is necessary to establish whether such improvements can be reflected in the rent at review.

4.2 Premiums and other capital payments

4.2.1 Consideration of premiums requires care because they rarely show a consistent pattern. A premium could be made up from several elements, which are necessary to establish so that only those elements that are appropriate to be reflected in an adjustment are identified. The timing of payments also needs to be considered, particularly where they are close to new lettings, reviews or renewals.

4.2.2 A payment by the landlord to the tenant is not necessarily an incentive as it may relate to other issues, such as taking on repairing obligations.

4.2.3 A payment by the landlord for the cost of works that improve the property in a way that enhances its rental value may not be an incentive, but merely a change in the nature of the property being let. Premiums can also be cash payments to the tenants at the commencement of (or at any time throughout) the lease term, or they can be payments in kind, such as subsidies or equipment, or tenants' removal/relocation costs.

4.2.4 A premium paid by the incoming tenant to the landlord, or an existing tenant on an assignment of a lease, may reflect the fact that the passing rent is below the current net effective rent. The value of improvements, goodwill, a need to be in a particular location or building or the assignee being a *special purchaser* may also be considered in this premium. In addition, the premium may account for special modification of the lease terms tailored for that tenant's particular trading circumstances, or even the benefit of restrictive covenants on other tenants in a development.

4.2.5 The assessment of the true capital cost of these benefits to both landlords and tenants can be problematic, and there may be differing interpretations which include the following:

- The landlord may argue that the whole of the premium represents capitalised profit rent, or it is common in prime locations to find new lettings significantly above reviews or lease renewals.
- The tenant may argue that:
  - treating premiums as capitalised profit rent may result in high figures that cannot be justified by other market evidence
  - its payment of a premium is solely to obtain occupation that is not related to rental value or
  - an occupier may be prepared to pay a premium, but would not pay an equivalent amount as rent because of its particular accounting practices.

4.2.6 The validity of these arguments requires careful review to establish what proportion (if any) of the premium should be considered to be paid in lieu of rent.

4.3 Stepped rents, rent capping and fixed rent on reviews

4.3.1 Stepped rents and fixed rents are common in sale and leaseback transactions. In these circumstances they are not an incentive but a reflection of the price of the capital raised by the lessee. However, in an open market letting, these features can be used as incentives and may influence the headline rent.

4.3.2 The period over which rents may be stepped is usually, but not always, within the period to the first rent review. Rents may be capped to a maximum or minimum level, or a range, and may also be linked to factors not directly property related.

4.4 Lease surrenders or take-backs

4.4.1 The landlord may agree to accept the tenant's ongoing liabilities, either partially or in their entirety, in respect of the previous or other premises of the tenant.

4.4.2 The calculation of the benefits to a tenant may consider not only the projected void costs in any existing leases surrendered or assigned, but also the costs of disposal (including legal and agency fees, and any necessary incentives) and any accrued dilapidations or other liabilities.

4.4.3 The landlord may be influenced by its ability or wish to redevelop or refurbish the premises taken back.

4.4.4 Another example might be *marriage value* (or *synergistic value*) accruing to the landlord by taking back the premises. This might influence the valuer to make an upwards adjustment of the rent, rather than discounting it.

4.5 Other incentives

4.5.1 The parties may agree to incentives that may reflect circumstances particular to the letting, such as concessions in the lease covenants and service charge caps.

4.5.2 The assessment of these incentives may not be straightforward due to the difficulty in obtaining full details of the amounts involved and assessing the real benefits to the tenant.

5 Analysing the transaction

5.1 Methods of analysis

5.1.1 The purpose of the analysis is to establish the effective rent, having regard to the package of incentives incorporated into the specific transaction.

5.1.2 There are three different types of method normally applied to this analysis.

(a) The first method does not take into account the timing of cash flows and simply sets the total income and expenditure from the actual lease, including any incentives, against an equivalent lease that assumes no incentives to let had been granted. The method does not anticipate any change to the cash flow over time regardless of whether there are rent reviews in the lease.

(b) The second method adopts a similar 'conventional' approach to future rental value change during the lease but adopts a time value of money discounting approach to the problem. This requires a discount rate that may be either some form of target return rate or a capitalisation rate or a combination of both.

(c) The third method is an explicit discounted cash flow approach requiring both a target return rate and a rental growth rate as inputs.

5.1.3 Section 7 of this *guidance note* sets out two examples to illustrate how these methods work; one with rent reviews within the lease and one without.

- Example 1 is a short lease with a rent-free period, no reviews and a small amount of capital payment.
- Example 2 is a longer lease with upwards only rent reviews, a longer rent-free period and a larger capital payment.

All the examples and discussion assume that any rent reviews are upwards only and that the lease term is assumed to be the end of the lease or the period to the first break clause, if one exists.

5.1.4 There are a number of issues concerning the methods. The three issues that apply to all of the methods are:

- the treatment of comparables
- the approach to any rent-free period for fitting out of the premises and
- the individual circumstances of the parties.

5.2 Treatment of comparables

5.2.1 There are two primary approaches to the treatment of comparables in common use in the UK:

(a) devalue each comparable to an effective rent and then apply all of them to arrive at one net effective rent for the subject premises, after making appropriate adjustments for differences (for example, in lease length) that might cause the appropriate scale of the incentives, and hence the effective rent, to differ or

(b) use the comparable evidence to find the market package (that is, headline rent and incentives) that would be likely to be agreed in the marketplace for the subject premises, and then adjust that transaction to reflect the assumed lease terms. Having arrived at the market package applicable to the subject premises, the effective rent is then calculated.

5.3 Rent-free periods for fitting out

5.3.1 The valuer may need to decide if the effective rent is to be calculated including or excluding a rent-free period during which the fitting-out works took place.

5.3.2 For general valuation purposes, the logical approach to the valuation would be that the tenant needs to occupy for a period to fit out, and therefore the rent-free period would start at the beginning of the lease and the total rent-free period would include both fitting-out and incentive periods. The effective rent lease would have just the fitting-out period.

5.3.3 For lease renewals, the legislation (in England and Wales, the *Landlord and Tenant Act* 1954) and associated case law will be relevant in all cases, although the Act is silent on fitting-out *assumptions* in its definition of rental value.

5.3.4 In the case of rent reviews, the lease wording should be checked carefully. There are two possible approaches. The first is to assume that under the hypothetical 'net effective rent deal', the tenant would receive a rent-free period equal

to the fitting-out period only. An alternative approach is to assume that the fit-out took place before the start of the lease term and it is quite common in UK rent reviews to have this assumption written into the rent review clause.

5.3.5 This difference can be accommodated within all the methods set out in all the methods set out in the examples. The basic approach of this note is to assume that the fit-out period is part of the lease term; however, Example 1 in section 7 of this *guidance note* illustrates the alternative approach.

5.4 Accounting and tax

5.4.1 It is arguable that the tax and accounting implications of the incentives, from both the landlord and tenant's point of view, should be taken into account in the analysis. However, in market valuation generally, these are not taken into account as market rents should be priced by competition in the market and not by the personal tax circumstances of individual parties. These may influence the amount a landlord and tenant could afford to pay but these personal advantages or disadvantages do not normally flow into market prices unless they are available to all, in which case they should be picked up within the comparable information.

5.5 Write-off periods and discount rates

5.5.1 There are three major issues concerning the application of methods to the analysis of effective rental values from headline rents which do not impact equally on each method. These are the choice of write-off period, the choice of any discount rate required and the choice of any growth rate. Section 5.1.2 identifies which methods need which inputs. In summary the cash flow approach requires a choice of discount rate and growth rate. Method 1 does not require the choice of a discount rate or growth rate but does require a choice of a write-off period. Method 2 requires a write-off period to be chosen and a discount rate.

5.5.2 The use of a capitalisation rate as a discount rate implies change in the future cash flow. It may be assumed that, where some changes to rent are expected, the capitalisation rate could be used in the calculations.

5.5.3 However, there are some interesting contradictions with this assumption that are related to the issue of the write-off period. Effective rents could grow rapidly enough such that the headline rent is superseded at the first review. However, it is also possible that it would not, with the result that the headline level of rent persists as the passing rent beyond the first review date (assuming an upwards only rent review clause). In the latter case, it would be appropriate to discount the effective rent within method 2 at the capitalisation rate where the effective rent is assumed to last beyond the review date. If the write-off period is to the first review only, the effective rent is fixed for the duration of the calculation and so a target rate of return would be more appropriate.

5.5.4 Yet the headline rent is a fixed rent so a growth implicit capitalisation rate would not be appropriate to discount that income flow. Where the write-off period extends beyond the rent review, an assumption is being made that the headline rent, underpinned by an upwards only clause, remains above the effective rental value at the review date. So, even where the write-off period extends beyond the first review,

it is still appropriate to discount it at the target rate. It may therefore be appropriate to discount the headline rent at a target rate and the effective rent at a capitalisation rate.

5.5.5 Method 3 has no such ambiguities. It is based on an explicit cash flow, so all cash flows are discounted at the target rate of return. The choice of target rate is not simple and is discussed in the RICS *guidance note*, *Discounted cash flow for commercial property investments* (2010).

5.5.6 As each method requires a different set of inputs, the choice of each of these inputs has a very different impact on the outcome. The various outcomes to Examples 1 and 2 are set out below in Table 1 and range between effective rents of £64,632 and £73,684 for Example 1 and between £10,465 and £74,576 for Example 2. The huge range in Example 2 is primarily caused by the different write-off periods adopted.

5.5.7 IPF (2013) (Innovation in Public Finance Conference) examines a greater range of different inputs and finds variation in the other inputs as well as the write-off period – low capitalisation rates and high growth rates should lead to shorter write-off periods while low growth rates and higher capitalisation rates tend to favour longer write-off periods. More obviously, lower levels of incentives should be written off over shorter periods. IPF (2013) also found that using a compromise write-off period in methods 1 and 2 reconciles more closely with a more sophisticated cash flow approach across a range of capitalisation rates, target rates and write-off periods than where these methods are applied using either rent review or full lease term as the write-off period.

Table 1: Range of solutions to the various methods

	Method 1	Method 2 Capitalisation rate	Method 2 Target rate	Method 2 Target rate and capitalisation rate	Method 3 DCF
Example 1					
Write off to lease end	£73,684	£69,724	£68,365	£64,632	£68,365
Example 2					
Write off to rent review	£21,053	£13,581	£11,078	£10,465	
Write off to lease end	£74,576	£63,764	£59,875	£52,605	
Write off half way between rent review and lease end	£61,538	£51,792	£48,409	£44,008	£55,304[1]

Note 1: The DCF method does not require a compromise write-off period, it selects the correct one for the growth assumptions made.

6 Conclusion

6.1 The effective rental value depends on the terms of the lease as well as the usual location and building characteristics. When providing an estimate of *market rent*, valuers must take care to set out clearly the principal lease terms that are assumed, as well as any other payments or concessions by one party to the other as an incentive to enter into the lease (see **VPS 4 paragraph 1.3, Market rent**).

6.2 There are occasions when it is necessary to amend the details of the actual letting in order to calculate the effective rent assuming no incentives had been given. These could include clarifying rental evidence in rental negotiations at rent review, as well as developing consistent bases for the construction of rental value indices through time, and identifying the *market value* or *investment value* of both let and vacant properties.

6.3 There are a number of methods of analysing contract, face or headline rents in order to determine the level of effective rent for any individual transaction. The choice of method is for the valuer to determine in the light of the individual circumstances. This choice may vary on account of the type and quality of property. It may also vary according to the role of the rental analysis; for example, at the time of writing there is an industry consultation taking place in the UK to identify a consistent method of analysing rental transactions for performance measurement purposes. In this case, consistency of application of technique may be more important than applying the best method to each individual circumstance.

6.4 Different applications of three methods of analysis have been identified in section 7 of this *guidance note*, ranging from simple addition of the benefits of the individual leases through conventional cash flow, to more explicit cash flow approaches. The examples are not exhaustive and the methods not inclusive of all possible approaches. In addition, the methods are not mutually exclusive of each other and some or all can be used by valuers to support their valuation.

6.5 There are a number of important issues to consider when determining effective rental values.

(a) First, the write-off period can be determined objectively but it does require some explicit assumptions on the future behaviour of the cash flows from the different leases being compared.

(b) Second, valuations require the choice of a discount rate and this can be based on the capitalisation rate or on a target rate of return. These choices can be side-stepped but only by applying a technique that ignores discounting; and discounting is the cornerstone of modern valuation practice.

Variations in these inputs will have varying effects on the different methods and will create some valuation uncertainty. This is normal in all valuations and it is for the valuer to determine the appropriate method for the different circumstances.

7 Examples of the analysis of incentives

This section illustrates and compares the results of analysing two transactions using the methods outlined in section 5, Analysing the transaction. They do not

recommend or endorse any particular approach. To illustrate the principles, the examples are highly simplified and thus cannot be used as a model approach to the analysis of a specific lease.

Discount rates and growth rates

In all of the examples, the following discount rates and growth rates have been assumed:

- equivalent yield: 6.0% (the investment capitalisation rate)
- target internal rate of return (IRR): 8.0% (investors' typical target IRR)
- growth rate 2% (a simplified implied rate from the target and capitalisation rate).

Cash flow in arrears or advance

In methods 2 and 3, where a DCF concept is adopted, the calculations are presented using a DCF shortcut approach employing years purchase (YP) and present value factors. The YP factors are on an annually in arrears basis to reflect general market practice and the analysis of capitalisation rates, which are often also based on these assumptions. However, YP quarterly in advance or a YP for any other period can easily be substituted into the calculations illustrated.

Example 1

A short lease with a rent-free period, no reviews and an amount of capital payment. Headline rent £100,000 pa, capital payment £50,000, lease 5 years, rent free 1 year of which fitting-out period 3 months.

Headline rent	£100,000 pa
Lease length	5 years
Capital payment	£50,000
Capitalisation rate	6%
Target rate	8%
Assumed growth rate	2%
Rent-free period	1.00 year
Fitting-out period	0.25 years

Method 1: Straight line

Headline rent	£100,000 pa
Lease length	5 years
Capital payment	£50,000
Capitalisation rate	6%
Target rate	8%
Assumed growth rate	2%
Rent-free period	1.00 year
Fitting-out period	0.25 years

Method 1

Headline rent	£100,000
Received for (yrs)	4.00 years
Capital value of headline rent	£400,000
Less capital payment	£50,000
Capital value of inducements	£350,000
Spread over/divide by (yrs)	4.75 years
Effective rent	£73,684

Method 2: Time value of money

Method 2 (using target rate)

Headline rent	£100,000
YP @ target rate for 4.00 yrs	3.3121
PV £1 @ target rate for 1.00 yr	0.9259
Capital value of headline rent	£306,678
Less capital payment	£50,000
	£256,678
Divide YP @ target rate for 4.75 yrs	3.8274
PV £1 @ target rate for 0.25 yrs	0.9809
Deferred YP	3.7545
Effective rent	£68,365

Method 2 (using capitalisation rate)

Headline rent	£100,000
YP @ capitalisation rate for 4.00 yrs	3.4651
PV £1 @ capitalisation rate for 1.00 yr	0.9434
Capital value of headline rent	£326,897
Less capital payment	£50,000
	£276,897
Divide YP @ capitalisation rate for 4.75 yrs	4.0296
PV £1 @ capitalisation rate for 0.25 yrs	0.9855
Deferred YP	3.9713
Effective rent	£69,724

Method 2 (Headline rent target rate, effective rent rate)

Headline rent	£100,000
YP @ target rate for 4.00 yrs	3.3121
PV £1 @ target rate for 1.00 yr	0.9259
Capital value of headline rent	£306,678
Less capital payment	£50,000
	£256,678
Divide YP @ capitalisation rate for 4.75 yrs	4.0296
PV £1 @ capitalisation rate for 0.25 yrs	0.9855
Deferred YP	3.9713
Effective rent	£64,632

Method 3: Cash flow

Headline rent	£100,000
YP @ discount rate for 4.00 yrs	3.3121
PV £1 @ discount rate for 1.00 yr	0.9259
Capital value of headline rent	£306,678
Less capital payment	£50,000
Capital value of inducements	£256,678
Divide YP @ discount rate for 4.75 yrs	3.8274
PV £1 @ discount rate for 0.25 yrs	0.9809
Deferred YP	3.7545
Effective rent	£68,365

Example 1 using an alternative fit-out assumption

Method 2: Using capitalisation rate and assuming rent review clause suggests fit-out period before the start of the lease	
Headline rent	£100,000
YP @ capitalisation rate for 4.25[1] yrs	3.6560
PV £1 @ capitalisation rate for 0.75 yrs	0.9572
Capital value of headline rent	£349,969
Less capital payment	£50,000
	£299,969
Divide YP @ capitalisation rate for 5[1] yrs	4.2124
Effective rent	£71,212

Note[1]: The incentive is still 0.75 years of the one year total rent free but the fit-out period is assumed to be outside of the lease term and so the headline rent period is 4.25 years and the effective rent write-off period is the full 5 years.

Example 2

A longer lease with upwards only rent reviews, a longer rent free and capital payment. Headline rent £100,000, rent free 3 years, capital payment £100,000, lease 15 years with 5-year upwards only reviews.

Headline rent	£100,000 pa
Lease length	15 years
Rent review	5 years
Capital payment	£100,000
Capitalisation rate	6%
Target rate	8%
Assumed growth rate	2%
Rent-free period	3.00 years
Fitting-out period	0.25 years

Method 1: Straight line

Method 1 (write off full lease period – 15 years)

Headline rent	£100,000
Received for (yrs)	12.00
Capital value of headline rent	£1,200,000
Less capital payment	£100,000
Capital value of inducements	£1,100,000
Spread over/divide by (yrs)	14.75
Effective rent	£74,576

Method 1 (write off to rent review – 5 years)

Headline rent	£100,000
Received for (yrs)	2.00
Capital value of headline rent	£200,000
Less capital payment	£100,000
Capital value of inducements	£100,000
Spread over/divide by (yrs)	4.75
Effective rent	£21,053

Method 1 (write off over compromise period – 10 years)

Headline rent	£100,000
Received for (yrs)	7.00
Capital value of headline rent	£700,000
Less capital payment	£100,000
Capital value of inducements	£600,000
Spread over/divide by (yrs)	9.75
Effective rent	£61,538

Method 2: Time value of money

Method 2 (capitalisation rate write off full lease period – 15 years)

Headline rent	£100,000 pa
YP 12 years x PV 3 yrs @ 6%	7.0392
Value of headline rent	£703,924
Less capital payment	£100,000
Value of headline lease	£603,924
Divide by YP 14.75 yrs x PV 0.25 yrs @ 6%	9.4712
Effective rent	£63,764

Method 2 (capitalisation rate write off over rent review period – 5 years)

Headline rent	£100,000 pa
YP 2 years x PV 3 yrs @ 6%	1.5394
Value of headline rent	£153,935
Less capital payment	£100,000
Value of headline lease	£53,935
Divide by YP 4.75 yrs x PV 0.25 yrs @ 6%	3.9713
Effective rent	£13,581

Method 2 (capitalisation rate write off over compromise period – 10 years)

Headline rent	£100,000 pa
YP 7 years x PV 3 yrs @ 6%	4.6871
Value of headline rent	£468,708
Less capital payment	£100,000
Value of headline lease	£368,708
Divide by YP 9.75 yrs x PV 0.25 yrs @ 6%	7.1191
Effective rent	£51,792

Method 2 (target rate – as above at 8%)

Effective rent over whole lease period	£59,875
Effective rent over rent review period	£11,070
Effective rent over compromise period	£48,409

Method 2 (Headline rent target rate 8%, effective rent capitalisation rate 6%)

Effective rent over whole lease period	£52,605
Effective rent over rent review period	£10,465
Effective rent over compromise period	£44,008

Method 3: Cash flow

Headline rent	£100,000 pa
YP 12 years x PV 3 yrs @ 8%	5.9824
Value of headline rent	£598,238
Less capital payment	£100,000
Net value of headline lease	£498,238
Value of effective rent	£x
YP 5 years x PV 0.25 yrs @ 8%	3.7545
Value of first term	£3.7545x
Reversion to future rental value @ 2% pa	£1.1041x
YP 5 years @ 8% x PV 5 years @ 8%	2.7174
Value of 1st reversionary rent	£3.0002x
Reversion to future rental value @ 2% pa	£1.219x
YP 5 years @ 8% x PV 10 years @ 8%	1.8494
Value of 2nd reversionary rent	£2.2544x
Value of effective rent	9.0091x
Effective rent = value of HR divide by value of ER =	£498,238/9.0091
Effective rent (x) =	£55,304 pa
Effective rent at first review = £55,304 x $(1.02)^5$ =	£61,060 pa
Effective rent at second review = £61,060 x $(1.02)^5$ =	£67,415 pa

The result illustrates that the impact of the incentive spreads over the whole of the lease term but that the impact diminishes over time assuming positive growth. Had the level of incentives and/or the target rate and growth rate used suggested that the effective rental value had overtaken the headline rent at either of the rent reviews, the calculation would need to be redone using a 10-year write-off period only or even a write off to the first review. Example 3 illustrates such a situation and is assessed by a cash flow approach only.

Example 3

The same lease as in Example 2 with no capital payment and a shorter rent-free period of 1 year.

Headline rent	£100,000
Lease length	15 years
Rent review	5 years
Capitalisation rate	6%
Target rate	8%
Assumed growth rate	2%
Rent free	1.00 year
Fitting out	0.25 years

Method 3: Cash flow assuming full term

Headline rent	£100,000 pa
YP 14 years x PV 1 yrs @ 8%	7.6336
Value of headline rent	£763,355
Value of effective rent	£x
YP 5 years x PV 0.25 yrs @ 8%	3.7545
Value of first term	£3.7545x
Reversion to future rental value @ 2% pa	£1.1041x
YP 5 years @ 8% x PV 5 years @ 8%	2.7174
Value of 1st reversionary rent	£3.0002x
Reversion to future rental value @ 2% pa	£1.219x
YP 5 years @ 8% x PV 10 years @ 8%	1.8494
Value of 2nd reversionary rent	£2.2544x
Value of effective rent	9.0091x
Effective rent = value of HR divide by value of ER =	£763,355/9.0091
Effective rent (x) =	£84,732 pa
Effective rent at first review = £84,732 x $(1.02)^5$ =	£93,550 pa
Effective rent at second review = £95,550 x $(1.02)^5$ =	£103,207 pa

RICS UK guidance notes

If the growth projection within the calculation suggests that headline rent will be overtaken by the effective rental value at the second review, the calculation needs re-working under that assumption of a 10-year write-off period.

Method 3: Cash flow assuming 10-year write-off period

Headline rent	£100,000 pa
YP 9 years x PV 1 yr @ 8%	5.7842
Value of headline rent	£578,416
Value of effective rent	£x
YP 5 years x PV 0.25 yrs @ 8%	3.7545
Value of first term	£3.7545x
Reversion to future rental value @ 2% pa	£1.1041x
YP 5 years @ 8% x PV 5 years @ 8%	2.7174
Value of 1st reversionary rent	£3.0002x
Value of effective rent	6.75471x
Effective rent = value of HR divide by value of ER =	£578,416/6.75471x
Effective rent (x) =	£85,632 pa
Effective rent at first review = £85,632 x $(1.02)^5$ =	£94,544
Effective rent at second review = £94,544 x $(1.02)^5$ =	£104,384 pa

Headline rent is predicted to be extinguished by the second review in year 10, as the rent of the headline rent lease will be reviewed upwards to the same rent as if the property had been let at an effective rental value of £85,632 per annum.

UKGN 7 Valuations for charities

1 Introduction

1.1 There are various statutory provisions that apply to charities. These include:

- the *Companies Act* 2006
- the *Charities Acts* 2006 and 2011
- the *Trusts of Land and Appointment of Trustees Act* 1996 and
- the *Trustee Act* 2000.

1.2 In addition, the Charity Commission publishes various booklets giving advice on specific topics that are available on its website (www.charitycommission.gov.uk/detailed-guidance/land-and-property/). Booklets CC33, *Acquiring Land,* and CC28, *Sales, leases, transfers or mortgages*, together with their operational guidance, are particularly useful. Where charities are producing *financial statements*, they will follow the Charity Commission's statement of recommended practice (SORP). For accounting periods up to 31 December 2014, the Charities SORP 2005 applies, which broadly follows FRS 15. For accounting periods on or after 1 January 2015 the new Charities SORPs, based on FRS 102, apply. Two new SORPs provide a comprehensive framework for charity accounting that all charities that prepare accrual accounts must follow:

- **Charities SORP (FRSSE)** – Applicable to charities preparing their accounts in accordance with the Financial Reporting Standard for Smaller Entities and
- **Charities SORP (FRS 102)** – Applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland.

UKVS 1, Valuation of real property, plant and equipment for financial statements under UK GAAP, gives more information on the latest UK GAAP (FRS 100–103 and FRSSE 2015).

1.3 This guidance, which is based on CC28 and CC33, provides further information for valuers who are requested to provide valuations for acquisitions and disposals by charities. *Members* who require more information about the powers of trustees or any other matter related to charities should seek advice from the charity's own professional advisers.

2 Acquisitions

2.1 Where trustees propose to acquire land, there is no requirement for them to obtain professional advice, unless such a requirement is in the trust deed. However,

the Charity Commission strongly recommends that they obtain a report from a 'qualified surveyor' (as defined in CC33 and given in paragraph 2.2) who is acting solely for the trustees. Where the proposed transaction requires the trustees to obtain an order of the Charity Commission before acquiring land (for example, acquiring land other than freehold land, buying land from one of the trustees or where there is no power to acquire land), it is anticipated that the Commission will expect such an application to be accompanied by a surveyor's report.

2.2 A 'qualified surveyor' is defined in CC33 as 'a fellow or professional associate of the Royal Institution of Chartered Surveyors (RICS)'. Pending any review of this publication, the reference with regard to RICS may be read as referring to any '*member*' of RICS, as defined in the Rules of Conduct.

2.3 When considering the purchase of land, the trustees must take all reasonable steps to ensure that, among other matters:

- the property is suitable for its intended use and, in particular, is not subject to any legal or planning restrictions or conditions that might conflict with that use, or with which it may be difficult for the trustees to comply
- any necessary planning permission is obtained
- the price or rent is fair compared with similar properties on the market and
- when acquiring a lease, they understand the obligations to which they will be subject under the lease and ensure that the terms of the lease are fair and reasonable.

2.4 Basis of value

2.4.1 Although there is no *basis of value* specified in the guidance, the presumption is that it will be *market value* or *market rent*.

2.4.2 There may be circumstances where a charity is in a special position – for instance, where it has the benefit of certain tax exemptions or is a *special purchaser* – and therefore may be able to justify paying more than *market value*. Such circumstances, which are assessments of *worth*, are not to be reflected in the valuation but should be referred to in the general advice as to what the trustees should offer to pay or bid at auction.

2.5 Matters to be included in the report

2.5.1 The valuer will comply with the general requirements of **VPS 3, Valuation reports**, having regard to the commission's recommendation to include the following:

- a description of the land
- details of any planning permission needed
- a valuation of the land
- advice on the price that the trustees ought to offer to pay, or the maximum bid they ought to make at auction
- a description of any repairs or alterations the trustees would need to make and their estimated cost
- a positive recommendation (with reasons) that it is in the interests of the charity to purchase the land and

- anything else the surveyor thinks is relevant, including a description of any restrictive or other covenants to which the land is subject.

3 Disposals

3.1 Where a charity wishes to dispose of an interest in land exceeding a term of seven years, a report must be obtained from a 'qualified surveyor' (section 119 of the *Charities Act* 2011).

3.2 For these purposes, a 'qualified surveyor' is a *member* of RICS. The *member* must also be reasonably believed by the trustees of the charity to have ability in, and experience of, the valuation of land of the particular kind and in the particular area in question.

Matters to be included in the report

3.3 The report must include a range of information laid down in the *Charities (Qualified Surveyors' Reports) Regulations* 1992 (SI 1992/2980), as summarised in the following paragraphs.

3.4 A description of the relevant land and its location, by reference to a plan if convenient, is to include:

- the measurements of the relevant land
- its current use
- the number of buildings (if any) included in the relevant land
- the measurements of any such buildings and
- the number of rooms in any such buildings and their measurements.

3.5 Details of whether the relevant land, or any part of it, is leased by or from the charity trustees should be included and, if it is, so should details of:

- the length of the lease and the period of this which is outstanding
- the rent payable under the lease
- any service charge payable
- the provisions in the lease for any review of the rent payable under it, or any service charge payable
- the liability under the lease for repairs and dilapidations and
- any other provision in the lease that, in the opinion of the surveyor, affects the value of the relevant land.

3.6 The report should contain information on whether the relevant land is subject to the burden, or enjoys the benefit, of any easement or restrictive covenant. In addition it should inform if the land is subject to any annual or other periodic sum charged on, or issuing out of, the land, except rent reserved by a lease or tenancy.

3.7 Information on any buildings included in the relevant land and whether they are in good repair should be commented on. If not, the surveyor should give advice on:

- whether or not it would be in the best interests of the charity for repairs to be carried out prior to the proposed disposition
- what those repairs, if any, should be and

- the estimated cost of those repairs.

3.8 Advice should be given on whether it would be in the best interests of the charity to alter any buildings included in the relevant land prior to disposition (because, for example, adaptations to the buildings for their current use will not command the best market price on the proposed disposition). An estimate of the outlay required for any alterations should be suggested.

3.9 Advice should be given on the manner of disposing of the relevant land so that the terms on which it is disposed of are the best that can reasonably be obtained for the charity, including:

- where appropriate, a recommendation that the land should be divided for the purposes of the disposition
- the period for, and the manner in which, the proposed disposition should be advertised (unless the surveyor's advice is that it would not be in the interests of the charity to advertise the proposed disposition)
- where advised that it would not be in the best interests of the charity to advertise the proposed disposition, the reasons for that advice (for example, that the proposed disposition is the renewal of a lease to someone who enjoys statutory protection, or belief that a *special purchaser* will pay considerably more than the market price for it) and
- any view the surveyor may have on the desirability or otherwise of delaying the proposed disposition and, if it is reasonable to believe that such delay is desirable, what the period of that delay should be.

3.10 The report should include the surveyor's opinion of:

- the current value of the relevant land, taking account of its current state of repair and current circumstances (such as the presence of a tenant who enjoys statutory protection), or, where the proposed disposition is a lease, the rent that could be obtained in its current state
- the value of the relevant land, or what the rent under the proposed disposition would be if advice under paragraph 3.7 has been given and followed; or where an opinion expressed under paragraph 3.8 has been acted on; or if both such advice and opinions had been acted on
- the increase in the value of the relevant land or rent if a recommendation made under paragraph 3.9 had been followed
- the amount by which the price that could be obtained by not advertising exceeds the price that could be obtained if the proposed disposition were advertised (where the advice is that it would not be in the best interests of the charity to advertise the proposed disposition because it is believed a higher price can be obtained by not doing so) or
- where a delay is advised in the proposed disposition under paragraph 3.9, the amount by which the surveyor believes the price that could be obtained due to such a delay exceeds the price that could be obtained without it.

3.11 In cases where it is relevant, and the surveyor feels competent to do so, advice should be given on whether VAT can be charged on the proposed disposition, and the effect it would have on the valuations given in paragraph 3.10. In cases where either the surveyor does not feel able to give such advice, or believes that such advice is not relevant, a statement should be made to that effect.

3.12 The surveyor may be of the opinion that the proposed disposition is not in the best interests of the charity because it does not make the best use of the relevant land. If so, the reasons for this opinion, together with advice on the type of disposition that would constitute the best use of the land are to be given. For example, this would include any relevant advice on the prospect of buying out a sitting tenant, or of succeeding in an application for a change in the use of the land under the laws relating to town and country planning or similar.

Confidence through professional standards

RICS promotes and enforces the highest professional qualifications and standards in the development and management of land, real estate, construction and infrastructure. Our name promises the consistent delivery of standards – bringing confidence to the markets we serve.

We accredit 118,000 professionals and any individual or firm registered with RICS is subject to our quality assurance. Their expertise covers property, asset valuation and real estate management; the costing and leadership of construction projects; the development of infrastructure; and the management of natural resources, such as mining, farms and woodland. From environmental assessments and building controls to negotiating land rights in an emerging economy; if our members are involved the same professional standards and ethics apply.

We believe that standards underpin effective markets. With up to seventy per cent of the world's wealth bound up in land and real estate, our sector is vital to economic development, helping to support stable, sustainable investment and growth around the globe.

With offices covering the major political and financial centres of the world, our market presence means we are ideally placed to influence policy and embed professional standards. We work at a cross-governmental level, delivering international standards that will support a safe and vibrant marketplace in land, real estate, construction and infrastructure, for the benefit of all.

We are proud of our reputation and we guard it fiercely, so clients who work with an RICS professional can have confidence in the quality and ethics of the services they receive.

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