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RED, WHITE OR BLUE?

COLOURING VALUERS' PERCEPTIONS

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Abstract:
The issue of guidance and regulation of valuers' practice is topical. There exists an ambition for convergence of valuation practice internationally but this is far from being realised. Yet, the ambition for consistent bases of valuation remains an ambition of national and supra-national bodies. Indeed it is increasingly important given the continuing rise in cross-border property transactions.

Within the last 12 months, notable changes have occurred within the compulsory and best practice guidance given to valuers notably by the International Valuation Standards Committee (IVSC) and the European Group of Valuers' Association (TEGoVA). Some of these revisions are part of the ongoing overhaul of all standards. However, some of the developments have been driven by changes in accounting standards and their application. It was these, specifically, that led the RICS to re-issue its mandatory practice statement on company accounting valuations in March 2000.

The changes have led to a lacuna between the recognised bases for asset valuations as between the three major bodies (RICS, TEGoVA and IVSC). The area in which this is most apparent is the acceptance, or otherwise, of EUV (existing use value). This is recognised by both TEGoVA and RICS but not internationally

This paper explores the implications of the abandonment of EUV in international guidance particularly in relation to properties that have to be valued for accounting purposes but for which there is little or no ready market. It is contended that if market value is the only acceptable approach to accounting valuations, this will have implications for corporate entities and may give their advisers some practical problems. If EUV is abandoned it also calls into question the appropriateness of DRC (depreciated replacement cost) as a valid 'surrogate' of market value

1.0 Introduction

The issue of the possible convergence in valuation standards and practice is considered to be highly topical and it is accepted to be an ambition amongst professional bodies (Adair *et al.*, 1996). In papers delivered to the ERES and Cutting Edge conferences last year (Sayce and Connellan, 2000[a] and [b]) it was debated in the context of current valuation practice in Europe. These papers started from the premise that asset valuations were the most likely vehicle for convergence because valuations for financial statements had been observed to be the original driver behind the ambition. Furthermore the early guidance issued by the Royal Institution of Chartered Surveyors (RICS) (RICS, 1974) and TEGOVOFA[2] only addressed asset valuations. It was not until 1995 that the RICS issued *mandatory* standards (RICS,

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[2] TEGOVOFA (The European Group of Valuers of Fixed Assets) is now subsumed into TEGoVA (The European Group of Valuers' Associations). The first editions of their *guidance* notes were issued in 1976 (RICS) and 1977 (TEGOVOFA).

1995) applying to the vast majority of valuations[3] and 1997 before European standards were extended (Champness, 1997), albeit advisory only, to most valuations (Waters, 1997).

Parallel to the development of UK [United Kingdom] based and European standards, International Valuation Standards were first published in 1985 (TIASVC, 1985) and amended several times thereafter (IVSC, 2000:v). These have as their primary objective the production of "*truly international standards and reporting that meet the needs of financial reporting, international property markets and the international business community…*"

The work reported last year was based on a limited range of questionnaire responses together with examination of the then extant guidance and regulation governing valuations prepared for financial statements. It was found that *"the basic building blocks are still not there … and to achieve true convergence will require far more than the writing and issuing of agreed European or international standards. There are unresolved issues in relation to the cultural and legal context, which remain deep-rooted*" (Sayce and Connellan, 2000[b]:19). This could be interpreted as presenting a very negative view as to the prospects for a unified (or at least consistent) European valuation profession to emerge.

Further, it was concluded that:
?? despite the acknowledged shared ambition evidenced in the guidance, the guidance offered appears to be so broad as to render many definitions and interpretations possible;
?? the continued ability to enter assets at historic cost, not at re-valuations, was leading to a stagnation in the exercise and disabling of analysis; and
?? that financial accounts may not be the most appropriate purpose to drive the convergence agenda forward.

A final conclusion to the work was that the real drive towards greater integration could lie "*in the assessment of performance - both as an investment and as working asset for which value in use is the* ***real*** *issue*" (Sayce and Connellan, 2000[b]: 19). So, the authors highlighted the concept that '*value in use'*, as well as '*value in exchange'*, could be important in developing shared understanding between professionals working internationally. The paper delivered to the Cutting Edge (Sayce and Connellan, 2000[b]) incorporated initial views on the revised International Standards but since that time, new guidance has been issued by TEGoVA[4], thus enabling a closer analysis of apparent issues between the three sets of guidance.

This paper debates one particular issue: the valuation treatment of corporate assets within financial accounts. This is one that has received comparatively little attention but is extremely important in terms of analysis of company performance (see for example Krumm, 2000). The position of financial accounting is important not for its own sake as "*financial accounting is not an end in itself but is intended to provide information that is useful in making business and economic decisions…"* (FASB: 1998: Appendix B).

The paper considers the position of '*value in use'* and *'Existing Use Value'* [EUV] and their relationship to the accounting concept of '*fair value'*. The paper takes as its stance that the very notion of Existing Use Value [EUV] is outdated and, despite its recent seeming endorsement in European standards, is not consistent with the ambition of convergence.

The paper then postulates that if EUV is abandoned at a national or European level, the use of Depreciated Replacement Cost [DRC] as a recognised basis of assessing value will need to be radically revised from its current form.

The paper is put forward as one to promote discussion and debate.

[3] Prior to this the RICS issued guidance to valuers on other types of valuation (RICS, 1980) but this was not as well known amongst members or their client base (Mallinson, 1994)
[4]TEGoVA (the European Group of Valuers' Association) published their *European Valuation Standards* in November 2000.

2.0 An Emerging Set of Standards

The purpose of this paper is not to address the history of valuation standards within an international context, nor to track their inter-relationship with accounting standards. However, as a preliminary to discussion the context must be set.

The call for valuation standards first arose in connection with concerns about financial accounting and the lack of consistency both in accounting treatment and in valuers' approach (RICS, 1974). Through a series of publications by a variety of bodies, the situation has arisen where, within a European context, there are three 'levels' of valuation standards. First, valuers have the guidance supplied by the ISVC in their International Standards (ISVC, 2000a). Second, TEGoVA's European Standards claim to adhere, where practicable, to the International Standards but they aim to be more explicit (TEGoVA 2000:6). At a national (third) level various bodies publish standards (see for example Gelbtuch, 1997; Strevens, 2000).

Within the UK, the RICS publish their Appraisal and Valuation Manual (RICS, 1995), colloquially known as the Red Book. The Red Book differs from both the European and International Standards in that adherence to its Practice Statements is mandatory upon RICS members. Also, although it is a UK publication, Practice Statement 1 makes it clear that, in the case of valuations of assets outside the UK, valuers have the option to use the Red Book or if they do not, they must do so insofar as the other (national) guidance is silent. They are mandated to comply with the RICS rules of engagement. Therefore the Red Book does have some international application.

The issue of parallel publications with overlapping remits potentially could lead to confusion, and this, Dunckley (2000) argued, was the recent historical position. In this paper the extant position is reviewed in terms of whether it has clarified the issues.

Valuation standards in relation to financial accounting are not produced in a vacuum. As Holt (2001) acknowledges, dialogue exists between accounting and property professions in a systematic way. However, he argues, "*…each of these professions interprets and utilises the notion of 'value' using quite different bodies of knowledge. As a result, accountants and surveyors may often ascribe different values to the same underlying asset"* (Holt, 2001:5). He therefore calls for further inter-actions between the two disciplines.

Holt is writing within the context of the UK. At the supra-national level, dialogue between the IVSC and IASC is systematic[5] but there is not a similar facility at European level, due to a lack of a single pan-European accounting body (Sayce and Connellan, 2000[b]).

3.0 Methodology

This paper has been prepared following an examination of the latest guidance available to valuers, including the European Standards (TEGoVA, 2000), and after consultation with a number of key individuals, both by correspondence and by personal interview, including authoritative members of both TEGoVA, RICS and IVSC. The views of those with whom discussion has taken place have not been individually attributed in order to protect confidentiality and to ensure that respondents did not feel in any way inhibited in giving their opinions. Appendix A provides a list of the key practitioners whose views have influenced the development of this paper.

Additionally, the authors have drawn down on the results of research undertaken by Griffiths (2001). This contained in depth interviews with consultant surveyors practising in France, Portugal, Spain and the UK, all of who undertake valuations, including for financial statements, across a European platform.

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[5] Indeed, the research revealed increasing co-operation between both accounting and surveyor organisation in relation to the setting of standards.

A decision was made not to process by way of questionnaire survey, as the aim was to explore in depth a narrow area in which only a limited number of people were likely to have the appropriate expertise. It is acknowledged that the perspective is essentially UK, but interviews with members of the supra-national bodies has ensured that this is tempered by appreciation of the wider views.

4.0 Some Critical Issues in the Debate

The aim of the paper is to explore some of the potential inconsistencies that exist in relation to valuer guidance in respect of owner-occupied assets valued for the balance sheet. To do this the over-arching accounting principle is first explained and debated and then related to valuer guidance. This highlights a range of issues that require to be considered, if the ambitions of consistency and harmonisation of practice are to be promoted.

4.1 Fair value: a fundamental accounting principle

The concept of fair value is derived from accounting standards as being the over-arching principle upon which property assets should be included in financial accounts – where such assets are carried under a revaluation policy. Fair value is a term not used within a US context as their accounting principles (US GAAP) specifically do not allow a policy of revaluation (PriceWaterhouseCoopers, 2000). Therefore, the concept of fair value is relevant to International accounting practice, but excluding the US. It is defined in International Accounting Standard [IAS] 16. The UK Accounting Standards Board [ASB] has interpreted the term in its Financial Reporting Standard [FRS] 15.

The term 'fair value' is a generic term that is defined in International and other Accounting Standards. It is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. IAS 16, Clause 30 states "*the fair value of land and buildings is usually its market value. This value is determined by appraisal normally undertaken by professionally qualified Valuers".* The determination of the highest and best use of a property is fundamental to valuations performed on the basis of *Market Value,* requisite for financial statements and related accounts.

So, in one sense, fair value is Market Value [MV]. However, it some ways it differs. In so far as fair value is a market value it "*does not address proper marketing period and may anticipate a sale transaction occurring under circumstances and conditions other than those prevailing over the duration of the market for the normal, orderly disposition of assets*" (IVSC, 2000[a]:41).

However, it is generally regarded as being wider than MV. From an accounting perspective "*the fair value of real estate included among the assets of a corporate enterprise may consider the contribution of the real estate to the enterprise (its value in use*)" (IVSC, 2000[a]:41). Additionally, but of less relevance to this paper, the "*term fair value is also used in legal actions in some states to derive a settlement figure in disputes between parties, the circumstances of which may not meet the definition of market value.*" (IVSC, 2000[a]:41).

The second 'head' of the definition is important. Under this "*fair value is seen to represent the value of the service potential of an asset to an entity, i.e., the future economic benefits embodied in the asset in terms of its potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. Service potential is measured as the level of productive capacity that would have to be replaced if the entity were deprived of the asset. While a Valuer provides an estimate of asset value for the directors and/or accountants of the enterprise, it is they who decide whether the value estimate meets the test of fair value* " (IVSC, 2000[a]: 140).

Therefore, using international definitions, fair value may be viewed in terms of a market value (value in exchange) or in terms of a personal 'worth' to the owner (value in use). Further the implication is that the latter calculation is within the control of the property owner, not the valuer.

An examination of the European Standards interpretation of IAS 16 (TEGoVA, 2000) reveals a remarkable similarity to that contained in the International Standards. This is not surprising, as it does not have a European accounting body interpretation with which to contend. Indeed it states that fair value can "*be synonymous with market or the service potential of an asset. The term is also used in some jurisdictions to provide a legal definition for attributing an equitable settlement between the parties to an action, which it before the courts, or is in contemplation of proceedings*" (TEGoVA, 2000:36).

However, whilst this appears, *prima facie*, to be an unequivocal endorsement of the international interpretation, this is not so if the detail is examined further. Standard 5, which deals with valuations prepared for the purpose of financial reporting states that "*fair value defined**, only in this context**[6], as Existing Use Value – for properties occupied for the purpose of the business*" (TEGoVA, 2000:56).

If existing use value is not synonymous with market value there is a conflict. To understand where this conflict originates, it is illuminating to consider the interpretation of fair value by the UK's Accounting Standards Board [ASB]. The relevant standard is Financial Reporting Standard [FRS] 15. This was published in 1999 following extensive consultation with the RICS (Eccles and Holt, 2001) to ensure that the standard had the backing of property professionals. Under FRS 15, the term fair value was rejected in favour of the "*value to the business model"* which defined "*current value as the lower of replacement cost and recoverable amount".* The Board's justification was that this "*gives a more precise and clear indication of the amount at which the asset should be revalued".* (Institute of Chartered Accountants, 2000:1014).

As the statement was developed in consultation with the RICS, it is unsurprising that they share the ASB's views and Appendix B reproduces an extract from Practice Statement [PS] 12, which governs the treatment of owner-occupied assets valued for the balance sheet. The important point to note from this is that under the ASB/RICS regime, the concept of valuing owner-occupied property has three heads. These are:

- the recoverable amount, which is defined as existing use value (or Depreciated Replacement Cost (DRC) in the case of non-market assets);
- the net realisable value, in essence market value; and
- value in use.

The last two heads are consistent with the IAS's definitions of fair value; the first is not. Indeed, this distinction from the IAS definition is recognised by the RICS who state that:

> "*FRS. 15, along with the other standards published by the Accounting Standards Board are applicable to companies reporting in the United Kingdom. If valuing assets owned by companies reporting outside the United Kingdom, valuers may be asked to produce valuations in accordance with the International Accounting Standards (IAS). Under IAS 16, property is valued or revalued on the basis of "fair value", which is usually the equivalent of Market Value. Existing Use Value is no longer a basis recognised in International Accounting Standards. At the time of writing (March 2000), both the IVSC and TEVoVA are modifying their valuation standards accordingly. Valuers asked to undertake valuations in accordance with international standards should be aware of the distinctions and take steps to familiarise themselves with the latest guidance published by the international valuation organisations.*"
>
> (RICS, 1995: PS.12.1.6.)

To conclude, fair value is an imprecise term designed to give accountants and their corporate clients flexibility. This may conflict with the needs of valuers who require specificity in order to give consistent advice. This dichotomy is not yet resolved. Indeed, it could be argued that the ASB's rejection of the international interpretation of fair value has highlighted the differences. But, notwithstanding, it is currently proposed that by 2005, all EU members will be required to

[6] Authors' bolding.

conform to IAS. It follows that the ASB may have to re-think their interpretation within a short timeframe.

The valuation implications relate to the inclusion of the concept of replacement cost as being an appropriate measure for accounting purposes. The replacement cost is deemed to be an 'entry value' – that is what an entity would have to pay, either by purchase or rebuilding, to replace the asset were they to be deprived of it. This, it is stated in PS 12 is the existing use value [EUV] or, where no market exists, the depreciated replacement cost [DRC]. Accordingly these concepts are now debated in the light of the fair value interpretations.

4.2 Existing Use Value: a basis of any use?

At the crux of the current debate on valuation standards lies the issue of Existing Use Value. This ties the argument back to valuations prepared for financial accounts, for its is only for this purpose for which EUV is recognised as a basis for valuation. Indeed, it is narrower than this. EUV is only used for the valuation of *owner-occupied* assets for inclusion in the balance sheet. The basis is, as defined by the RICS ((PS3) relates to the concept of Open Market Value[7] in so far as EUV is effectively OMV but with the inclusion of 2 additional assumptions. These are that:

?? *the property can be used for the foreseeable future only for the existing use; and*
?? *that vacant possession is provided on completion of the sale of all parts of the property occupied by the business.*

The definition of EUV as recently given in the European standards is similar as it is the price "*for which a property should exchange on the date of valuation based on* ***continuation of its existing use, but assuming the property is unoccupied….***" TEGoVA are very clear that EUV relates to deprival value - or what it would cost for the asset to be replaced in the market place, should it be deprived of the subject property.

The International Standards give no definition of EUV (or Market Value for the Existing Use) in their latest publication as the IASC and IVSC have abandoned the concept and removed it from their standards (IVSC, 2000:344). The explanation for this decision is very simple: MVEU was regarded as "*inconsistent with the definition of fair value, and should not override that definition*". It goes on to argue that *"In an efficient market, transaction prices cannot necessarily be said to reflect purely existing use or purely an alternative use because different market participants may well take different views". .* This appears to conflict with the view expressed by TEGoVA that it has "*close affinity*" to Fair Value (TEGoVA, 2000:37).

From these definitions and the IVSC commentary on EUV and the reasons for its abandonment it is clear that that EUV is a 'value in exchange' - not a 'value in use'. It relates solely to the value of a property asset, in isolation to the activity taking place in/on the land; it is *not* a value of the business.

To establish EUV, therefore, does not require the valuer to have any knowledge of the business in occupation, other that the baseline knowledge required for the preparation of any market valuation.[8] Instead it requires the valuer to ignore any bids that might arise for the property from any potential purchaser or class of purchaser who might use the asset for a different use. It is therefore fundamentally different from a valuation for 'highest and best use' although in reality the existing use may well represent the highest and best use. So, for assets for which there is a ready market, the most usual situation is that EUV will equate to market value. However, if a property is not being deployed to its 'highest or best use' (for example where development value exists) it may well be less than market value.

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[7] The term Open Market Value (OMV) is defined within the Red Book as being synonymous with Market Value (MV).
[8] It is accepted that to value any property the economic and business context is a vital element. However, due to the fundamental principle of comparative valuations, it is comparable sales data, rather than business factors that drive valuations. Notwithstanding for types of assets (for example, hotels, nursing homes etc.) the value of the trade is very closely connected with the price achievable in the market place.

However, not all properties do have a ready market - at least unless alternative use is included within the calculation. For these assets the EUV is interpreted as being the Depreciated Replacement Cost, albeit that where such a value is reported, the Directors will make a decision as to whether such figure will be the 'carrying amount' or some other, possibly lower, figure substituted in which case it becomes hard to see the relevance of the exercise - other than from the valuer's income perspective!

The issues surrounding DRC and its prospect of continuance if EUV is abandoned in due time, is considered below.

For now, the tentative conclusion can be drawn that EUV is capable of determination by a qualified valuer, but that the resultant figure will *either* equate to the MV, where the asset is one for which a market exists and is being used in its most profitable way, *or*, will be at best a hypothetical figure unrelated to value in transfer.

At this point it is worth reflecting on *why* the concept of EUV was first introduced. According to the IVSC, it *"was developed specifically for financial accounting"* (IVSC, 2000:345) and this is supported by both the European and RICS standards, which both recognise the basis only for this purpose. In both cases, where an EUV is reported, if this differs from the OMV the valuer must report both - so that the client may, within the accounts, reveal the value gap.

The justification of this process, from a valuer perspective, has been that the business should not bear in its published accounts, property values that are unreflective of the ability of the business to support that value. So, for example, a company occupying a property with very great development value which can only be realised on vacation of the building (and possibly cessation of the business) will be aware of the issue but the accounts will only formally bear the cost at EUV. The debate must be whether this information, which is at best an artificial construct and open to various interpretations, is *consistent* with the concept of 'fair value' which is the overarching ambition of accounting standards, be they UK or international.

So, EUV *only* has a role if it is seen to be a defensible measure by which an owner-occupied asset can be valued for financial accounts and this means that it must be consistent with the principles enshrined by the accounting standards. The concept of EUV has long had its opponents (see for example Dunckley, 2000) and the interviews and consultations carried out by the authors found little sympathy for its retention, with views being expressed including the terms *"meaningless" "useless"* and *"a complete nonsense".* At the current time the UK and Europe are on course to adopt the International Accounting Standards by 2005 and this would lead to an automatic abandonment of EUV.

However, EUV was not completely without support as one correspondent, responsible for a large industrial portfolio considered that *"EUV has its place as a method"* although in this case the correspondent revealed that, in order to avoid possible issues surrounding revaluations, they have opted not to undertake revaluations but work their accounts on an historic basis for property, as allowed under FRS 15.

The relationship with FRS 15 is relevant as this standard, published in 1999 after a long period of consultation between the RICS, the ASB and individuals, represents the latest UK position. This standard sets quite unequivocally that one of its main objective is to ensure that *"where an entity **chooses**[9] to revalue tangible fixed assets the valuation is performed on a consistent basis and kept up-to-date…"* (ASB, 2000: 984). The issue here is 'chooses'. Holt (2001) quoting figures produced by the ASB in 1997 highlights that, prior to the introduction of FRS some one-third of all UK entities chose not to revalue. This question was raised by several of those professionals with whom the authors have discussed material for this paper. Most were of the opinion that this figure is likely to be increasing rather than decreasing with companies seeking to opt out of the revaluation process. Their views appear to be at variance with that expressed by Evans *et al.* (2001) who take the stance that the recent changes to accounting standards within the UK may lead to greater adoption of revaluation policies.

[9] Authors' bolding.

The reasons given for this include:

?? to revalue is inconsistent with US practice and that of some European countries so for multi-national organisations it makes little sense;
?? FRS 15, when combined with the requirements to report losses under the 'Impairment of Assets' rules (IAS 36), renders the company vulnerable to disclosure of losses in the event of economic downturn; and
?? the costs and complexity involved.

In conclusion, the concept of EUV is essentially an interpretation of a value in transfer, but in this it does not prove representative. The view that EUV is consistent with 'fair value' appears flawed: they are potentially conflicting. As a concept it is not recognised under US accounting practice nor does it have any status now under International Accounting or valuation standards.

So, why does it continue to be recognised within the new European Standards and continue to have the approval of UK bodies? The introduction of new UK Accounting Standards appear to do little to provide it with a rationale and the new Blue Book has a basic ambition to comply with International Standards. The only conclusion that can logically be drawn is that the continued recognition is an interim position and that unless a change of direction is realised it will go by 2005.

This raises two further issues:

?? is there a continuing application for DRC? and
?? will the concept of value in use become part of the role of valuers under the new accounting regimes?

4.3 What price DRC?

Depreciated Replacement Cost [DRC] is accepted as a legitimate basis for the valuation of properties for which there is no ready market due to their specialised nature. On this all valuations standards agree. The method by which DRC is calculated is succinctly detailed in the Red Book (PS 4.8.1) as:

> "*The aggregate amount of the value of the land for the existing use or a notional replacement site in the same locality, and the gross replacement cost of the buildings and other site works, from which appropriate deductions may then be made to allow for the age, condition, economic or functional obsolescence and environmental and other factors; all of these might result in the existing property being worth less to the undertaking in occupation than would a new replacement."*

There are three elements required for the performance of a DRC calculation:

?? the value of the land in its *existing* use,
?? the gross replacement cost of the building and
?? the appropriate deductions from gross replacement cost for all types of obsolescence.

All three sets of standards share a common approach to this task except in relation to calculating land value, a point that is discussed later.

The calculation of DRC lies within the remit of the valuer. However, all three sets of standards recognise that it can produce figures that may prove difficult for companies in terms of their 'carrying amounts'. Accordingly there is a qualification provision in the Red Book, replicated in similar terms in both the European and International Standards. This requires the Valuer to *"qualify every valuation prepared on a DRC basis as being subject to the adequate potential profitability of the business compared with the total value of the assets employed".* (RICS, 1995: PS 4.8.5). Where the test of adequate potential profitability is not available, as in the public sector, PS 4.8.6 requires that *"DRC should be expressed as subject to the prospect and viability of the continuance of the occupation and use"*.

However, this qualification lies with clients who are thus able to control levels of valuation to suit their own purposes and entity policies. Again this raises issues in relation to consistency and the ambition of accounts to be useful and transparent.

Turning to the land value element, it is here that differences arise. These relate to the basis under which DRC derives its legitimacy.

Within the Red Book its application lies *only* as a sub-set of Existing Use Value (EUV) within the context of calculating the 'recoverable amount' for financial accounting (PS 12). Indeed, the Red Book is explicit, for example, in stating that properties valued on a DRC basis *"are not really suitable for a specific charge as a security".* It is *only* ever applied to non-market properties. It is only a method of using net current replacement costs to arrive at the value to the undertaking in occupation of the property as existing at the evaluation date, where it is not possible to ascertain EUV. Thus in Red Book terms DRC is a surrogate of EUV and in no way a confirmation of OMV.

The Blue Book follows the Red Book in DRC applications and is clearly an existing use surrogate with specialized properties and in limited market situations. However, conceptually it is *not* the same in that it makes the, arguably, artificial construct that EUV is consistent with fair value. Therefore the **supposition** is that DRC with a land value based on *existing use* is consistent with fair value.

This is not the stance adopted in the International Standards, which do not accept the legitimacy of EUV. Under the International Standards DRC is considered to be an acceptable surrogate method for deriving a '*market-related value'* in keeping with the concepts of fair value in the preparation of financial statements.

In order to achieve consistency with the notion of market value, the Red Book approach to land value of EUV is not utilised. Instead the White Book indicates the highest and best use. This is rational and consistent with the rejection of EUV – providing that it is accepted that non-market properties should have a notional market value *above* site value. If the accounting figure is really a *choice* between market value and value in use, as derived by the owner, then arguably, DRC could be abandoned in favour of site value, less costs of clearance, as the owner would have the ability to choose value-in-use. A perceived danger in such an approach is that it might be unacceptable in accounting terms, result in increased complexity and ultimately lead to rejection by companies of revaluation policies[10]. Despite this internal consistency in the treatment of land value for DRC in the International Standards, there are early indications that this might change[11].

The research revealed another approach to cost when undertakings opt not to revalue their owner-occupied properties. Evidence was obtained of use of indexed historic costs being used to which depreciation is applied towards an eventual residual cleared site value.

This appears to comply with the definition of "Net Revalued Amount" in IVA 1 whereby under the historical cost convention, net carrying amount represents the gross carrying amount less accumulated deprecation. It is also referred to as the net revalued amount found through an indexation of historical costs, or periodic revaluation of assets.

This procedure is also referred to in Sec 5.4 of International Valuation Application Standard 1 (Valuation for Financial Reporting issued by the IVSC (2000: 141)). What emerges is that this modified historic cost alternative does not appear on the face of it to be restricted to specialized properties or no-market situations. It therefore provides companies with a mechanism that overcomes many of the inherent DRC issues – but also circumvents the need to use a valuer's expertise!

[10] Holt (2001) reported that 35% of UK companies choose not to revalue their assets, instead pursing an historic cost approach, as used by the US (PriceWaterhouseCooper, 2000). Interviews point to expert opinion that concerns on revaluation issues are leading to this figure rising.

[11] Discussion with experts reveals that the issue is currently under debate in the IVSC.

4.4 Value in Use

Value in Use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. It is the value that a *specific* property has for a *specific* use to a *specific* user. It is, therefore, non-market related. It focuses on the contribution made by the property to the enterprise of which it is a part, without regard to the property's highest and best use or the monetary amount that might be realised upon its sale. (IVSC, 2000: 106)

Within the RICS interpretation (see Appendix B) Value in Use in a part of the 'value to the business model'. Under this value to the business is the *lower* of:

(1) Replacement Cost, and
(2) Recoverable Amount

And Recoverable Amount is the higher of:

(1) Value in Use, and
(2) Net Realisable Value

The replacement cost is deemed to be an 'entry value' whereas the recoverable amount is either the market value (or DRC) or value in use. In relation to the latter, the RICS is quite unequivocal when it states that:

> *"it should be noted that the use of the word 'value' in the expression 'Value in Use' does not necessarily mean that this is a figure which a Valuer is competent to determine. The term should not be regarded as an alternative valuation basis for fixed assets and should not be used by Valuers when preparing valuations."* (RICS,1995:PS 12)

Value in Use particularly comes into play as a concept when an asset becomes 'impaired' i.e. when it is held in the balance sheet at a carrying account which is more than it is worth either in terms of what it can be sold for or what it can earn in production. This is a matter, in interpreting accounting standards, which is common to the Red, White and Blue Books. Indeed it is apparent that impairment (IAS 36) is not an issue that is normally the concern of the valuer. IAS 36.27 makes it clear that ordinarily the financial managers of an enterprise would undertake the estimation using data specific to the enterprise and the asset, such as appropriate discount rates. However, valuers might be consulted on certain aspects such as the likely value at the end of the asset's useful life. (IVSC 2000: 133).

It can be concluded from this that, unless valuers have a specialised knowledge of a particular business they are unlikely to be involved in determining a value in use. Furthermore, if more reliance is to be made on value in use as a balance sheet solution then it will not be a case of valuers converging on bases and methods but of financial advisers agreeing on accounting precepts.

5.0 A Reflection on the Issues

So what do all these deliberations mean for the individual valuer instructed to prepare a valuation of corporate assets? Or, perhaps more importantly, does the situation thus detailed provide an adequate basis, or bases, on which to found valuations that will be useful and meaningful to the users of the accounts?

5.1 The interpretation of Fair Value

The accountancy bodies, at international and UK level have accepted the principle of 'fair value'. It is in relation to its *interpretation* that differences emerge. For IAS accounting purposes fair value is a generic term applying to a greater range of assets than *" property, plant and equipment"* (IAS 16) and *"investment property"* (IAS 40). Valuers do not have such a wide interest. To them the debate is concentrated in a narrow but specific interpretation. Within the UK the inter-action between the accountants and the valuers has led to a more

specific interpretation of fair value than is determined internationally. It is this UK based interpretation which gives continued legitimacy to EUV as a basis of valuation – and with it DRC. Within the European and International context, as EUV is not recognized, the basis on which DRC continued to be allowed differs and is taken as a market value surrogate.

Clearly this matter still requires resolution.

5.2 Acceptability

Strevens (2000) argued that valuation practice in France and the UK shared much similarity, despite differing local guidance. However, this related primarily to large-scale properties. He recognised that local valuers will continue to operate differently in local markets. This point is amplified by Griffiths (2001), who found that the increasing levels of international property investment transactions is leading to a two-tier market in which valuers have to recognise both local and supra-national frameworks. However, one common theme running through her findings was that, in choosing the regulatory framework (i.e. Red or Blue book) valuers were very influenced by both their clients' previous knowledge and by their own 'custom and habit'. Despite this, there are persistent concerns that valuers do not fully comply with the requirements (Waters, 2000). The RICS Red Book is the oldest-established code under consideration. This combined with the strong UK led presence within international property investment fields has undoubtedly been the reasons for this noted predominance in the use of Red Book. It is postulated that, as the international standards become better known and more extensive in their scope the situation may change. If the proposed adoption by the EU of International Accounting Standards by 2005 does proceed, this will require convergence of interpretation and in turn affect valuer practice.

5.3 A Need to Revalue

Some evidence of moves towards convergence is growing within investment circles. However, with owner-occupied assets, the situation is less clear. Where non-UK companies hold occupational property, the accounting principles adopted may circumvent the requirement to revalue. This is believed to be an issue as between the International Body and the US bodies as the accounting principles within the UK do not permit of valuation. Notwithstanding the necessity to achieve an international consensus that includes the US, the current complexity is not an encouragement to companies to adopt the revaluation route where their domestic accounting rules permit. The preferred route for many organisations will remain historic cost, especially as this may present less difficulty in the event of a market downturn.

There is a further dimension. The definition of fair value, which is the guiding accounting principle, includes not just the notion of value in exchange, but also value in use. In recent years the notion of value in use has become part of the *investment* valuers' armoury (see for example, RICS, 1997). However, within the occupational sphere this is not the case. All the main valuation standards examined are adamant that value in use lies outside the general scope of a valuer's expertise; instead it lies within the remit of the organisation itself. On this basis, an entity could satisfy fair value by adopting a self-determined value in use. And this might not be in the interests of consistency and objectivity.

6.0 Conclusions

The aim of accounting standards bodies and one shared by the professional valuers' bodies is that assets should be accounted for fairly and consistently so that investors may have better information on which to take decisions and control risk (Boorman quoted in Dunckley, 2000). It is also to enable the users of accounts to have the relevant facts (ASB: 2000: 1016). By implication, the valuations for the accounts should also enable Boards of Directors to be better informed and thereby improve the quality of management.

Within the UK, the development and introduction of a new accounting standard for tangible assets (other than investment properties), FRS 15, took place in 1999. This was aimed at addressing a situation in which large-scale differences and inconsistencies occurred and in

which companies could choose whether or not to revalue their assets on a regular basis (Holt, 2001).

The changes introduced by FRS 15 do not, on the basis of the research to date, appear to have changed that situation. Anecdotal information indicates that the issue of possible impairment of assets and the uncertainly surrounding the valuation basis may be instrumental in encouraging companies to continue to use an historic cost approach

The issue is quite simple. The accountants' ambition is that assets are entered at their 'fair value'. There can be no quarrel with this in concept. The difficulty comes in interpreting what fair value is and whether it can be established in any meaningful way. The International Valuation Standards are quite unequivocal. Fair value is interpreted as *either* market value, *or* equity value (in the case of disputes) *or* value in use (IVSC, 2000: 322). There is no acknowledgement of EUV. In fact, there is a clear statement that EUV has been abandoned on the basis that "*it is inconsistent with the definition of fair value, and should not over-ride that definition*." (ISVC, 2000:345).

The European Standards too, define fair value in similar terms. However, in developing the RICS standards, discussions with the UK ASB have led to a different interpretation with the 'value to the business model' being adopted in preference to fair value. This model allows for not only the net deprival value (i.e. Market value) but the replacement cost. In the case of corporate owner-occupied properties, this is defined by reference to EUV, or, in the case of specialised (non-market) properties, DRC.

On the face of it, therefore, there is a conceptual inconsistency. Where the valuer is assessing the value of an asset for which there is a ready market, and no development value, this conceptual difference is hidden because, in these circumstances, the EUV will equate with MV (OMV in RICS terms!). However this is not always the case. Where either the existing use is not the 'highest and best' use or the asset has no ready market, the matter takes on significance.

In the case of an asset used non-optimally in market value terms[12], the proposition presented to the valuer using the RICS Red Book is to adopt EUV, whilst also reporting OMV. For the valuer using the International Standards, the OMV will simply be recorded. For valuers operating within the guidance of the European Standards, the situation is contrived with the standard stating that for the purposes of financial accounting valuations *only*, fair value is defined as equivalent to EUV (TEGoVA, 2000:56)! As with the Red Book the OMV should also be reported.

So, for these properties it can be concluded, there is inconsistency of approach.

Inconsistency between approaches is highlighted where the properties being valued are ones for which no or limited markets exist. In such situations under both RICS and TEGoVA rules, the instruction to the valuer is quite clear. EUV embraces the concept of DRC. However, the IVS have a difficulty, as only market value is recognised. Their current solution is to allow DRC – but to define it as a market-related surrogate within the classification of fair value. This appears, *prima facie*, to overcome the issue. Or does it?

DRC comprises two elements: the land and the improvements thereon. Under the three codes the treatment of the improvements is consistent, albeit that the *methods* of depreciating are not generally prescribed. However, there is inconsistency with the basis upon which land value is determined. Under the RICS and TEGoVA standards, the basis is EUV; under IVSC guidance, the land must be entered in its highest and best use – consistent with the concept of the market value interpretation of fair value. So, inconsistency still prevails.

However, the research process has revealed that changes are occurring. The interviews revealed very little enthusiasm for the retention of EUV[13], and the proposed adoption by the EU and UK of international accounting standards by 2005 has prompted the UK RICS to

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[12] It is acknowledged that optimal *business* use needs and market value are not necessarily synonymous.
[13] The interviewees were almost, but not totally, unanimous in their dislike of EUV as a concept.

announce that it is undertaking "*a thorough review of IVS with a view to incorporating them into a new edition of the RICS Appraisal and Valuation Manual (the Red Book) supplemented only by specific national/regional guidance if needed*" *(IVSC, 2000b:preface). The recent establishment of a joint editorial board between TEGoVA and IVSC is further indication of the desire to achieve harmonisation at an international level.

It is not possible to forecast eventual outcomes. However, the indications to date are that the concept of fair value will increasingly be interpreted as either MV or value in use. Flowing from this will be the abandonment of EUV. Market value however, is recognised as being problematic in many cases, both public and private sectors. One solution to this could be that the value in use arm of fair value is adopted as the standard approach in such cases. This is not currently being advocated by any of the valuation standard setting bodies – perhaps not surprisingly, given that valuers are seen to have little or no role in advising on value in use!

Instead, DRC in the White book (as it now stands) is still promoted as a market-related surrogate for fair value because it adopts highest and best use for the land element, and is therefore admissible into the fair value category. The corollary is that the Red and White Books, by adopting existing use value for the land element, make DRC a surrogate for EUV and therefore not strictly admissible into the fair value category, despite the Blue Book ostensibly stating that it does!

Previous research by the authors[14] and outcomes of the current research interviews demonstrate that the extant position is both problematic and has questionable relevance to the users of accounts. If DRC does continue to be recognised, substantial revision is required in order to ensure that its treatment in each set of standards is consistent. Under the prevailing international thinking, it would appear appropriate that the land value element does relate to market value with an abandonment of EUV. Otherwise a continued inconsistency within the valuation treatment of assets will be perpetuated.

These views are entirely ones of interpretation and they are put forward for debate and discussion. The resolution of the issues will not, *per se*, lead to the convergence of valuation practice. The cultural issues, and adherence to deeply engrained custom and practice, as revealed by Griffiths (2001), are too deep-seated. However, it is argued, the very act of debating will, through a process of dialogue assist the cause.

[14] See for example, Connellan and Sayce, 1997and 1998; Sayce and Connellan, 2000[a] and [b]

APPENDIX A

Peter Biles, BOC
David Clarke, Collins, Son and Harvey
Peter Champness, TEGoVA
John Edge, Knight Frank and IVSC
David Gredley, Chesterton
Christopher Hedley, OPD
Michael Milgrim, IVSC
Marianne Tissier IVSC

APPENDIX B

RED BOOK PRACTICE STATEMENT 12

PS 12.1 The Accounting Standards Board's FRS 15 requires entities that revalue their tangible fixed assets to carry those assets in financial statements at current value. Current value is determined using the value to the business model set out in the FRS at Appendix IV, paragraph 19, which can be described as follows:

Value to the Business is the **lower** of:

(3) Replacement Cost, and
(4) Recoverable Amount

And Recoverable Amount is the **higher** of:
(3) Value in Use, and
(4) Net Realisable Value

(a) Replacement Cost is the cost of purchasing, at the least cost, the remaining service potential of the asset at the balance sheet date. It is an entry value.

(b) Value in Use is the present value of the future cash flows obtainable as a result of an asset's continued use, including those resulting from its ultimate disposal; and

(c) Net Realisable Value is the amount at which an asset could be disposed of, less any direct selling costs. It is an exit value.

PS 12.1.2 If the enterprise is to continue in its existing business at its current volume, the value to the business of an asset will normally be its Replacement Cost. Another way of expressing Replacement Cost is that it is a deprival value; that is, if the organisation had been deprived of the particular property, the price that it, or any other potential owner-occupier for the same use, would have had to pay in the open market to replace it.

PS 12.1.3 The concept of deprival value does not mean that the actual owner-occupier is deemed to be in the marketplace. The actual circumstances of the owner-occupier should not be taken into account since to do so would be to undertake a Calculation of Worth. There is also a risk that the actual owner-occupier could be vested with characteristics of a purchaser with a special interest, whose bid has to be ignored under the definition of Existing Use Value. To avoid reflecting any additional bid, which may be made by the actual owner-occupier because of its particular circumstances, Valuers should consider the 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.

PS 12.1.4 Whilst the value to business model assists Valuers in understanding the context in which valuations for financial statements are required, it should be noted that the use of the word 'value' in the expression 'Value in Use' does not necessarily mean that this is a figure which a Valuer is competent to determine. 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 and/or the Net Realisable Value, as defined in PS 12.1 .1. The bases in this Manual that equate to these concepts are discussed in PS 12.2.

PS 12.1.5 Notwithstanding the caution in PS I 2.1.4, 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 are to be found in FRS 11 'Impairment of Fixed Assets and Goodwill'.

PS 12.1.6 FRS 15, along with the other standards published by the Accounting Standards Board are applicable to companies reporting in the United Kingdom. If valuing assets owned by companies reporting outside the United Kingdom, Valuers may be asked to produce valuations in accord with the International Accounting Standards (IAS). Under IAS 16, property is valued or revalued on the basis of 'fair value', which is usually the equivalent of Market Value. Existing Use Value is no longer a basis recognised in international Accounting Standards. At the time of writing (March 2000), both the ISVC and TEGoVA are modifying their valuation standards accordingly. Valuers asked to undertake valuations in accordance with international standards should be aware of the distinctions and take steps to familiarise themselves with the latest guidance published by the two international valuation organisations.

PS 12.2 Selection of basis of valuation

PS 12.2.1 Valuers apply the concept of 'Replacement Cost' to land and buildings on the following bases:

For Non-Specialised Properties: Open Market Value (OMV); but Existing Use Value (EUV) for properties occupied for the purposes of the business.
For Specialised Properties: Depreciated Replacement Cost (DRC), subject to adequate potential profitability.

PS 12.2.2 A Valuer must agree with the Client which basis is applied, and be satisfied that the valuation basis is in accordance with this Manual and the requirements of FRS I S. He must stress that for properties valued on a DRC basis it is for the Directors to apply the test of adequate potential profitability and, if necessary, write down the valuation made by the Valuer.

PS 12.2.3 Basic accounting concepts postulate that accounts are prepared on the understanding that the undertaking will continue in operation for the foreseeable future and, in particular, that the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation. The Alternative Use Value of assets without which the business could not function, therefore, has no relevance in the accounts of the company. Such values may, however, be relevant to an overall appraisal of the company's situation and, where significant, should be disclosed in the directors' report (Paragraph 2, Schedule 7, Companies Act 1985).

PS 12.2.4 Properties, which are surplus to requirements, are valued on the basis of Open Market Value (OMV) so that the proper benefit of any higher Alternative Use Value may be reflected. If a large area of land, or a substantial building, is not used by the business and is capable of separate occupation, the Valuer must advise the owners that the land and/or buildings should be valued as surplus to requirements on the basis of OMV. If the Valuer believes that there is substantial latent potential value he must state so in the Report.

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