

**Meeting:** International Public Sector Accounting  
Standards Board

**Meeting Location:** Lisbon, Portugal

**Meeting Date:** September 12 - 16, 2022

## Agenda Item 3

For:

☐ Approval

☒ Discussion

☐ Information

### MEASUREMENT

<b>Project summary</b>	The project objective is to revise IPSAS requirements for measurement, provide guidance on measurement and address the treatment of transaction costs and borrowing costs.	
<b>Task Force members</b>	<ul style="list-style-type: none"> <li>David Watkins, IPSASB Technical Advisor (Task Force Chair)</li> <li>Takeo Fukiya, IPSASB Technical Advisor</li> <li>Francesco Capalbo, Second University of Naples</li> <li>Jonathan Fothergill, RICS</li> <li>Elles Mukunyadze, Public Accountants and Auditors Board (Zimbabwe)</li> </ul>	
<b>Meeting objectives</b>	<b>Topic</b>	<b>Agenda Item</b>
<b>Project management</b>	<a href="#">Measurement: Project Roadmap</a>	<a href="#">3.1.1</a>
	<a href="#">Instructions up to Previous Meeting</a>	<a href="#">3.1.2</a>
	<a href="#">Decisions up to Previous Meeting</a>	<a href="#">3.1.3</a>
<b>Decisions required at this meeting</b>	<a href="#">Approach to the September 2022 Meeting</a>	<a href="#">3.2.1</a>
	<a href="#">Principles of Current Operational Value – Entry Price and Existing Location</a>	<a href="#">3.2.2</a>
	<a href="#">Comparison of the Principles Underpinning the COV Basis and the FV Basis</a>	<a href="#">3.2.3</a>
	<a href="#">Income Approach</a>	<a href="#">3.2.4</a>
	<a href="#">Surplus Capacity</a>	<a href="#">3.2.5</a>
	<a href="#">Instructions from June 2022 Meeting</a>	<a href="#">3.2.6</a>
<b>Other supporting items</b>	<a href="#">Approaches to Valuation - the Surveyor's Perspective</a>	<a href="#">3.3.1</a>

**MEASUREMENT:  
PROJECT ROADMAP**

<b>Meeting</b>	<b>Completed Actions or Discussions / Planned Actions or Discussions:</b>
March 2019	1. Approve Consultation Paper and Illustrative Exposure Draft
June 2019 – September 2019	1. Document Out for Comment
December 2019	1. Preliminary Review of Responses to Consultation Paper
March 2020	1. Review of Responses to Consultation Paper 2. Discussion of Issues
June 2020	1. Discussion of Issues
September 2020	1. Discussion of Issues 2. Review [draft] Exposure Draft
December 2020	1. Discussion of Issues 2. Review [draft] Exposure Draft
April 2021 – October 2021	1. Document Out for Comment
December 2021	1. Preliminary Review of Responses
March 2022	1. Review Responses 2. Discuss Issues
June 2022	1. Review Responses 2. Discuss Issues
September 2022	1. Discuss Issues
December 2022	1. Develop Pronouncement
March 2023	1. Issue Pronouncement

## INSTRUCTIONS UP TO PREVIOUS MEETING

Meeting	Instruction	Actioned
December 2021	1. Develop a detailed response analysis for the IPSASB's review in March 2022	1. See <a href="#">Agenda Item 9.1.2</a> to the March 2022 meeting.
	2. Frame the public sector measurement basis analysis in the context of the Conceptual Framework Measurement objective and what the IPSASB is trying to achieve in developing the measurement basis	2. See <a href="#">Agenda Item 4.2.2</a> to the June 2022 meeting.
March 2022	1. Clarify in the Basis for Conclusions the reason why the cost approach is an appropriate measurement technique to estimate Fair Value.	1. See <a href="#">Agenda Item 4.2.6</a> to the June 2022 meeting.
	2. Clarify that the income approach is the only technique available to estimate the Cost of Fulfillment in paragraph D22.	2. See <a href="#">Agenda Item 4.2.6</a> to the June 2022 meeting.
	3. Develop an appropriate reference in [draft] IPSAS [X], Measurement to highlight the disclosure requirements are located in the relevant IPSAS.	3. See <a href="#">Agenda Item 4.2.6</a> to the June 2022 meeting.
	4. Update the model policy choice guidance as follows: a) Enhance consistency of principles with accounting policy choices guidance in IPSAS 3; b) Remove the word "often" in paragraph BC 23C; c) Clarify the phrase "current economic consumption or not" in paragraph BC 23D.	4. See <a href="#">Agenda Item 4.2.6</a> to the June 2022 meeting.
	5. Update the historical cost guidance as follows: a) Align the definition of "historical cost" in IPSAS Measurement and the Conceptual Framework as appropriate; and b) Retain the "historical cost" definition proposed in ED 77.	5. See <a href="#">Agenda Item 4.2.6</a> to the June 2022 meeting.
	6. Clearly indicate whether the reference to "historical cost" is to the model or the basis throughout [draft] IPSAS [X], <i>Measurement</i>	6. To be completed during the development of the Pronouncement.

**INSTRUCTIONS UP TO PREVIOUS MEETING**

Meeting	Instruction	Actioned
June 2022	1. Communicate in the Basis of Conclusions, why the IPSASB decided that the asset should be valued based on the physical items that comprise the asset.	1. See <a href="#">Agenda Item 3.2.6</a> .
	2. Review the Basis of Conclusions to ensure that it clearly explains why Fair Value is not applicable for assets held for their operational capacity, and why a public sector measurement basis is required.	2. <a href="#">See Agenda Item 3.2.6</a> .
	3. Analyze how 'surplus capacity' and 'current location' should be applied in the context of Current Operational Value and whether they are principles.	3. See <a href="#">Agenda Item 3.2.2</a> and <a href="#">3.2.5</a> .
	4. Develop analysis to foster a shared understanding of the 'income approach' across the IPSASB for September 2022.	4. See <a href="#">Agenda Item 3.2.4</a> .
	5. Compare 'Fair Value' principles with 'Current Operational Value' principles in tabular format.	5. See <a href="#">Agenda Item 3.2.3</a> .
	6. Develop practical valuation examples for different types of assets.	6. See <a href="#">Agenda Item 3.3.1</a> .
	7. Convey the cost approach approximates fair value in paragraph BC 64A.	7. See <a href="#">Agenda Item 3.2.6</a> .
	8. Work with members to enhance the consistency of the 'historical cost' and 'transaction price' definitions proposed.	8. See <a href="#">Agenda Item 3.2.6</a> .

**DECISIONS UP TO PREVIOUS MEETING**

Meeting	Decision	BC Reference
February 2021	1. All decisions made up until February 2021 were reflected in <a href="#">ED 77, Measurement</a>	1. All decisions made up until February 2021 were reflected in <a href="#">ED 77, Measurement</a>
March 2022	1. All decisions made during the March 2022 meeting were reflected in <a href="#">ED 77, Measurement</a> .	1. All decisions made during the March 2022 meeting were reflected in <a href="#">ED 77, Measurement</a> .
June 2022	1. All decisions made during the March 2022 meeting were reflected in <a href="#">ED 77, Measurement</a> .	1. All decisions made during the March 2022 meeting were reflected in <a href="#">ED 77, Measurement</a> .

## **Approach to the September 2022 Meeting**

### **Purpose**

1. To provide the Board with an overview of the development of the Current Operational Value (COV) basis, as of September 2022.

### **Background**

2. Respondents to the April 2019 Measurement Consultation Paper (CP) strongly supported the IPSASB's preliminary view that Fair Value is relevant and applicable in the public sector.
3. While respondents agreed the Fair Value definition proposed is applicable where assets are held to generate income either through use or sale, they also noted the definition is inappropriate as a current value measurement basis in most public sector cases; specifically, where assets are held for their operational capacity to deliver a service. Constituents' concerns with Fair Value related to the fact that when an item is held for its operational capacity, as is often the case in the public sector, Fair Value is inappropriate to apply because the following concepts generally are not applicable:
  - (a) Highest and best use; and
  - (b) Maximizing the use of market participant data.
4. Respondents expressed the view that a public-sector-specific current measurement basis is required.
5. In response to constituents' concerns raised in the CP, the IPSASB developed a current value measurement basis unique to the public sector – Current Operational Value (COV). Response to the COV proposals in the Exposure Draft (ED) was generally supportive,<sup>1</sup> and the IPSASB agreed in June 2022 to continue the development of this public sector measurement basis. As part of the continued development of COV, the IPSASB agreed with constituents that the principles and their application should be clarified.

### **September Overview**

6. Given respondents supported using Fair Value in IPSAS but have identified specific challenges when applying the basis to assets held for their operational capacity, the September Agenda Items finalize the evaluation of principles that apply to the measurement of assets held for their operational capacity, addressing the unique aspects of the public sector. We then compare the principles that underpin Fair Value with those of COV, thus addressing the June 2022 instruction.

#### *Fair Value*

7. [Draft] IPSAS [X], *Measurement*, defines Fair Value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Fair value is an exit, market-based measurement that provides monetary information about assets, liabilities,

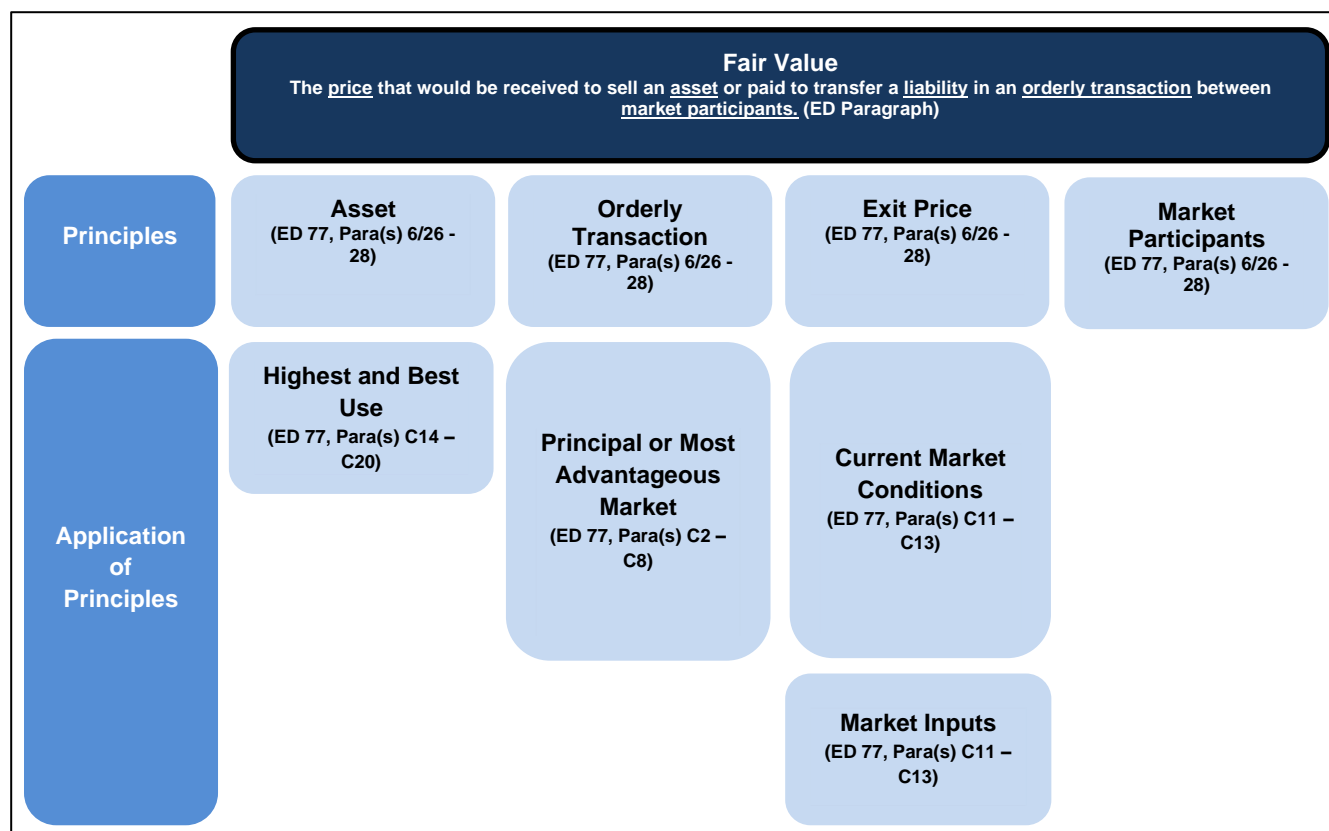
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<sup>1</sup> Review of the responses to ED 77, specifically SMC 5 and SMC 6, showed that there was strong support for moving forward with the public sector measurement basis and more importantly, moving forward with the COV principles proposed in ED 77. Two-thirds of respondents either supported the principles proposed or recommended building on the principles proposed.

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and related revenues and expenses, using information updated to reflect conditions at the measurement date. Fair value reflects the perspective of market participants. The asset or liability is measured using the same assumptions that market participants would use when pricing the asset or liability if those market participants act in their economic best interest.

8. The principles of the Fair Value measurement basis and the application thereof are illustrated in the below diagram:



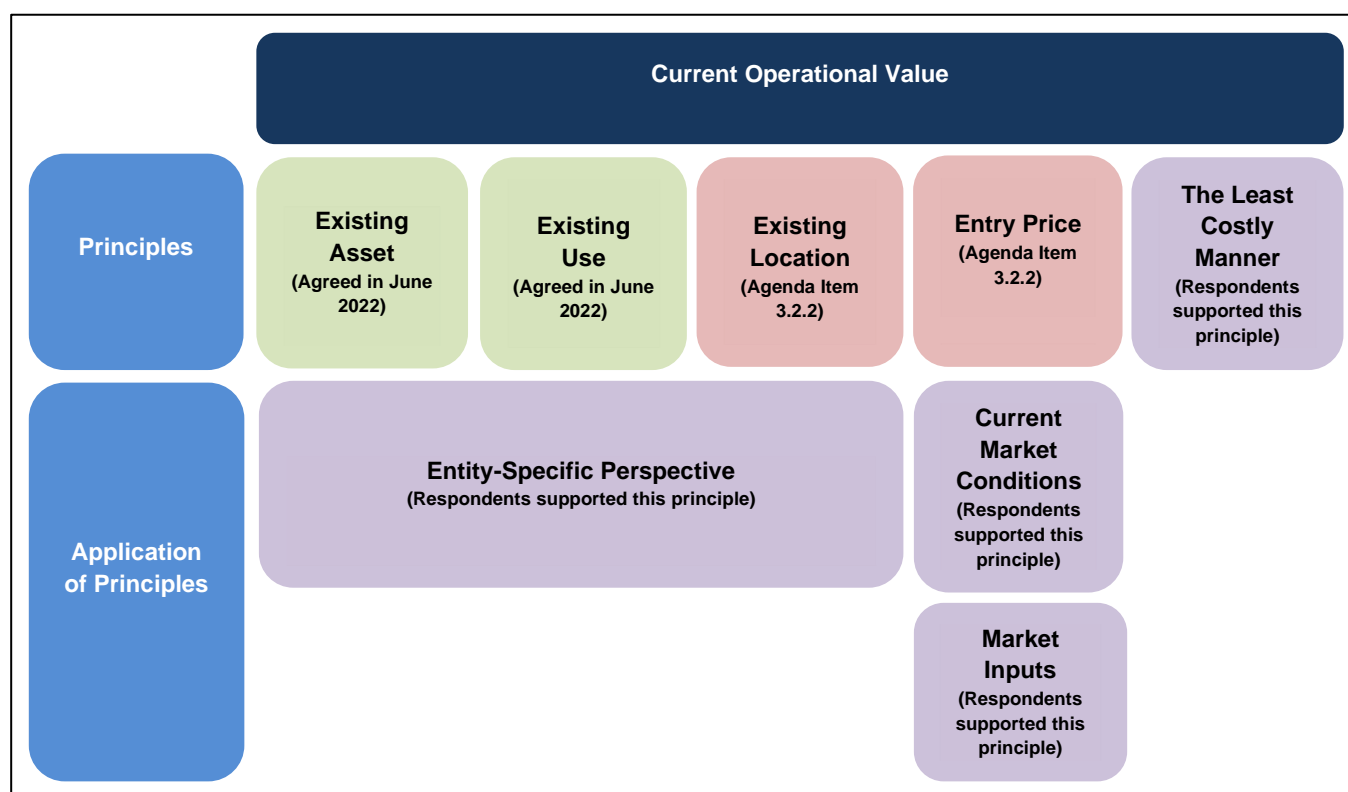
### *Current Operational Value*

9. As noted above, COV was developed in response to concerns identified in applying Fair Value to assets held for their operational capacity. In June 2022, the IPSASB agreed the following COV principles proposed in ED 77 should be retained:
- (a) **Existing Asset.** COV is an asset-specific measurement basis. The focus of the measurement basis is the existing asset held for its operational capacity. This approach considers an asset that is presently available, or in operation, rather than the acquisition, development, or construction of an asset that is planned for the future. In June 2022, the IPSASB agreed to retain this as a principle.
  - (b) **Existing Use.** An asset supports an entity in achieving its service delivery objectives in its existing use. Existing use is the current way an asset or group of assets is used. Existing use generally reflects the policy objectives of the entity operating the asset. Measuring the existing use of an asset disregards potential alternative uses and any other characteristics of the asset that could maximize its market value. This approach reflects the assumptions of the

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entity, rather than the assumptions of market participants. In June 2022, the IPSASB agreed to retain this as a principle.

10. The IPSASB instructed Staff to continue analyzing the appropriateness of the remaining COV principles proposed in ED 77 in relation to the applicability to assets held for their operational capacity.
11. The September Agenda Items address the June 2022 instructions and propose a complete set of COV principles, and application thereof, for the IPSASB's consideration. Based on Staff's proposals in Agenda Item 3.2.2, a diagram was developed to illustrate all aspects of COV.
12. The principles of COV, and their application, are illustrated in the below diagram<sup>2</sup>:



13. The objective of Agenda Item 3.2.2 is for the IPSASB to finalize the principles and application issues that underpin the COV basis. Concerns identified by the IPSASB will be addressed by Staff and the Task Force during the week of the IPSASB meeting. Recommendations will be brought back to the IPSASB on the final day of the meeting.

<sup>2</sup> Key:

■ The IPSASB discussed this principle and agreed to retain it in the June 2022 meeting.  
■ The IPSASB will discuss this principle in the September 2022 meeting.  
■ Respondents supported this principle, and no further consideration was required from the Board.

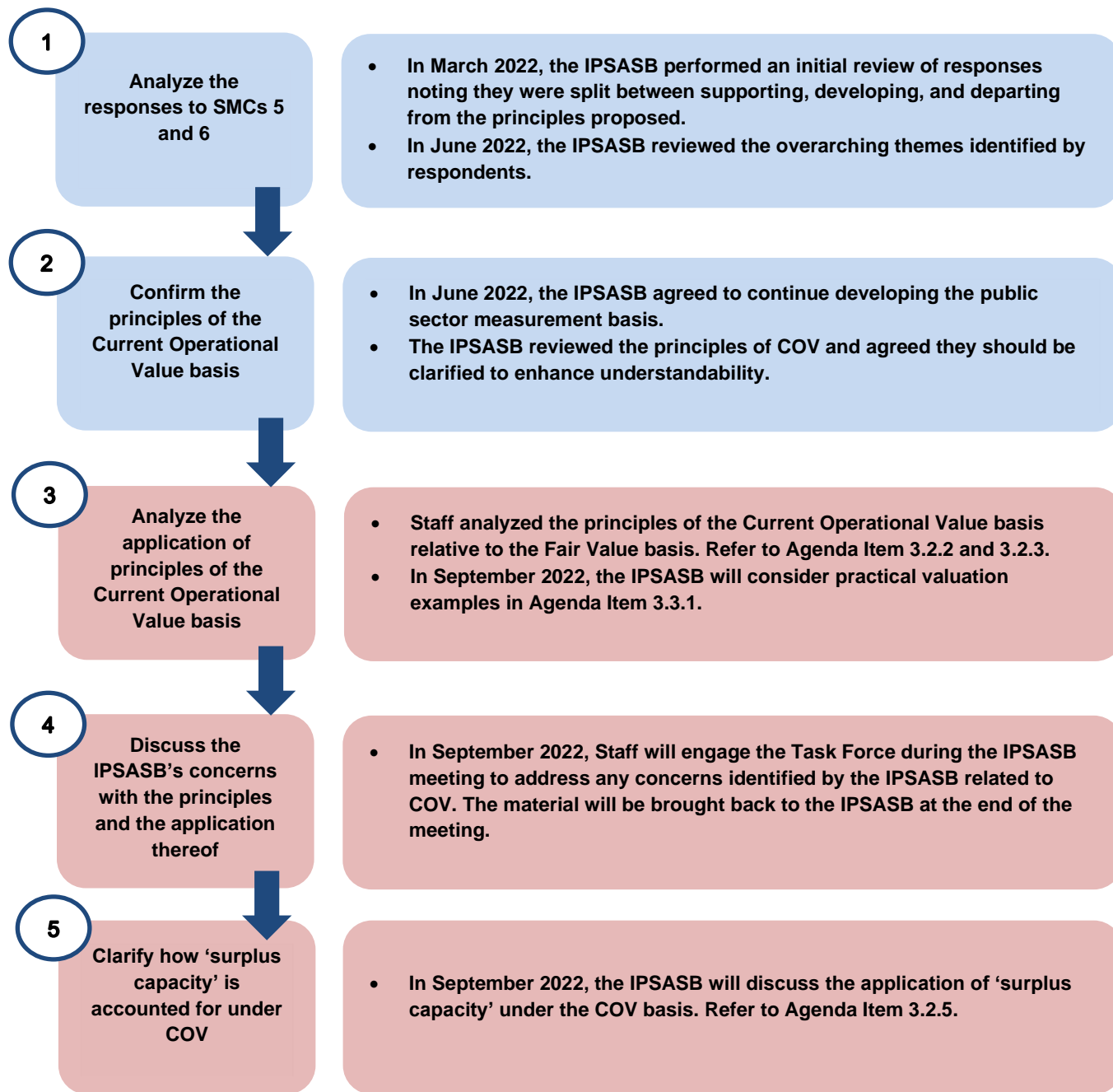


**Decision Required**

14. No decision required. This Agenda Item is to provide the IPSASB with an overview of the development of the Current Operational Value basis, as of September 2022.

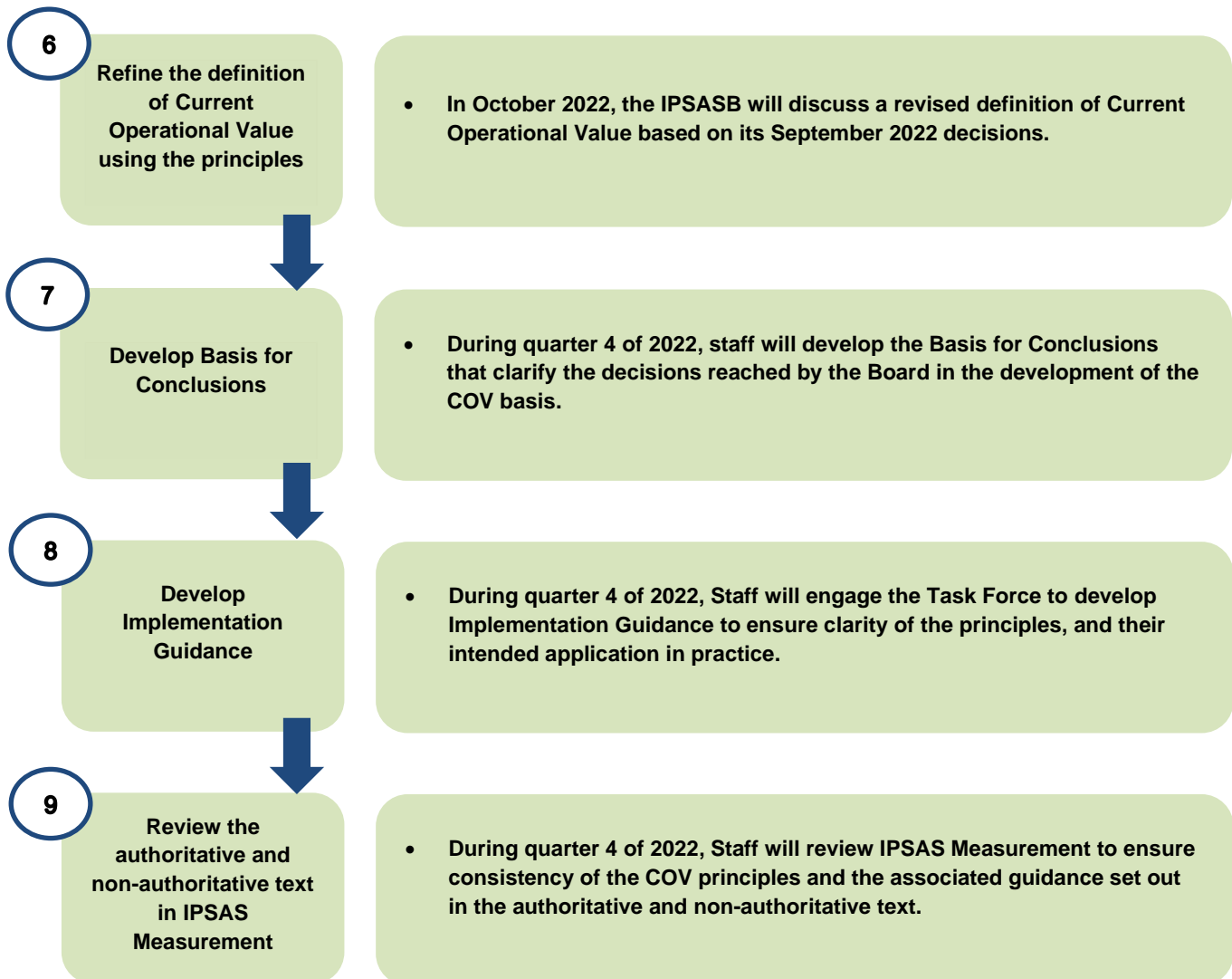
## Appendix – Project Timeline

- The steps below<sup>3</sup> show the links between the IPSASB decisions made in June 2022, the decisions to be made in September 2022, and the remaining actions to be taken by Staff and the Task Force in the development of the authoritative and non-authoritative guidance in IPSAS Measurement.



<sup>3</sup> Key:

- Step covered in past meetings.
- Step covered in September 2022 meeting.
- Step to be covered in upcoming meetings.



## Principles of Current Operational Value – Entry Price and Existing Location

### Question

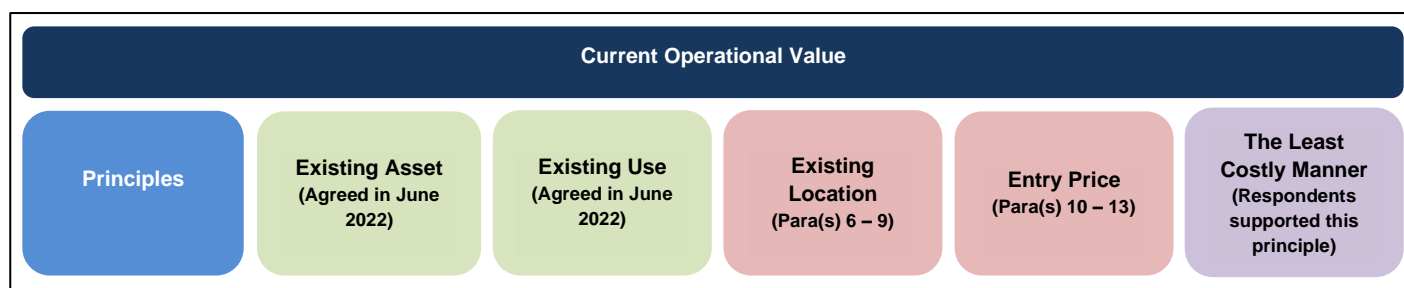
1. Does the IPSASB agree with the recommendations set out in this Agenda Item?

### Recommendation

2. Staff recommends that the Board retain the following ED 77, *Measurement* proposals that current operational value:
  - (a) Values the asset in its current location, and
  - (b) Is an entry price.

### Background

3. In June 2022, after analyzing the additional information and perspectives from respondents, the IPSASB agreed to retain two principles proposed in ED 77, which are necessary for a measurement basis that provides relevant information for assets held for their operational capacity:
  - (a) **Existing Asset.** COV is an asset-specific measurement basis. The focus of the measurement basis is the existing asset held for its operational capacity. This approach considers an asset that is presently available, or in operation, rather than the acquisition, development, or construction of an asset that is planned for the future.
  - (b) **Existing Use.** An asset supports an entity in achieving its service delivery objectives in its existing use. Existing use is the current way an asset or group of assets is used. Existing use generally reflects the policy objectives of the entity operating the asset. Measuring the existing use of an asset disregards potential alternative uses and any other characteristics of the asset that could maximize its market value. This approach reflects the assumptions of the entity, rather than the assumptions of market participants.
4. The IPSASB instructed Staff to analyze whether the ‘existing location’ and ‘entry price’ principles proposed in ED 77<sup>4</sup> were relevant when measuring assets held for their operational capacity.



<sup>4</sup> Key:  
The IPSASB discussed this principle and agreed to retain it in the June 2022 meeting.  
The IPSASB will discuss this principle in this Agenda Item.  
Respondents supported this principle, and no further consideration was required from the Board.

**Analysis**

5. Respondents supported using Fair Value, aligned with IFRS 13, *Fair Value Measurement*, in [draft] IPSAS [X], *Measurement* but have identified specific challenges when applying the basis to assets held for their operational capacity. This Agenda Item evaluates the appropriateness of the 'existing location' and 'entry price' COV principles proposed in ED 77, in the context of whether the associated Fair Value principles should be applied when measuring public sector assets (i.e., assets held for their operational capacity).

**Existing Location**

*Fair value concept*

6. A fair value measurement is for a particular asset (or liability). When measuring fair value, an entity considers the physical characteristics of the asset that market participants would consider when pricing the asset (i.e., the location or size of a property). For example, the fair value of a building is determined based on its current location.

*COV Concept*

7. The COV measurement is derived using the 'existing location' principle, which assumes that the entity will continue to meet its service delivery objectives from the same location in which the asset is currently situated or used.

*Analysis*

8. COV measures a particular asset. When measuring a particular non-financial asset, the most relevant and useful valuation information to present to users of the financial statements is the value of that asset in its current location.
9. While it may be possible to deliver the service the asset provides from another location, it is unlikely to be in the public interest, given that the location where the asset is currently situated, was selected for service delivery needs. Relocating the asset to another location is a separate, future policy decision that should not be taken into consideration when measuring the asset.

**Question for the IPSASB:**

Does the IPSASB agree that a current operational value measurement values the asset in its current location?

**Entry Price**

*Fair value concept*

10. Fair value in [draft] IPSAS [X], *Measurement* is an exit price. An exit price is the price that would be received to sell an asset (or paid to transfer a liability). When an asset is held for its financial capacity, an exit price is relevant because the asset is ultimately held to generate cash flows, either through use or by sale.

*COV Concept*

11. The value of an asset held to achieve the entity's service delivery objective can be determined with reference to the amount required to replace the operational capacity of the asset.

*Analysis*

12. When assets are held for their operational capacity in the public sector, they are held to achieve a service delivery objective. A strong indication of the value of the operational capacity of an asset is the amount the entity would incur to replace the operational capacity of the asset, to achieve its present service delivery objective.
13. An exit price, i.e., the amount that could be received to sell the asset, does not necessarily reflect the amount required to replace the operational capacity of an asset. An entry price, i.e., the amount required to replace the asset, will reflect the amount required to replace the operational capacity of the asset.

**Question for the IPSASB:**

Does the IPSASB agree that a current operational value measurement is an entry price?

**Decision Required**

14. Does the IPSASB agree with the Staff [recommendation](#)?

## Comparison of the Principles Underpinning the COV Basis and the FV Basis

### Question

1. Does the IPSASB agree that the principles proposed for the Current Operational Value basis in [draft] IPSAS [X], *Measurement* are complete?

### Recommendation

2. Staff recommends that the Current Operational Value basis comprise the principles set out in paragraph 4.

### Background

3. After analyzing the additional information and perspectives from respondents, the IPSASB agreed to continue developing its public sector measurement basis, COV, for assets held for their operational capacity. The IPSASB instructed Staff to provide the Board with a comparison of the principles underpinning the COV basis and the Fair Value basis.

### Comparison

4. Staff has presented a side-by-side comparison of the principles, and their application, of the COV basis and the Fair Value basis:

Fair Value	Current Operational Value
<p><b>Asset and liability.</b> An entity shall take into account the characteristics of the asset or liability (for example, the condition and location of the asset; and restrictions, if any, on the sale or use of the asset) if market participants would take those characteristics into account when pricing the asset or liability at the measurement date.</p> <p>(Refer to ED paragraphs 6/26 - 28)</p>	<p><b>Existing asset.</b> The asset measured is that which is presently available, or in operation, rather than the acquisition, development, or construction of an asset that is planned for the future.</p> <p>Refer to <a href="#">Agenda Item 4.2.4</a> of the June 2022 meeting.</p> <p><b>Existing location.</b> The measurement assumes that the entity will continue to meet its service delivery objectives from the same location in which the asset is currently situated or used.</p> <p>Refer to <a href="#">Agenda Item 3.2.2</a>.</p> <p>The COV principles are consistent with the Fair Value principles.</p>

<p><b>Highest and best use.</b> A fair value measurement takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.</p> <p><i>(Refer to ED paragraphs C14 – C20)</i></p>	<p><b>Existing use.</b> The asset is measured based on its existing use notwithstanding potential alternative uses and any other characteristics of the asset that could maximize its market value.</p> <p><i>Refer to <a href="#">Agenda Item 4.2.4</a> of the June 2022 meeting.</i></p>
<p><b>Principal or most advantageous market.</b> A fair value measurement assumes that the transaction to sell the asset takes place either in the principal market for the asset or in the most advantageous market.</p> <p><i>(Refer to ED paragraphs C2 – C8)</i></p>	<p><b>Not applicable.</b> Whilst not a principle under the current operational value measurement, the transaction is assumed to be undertaken between the entity as a willing buyer and a willing seller, in an arms-length transaction.</p>
<p><b>Market participants.</b> The measurement uses the assumptions that market participants would use when pricing the asset, assuming that market participants act in their economic best interest.</p> <p><i>(Refer to ED paragraphs 6/26 - 28)</i></p>	<p><b>Entity-specific perspective.</b> The measurement uses the assumptions from the entity's perspective, assuming that the entity acts in accordance with its policy objectives.</p> <p><i>Refer to <a href="#">Agenda Item 3.2.1</a>.</i></p>
<p><b>Orderly transaction.</b> The asset is exchanged in an orderly transaction between market participants at the measurement date under current market conditions.</p> <p><i>(Refer to ED paragraphs 6/26 - 28)</i></p>	<p><b>The least costly manner.</b> The measurement assumes the amount an entity would incur at the measurement date to be able to continue to achieve its service delivery objectives using its existing assets is incurred in the least costly manner.</p> <p><i>Refer to <a href="#">Agenda Item 3.2.1</a>.</i></p>
<p><b>Exit price.</b> Fair value is the price that would be received to sell an asset in an orderly transaction in the principal market.</p> <p><i>(Refer to ED paragraphs 6/26 - 28)</i></p>	<p><b>Entry price.</b> The measurement reflects the amount an entity would incur at the measurement date to replace the capacity to achieve its present service delivery objective using its existing assets. Any transaction costs that would be incurred in obtaining the asset are included in the current operational value measurement.</p> <p><i>Refer to <a href="#">Agenda Item 3.2.2</a>.</i></p>



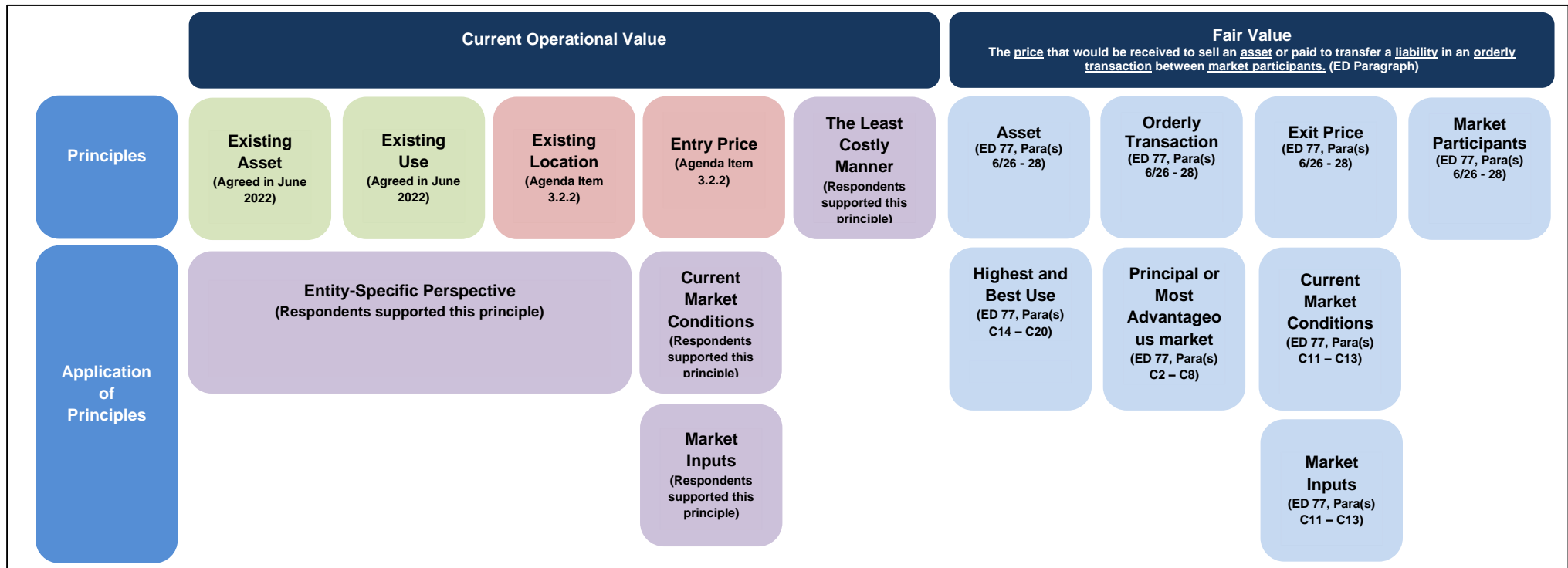
<p><b>Current market conditions.</b> The measurement techniques use prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets.</p> <p><i>(Refer to ED paragraphs C11 – C13)</i></p>	<p><b>Current market conditions.</b> The measurement techniques use prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets.</p> <p>Refer to <a href="#">Agenda Item 3.2.1</a>.</p> <p>The COV principle is consistent with the Fair Value principle.</p>
<p><b>Market inputs.</b> The measurement techniques use inputs that are developed using market data, such as publicly available information about actual events or transactions.</p> <p><i>(Refer to ED paragraphs C11 – C13)</i></p>	<p><b>Market inputs.</b> The measurement techniques use inputs that are developed using market data, such as publicly available information about actual events or transactions.</p> <p>Refer to <a href="#">Agenda Item 3.2.1</a>.</p> <p>The COV principle is consistent with the Fair Value principle.</p>

5. Current Operational Value differs from Fair Value because it:
  - (a) Is explicitly an entry value and includes all the costs that would necessarily be incurred when obtaining the asset;
  - (b) Reflects the cost to replace the operational capacity of an asset in its existing use, rather than the asset's highest and best use; and
  - (c) Reflects the assumptions of the entity, rather than the assumptions of market participants.
6. The principles and the application thereof of the Current Operational Value basis and the Fair Value basis is illustrated below<sup>5</sup>:

<sup>5</sup> Key:

- The IPSASB discussed this principle and agreed to retain it in the June 2022 meeting.
- The IPSASB will discuss this principle in the September 2022 meeting.
- Respondents supported this principle, and no further consideration was required from the Board.

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**Decision Required**

7. Does the IPSASB agree with the Staff [recommendation](#)?

## Income Approach

### Question

1. Does the IPSASB agree with the proposals provided on the 'Income Approach' as a measurement technique for the Current Operational Value basis, as set out in [draft] IPSAS [X], *Measurement*?

### Recommendation

2. Staff recommends that the Board retain the ED 77, *Measurement* proposals related to the 'Income Approach' as a measurement technique for the Current Operational Value basis, as set out in [draft] IPSAS [X], *Measurement*.

### Background

3. The Income Approach was proposed in ED 77 to be used as a technique that could be applied to estimate the Fair Value, Current Operational Value, and Cost of Fulfillment measurement bases. ED 77 proposed the income approach be defined and applied in a consistent manner as defined and applied in IFRS 13. Consistency with the application in IFRS 13 was proposed based on the strong support from constituents in the ED that IFRS 13 *Fair Value* was applicable in some cases in the public sector.
4. Respondents to ED 77 struggled with the concept of 'income approach'. Respondents raised concerns with the application of income approach to Current Operational Value and Cost of Fulfillment because they were of the view discounting incomes would not provide an accurate estimate of the measurement basis. 45% of respondents raised concerns about applying the Income Approach to estimate the Current Operational Value, and to a lesser extent Cost of Fulfillment. Respondents indicated that an income stream did not exist for most public sector assets and therefore using 'incomes' to estimate the value of the asset was not appropriate (for Cost of Fulfillment, no income exists for liabilities and therefore it is not possible to apply the Income Approach).

### Analysis

5. The income approach in [draft] IPSAS [X], *Measurement*, is defined and applied in a consistent manner as in IFRS 13. The income approach is defined in [draft] IPSAS [X], *Measurement* as:

*A measurement technique that converts future amounts (e.g., cash flows or revenue and expenses) to a single current (i.e., discounted) amount<sup>6</sup>.*

6. When estimating fair value, the income approach can be applied using several methods. Those methods include, for example, the following:
  - (a) Present value techniques;
  - (b) Option pricing models, such as the Black-Scholes-Merton formula or a binomial model (i.e., a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and

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<sup>6</sup> [draft] IPSAS [X], *Measurement*, paragraph 45

- (c) The multi-period excess earnings method, which is used to measure the fair value of some intangible assets<sup>7</sup>.
7. All paragraphs related to the income approach in [draft] IPSAS [X], *Measurement*, except paragraph C35 which lists the three methods identified in paragraph 5 above, provide guidance on the application of the present value method under the income approach. No guidance is provided on how the option pricing models method, nor the multi-period excess earning method are applied under the income approach. This is consistent with the guidance in IFRS 13.
8. The components of a present value measurement identified in [draft] IPSAS [X], *Measurement* include:
- (a) An estimate of future cash flows for the asset or liability being measured.
  - (b) Expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows.
  - (c) The time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (i.e., a risk-free interest rate).
  - (d) The price for bearing the uncertainty inherent in the cash flows (i.e., a risk premium).
  - (e) Other factors that market participants would take into account in the circumstances.
  - (f) For a liability, the non-performance risk relating to that liability, including the entity's (i.e., the obligor's) own credit risk<sup>8</sup>.
9. While the name of the technique implies that 'incomes' are used in the measurement, the guidance makes no reference to 'income' outside of the name of the technique. Based on the components of outlined in [draft] IPSAS [X], *Measurement*, it is clear the income approach:
- (a) Can be applied to measure both assets and liabilities; and
  - (b) Discounts future cash flows of the asset or liability being measured (cash flows or revenue and expenses).
10. While no guidance is provided on how to apply the option pricing models method, nor the multi-period excess earning method under the income approach, Staff are of the view the components of present value measurement outlined in [draft] IPSAS [X], *Measurement*, are equally applicable to option pricing models method and the multi-period excess earnings method.

**Decision Required**

11. Does the IPSASB agree with the Staff [recommendation](#)?

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<sup>7</sup> [draft] IPSAS [X], *Measurement*, paragraph C35

<sup>8</sup> [draft] IPSAS [X], *Measurement*, paragraph C37

## **Surplus Capacity**

### **Question**

1. Does the IPSASB agree with the recommendation set out in this Agenda Item?

### **Recommendation**

2. Staff recommend that the Task Force be engaged to review and refine the relevant Implementation Guidance, to note that 'surplus capacity' is a consideration that the entity and the valuation specialist will need to discuss and agree upon prior to the valuation assignment being undertaken.

### **Background**

3. In the June 2022 meeting, the IPSASB agreed to continue developing its public sector measurement basis, COV, for assets held for their operational capacity. The IPSASB took into consideration respondent views and reviewed the COV principles proposed in ED 77 and agreed they should be clarified to enhance understandability. Some respondents to ED 77 noted that the IPSASB should provide a more detailed explanation of why the value of an asset used to achieve the entity's service delivery objectives requires the asset to be measured as if it is being used to full capacity<sup>9</sup>.

### **Analysis**

4. Staff interpret ED 77 to propose that 'spare capacity' exists when:
  - (a) Part(s) of the non-financial asset is unused<sup>10</sup> (refer to Appendix A for further detail), and
  - (b) There are no specific constraints<sup>11</sup> (such as security requirements, legal restrictions, externally imposed restrictions, and/or functional limitations) that prevent the use of the part(s) of the asset that is unused (refer to Appendix A for further detail).
5. Spare capacity is not unique to the public sector. However, in the private sector, spare capacity is not an explicit factor when measuring assets at their current value. This is because Fair Value measures the amount that would be received to sell an asset. Fair Value assesses what factors a market participant would consider in determining the highest and best use of the asset, and not whether the current use of the asset results in spare capacity.
6. In some cases, when estimating the Fair Value of an asset, an entity may apply the cost approach whereby it estimates the amount necessary to replace the operational capacity of the asset. In these cases, the value of the asset is evaluated taking into account the entity's usage of the asset, and by extension, would need to consider whether any of the spare capacity is surplus to requirements (i.e., surplus capacity).
7. Similarly, in the public sector, the valuation specialist assesses the value of the asset from the perspective of the entity using the asset. As such, spare capacity could impact the valuation when using the cost approach measurement technique if that spare capacity would necessarily be

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<sup>9</sup> [draft] IPSAS [X], Measurement, B10

<sup>10</sup> [draft] IPSAS [X], Measurement, B10

<sup>11</sup> [draft] IPSAS [X], Measurement, BC36

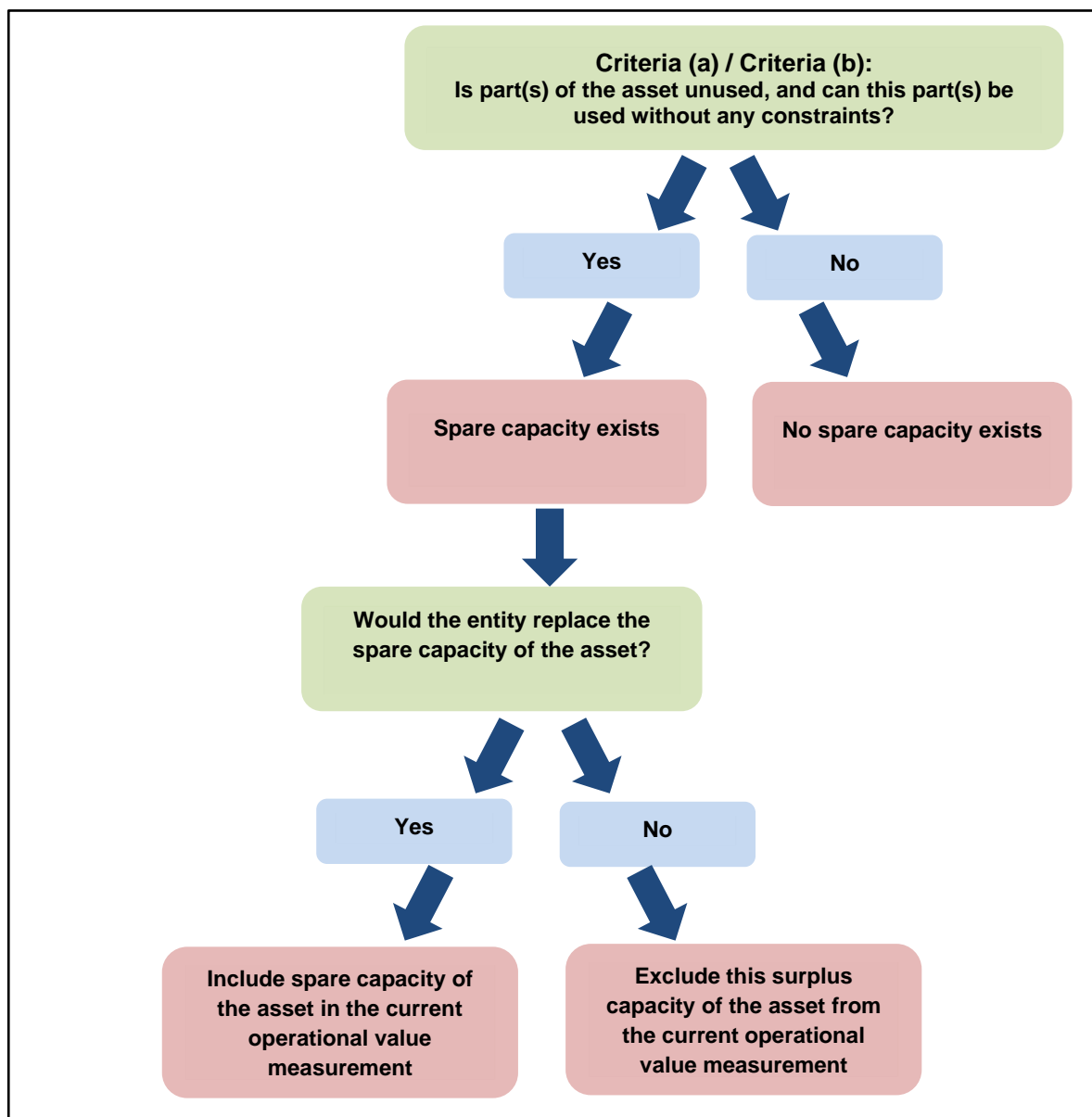
replaced for operational reasons. The valuation specialist would measure the spare capacity when deriving the current replacement cost of the non-financial asset.

8. Prior to the valuation assignment being undertaken, the entity and the valuation specialist will need to discuss and agree on whether or not any surplus capacity exists (i.e., spare capacity which is surplus to operational requirements).
9. In the event the entity and valuation specialist determine the spare capacity would be replaced in order to fulfill the service delivery objective of the asset, the value of surplus capacity is included in COV. Where the spare capacity is surplus to operational requirements, this surplus capacity will be valued using the most appropriate measurement technique depending on the potential use of the surplus capacity (see Appendix B for more detail).
10. Determining whether or not any spare capacity is surplus to operational requirements (and thus surplus capacity) is a decision for the management of a reporting entity, based on the particular operating requirements or other constraints. Once that decision has been made, it needs to be communicated to the valuation specialist. Staff's recommendation is that the Task Force review the existing Implementation Guidance in ED77 to ensure that 'surplus capacity' is a consideration that the entity and the valuation specialist will need to discuss and agree upon prior to the valuation assignment being undertaken.

**Decision Required**

11. Does the IPSASB agree with the Staff [recommendation](#)?

**Appendix A: Decision Tree showing how a valuation specialist would treat surplus capacity in Current Operational Value measurement**



1. Staff discussed the following examples to clarify when part(s) of the non-financial asset is unused and surplus to the operational requirements of the entity (i.e., surplus capacity exists), within the context of the [draft] IPSAS [X], *Measurement* and the impact on the valuation approach.
  - (a) According to the Secure Embassy Construction and Counterterrorism Act, the ground floor of an embassy building cannot be used in any manner other than as a security deterrent, as high-perimeter walls and fences are erected on the ground floor, protecting the compound by deterring attackers on foot. No part(s) of the embassy building is unused and surplus to the



operational requirements of the entity, as the ground floor is being used as a security deterrent.

Because security requirements and the Secure Embassy Construction and Counterterrorism Act prevent the use of the ground floor in any manner other than as a security deterrent, the reporting entity requires that capacity. No surplus capacity exists therefore, and the embassy building is valued as it is being used in its existing location.

- (b) A school was constructed with a capacity of 500 students. However, demographic shifts have reduced enrollment, for the remaining economic life of the asset, to 300 students – part(s) of the school is unused and surplus to the operational requirements of the entity, as only 60% of the operational capacity of the school is being used.

Because the spare capacity (space for 200 students) is surplus to requirements and is expected to remain so for the remaining economic life of the building, there is surplus capacity. The reporting entity and the valuation specialist need to determine whether it is possible to use the surplus capacity for any other purpose during the remaining useful economic life of the asset.

If an alternative is possible, then the 40% currently unused will be valued using the Fair Value measurement technique appropriate for the anticipated use, and the 60% will be valued using the appropriate COV measurement technique for the existing use.

If an alternative use is not possible, then the 40% currently unused will be ignored in the COV valuation (effectively valued at zero).

Please see Appendix B for further examples.

## **Appendix B: The Valuation Treatment of Surplus Capacity in Practice**

*This Appendix sets out the practical approaches to valuation from the perspective of a valuation specialist using International Valuation Standards. The valuation specialist provided his views on how they would account for surplus capacity in practice. These examples were used to help direct and test the guidance proposed in [draft] IPSAS [X], Measurement.*

*Scenario 1: The reporting entity has two floors in an office block that are surplus to requirements and is able to rent them out*

### **Approach:**

1. In discussion with the entity's accounting team, the valuer should clarify that the owner-occupied operational part and vacant part should now be re-classified separately for accounting purposes given they are surplus to operational requirements. In practice, the position may not always be immediately clear and establishing the situation will require early dialogue with the client, usually when the valuer is being notified at the outset by the client of how they have classified their assets. Classification of an asset drives the valuation basis which is to be adopted. While classification is ultimately the decision of the entity, advice may on occasion be sought from the valuer and additionally, the valuer should always be prepared to sensitively query a classification and seek confirmation from the client of its decision if it appears to the valuer to potentially be inappropriate.
2. Assuming this is the case, the 2 vacant floors are classified as an investment/surplus asset and valued separately at Fair Value.
3. The remaining operational accommodation required to deliver the entity's ongoing operational purposes are valued to Current Operational Value.
4. In assessing the Fair Value of the vacant part, due allowance should be made for factors such as letting voids, holding and management costs. No such allowance should be applied in the Current Operational Value assessment of the operational parts.
5. While 100% of the property is valued for balance sheet purposes, this will take the form of two valuations, and these should be separately stated and not totalled.

*Scenario 2: The reporting entity has two floors in an office block that are surplus to requirements and is unable to rent them out*

### **Approach:**

1. These floors are not required for service delivery and therefore the operational capacity which the surplus 2 floors offers would not feature in a valuation for a replacement at least cost.
2. The valuation treatment of such surplus parts depends upon whether they are capable of being separately sold or leased without detriment to the continuing service delivery functions of the operational remainder. In this instance, unlike scenario 1, we are advised that the space is not capable of being let to third parties.
3. As the 2 vacant floors are not capable of separate occupation without impediment to the ongoing operational use of the other floors, the building as a whole will be classified at a PP&E asset and it will be valued using the Current Operational Value basis.

4. The floors required for the entity's operational functions will be valued having regard to comparable market evidence. However, having regard to the principle of replacement of operational capacity at least cost for the existing business functions being delivered from the premises, the value attributed to the 2 floors will be de minimis / negligible.
5. The whole building is valued at Current Operational Value, but effectively ignoring (ascribing no value to) the parts that are not required and cannot be separately occupied.
6. All other factors being equal, in the case of a 4-storey building, the Current Operational Value will be potentially circa 50% lower than the Market Value as the operational capacity offered by only 2 rather than all 4 of the floors has been reflected.
7. As above, no allowance should be applied in respect of factors such as letting voids, holding and management costs in the Current Operational Value assessment of the operational parts.
8. In addition to supplying the Current Operational Value figure in their report, the valuer should separately draw the attention of the client to the property having a potentially higher Market Value should their existing requirement for it cease to assist their strategic asset management planning.

*Scenario 3: A depreciated replacement cost (DRC) valuation of a specialist building (hospital) due to the modern equivalent asset not requiring the entire existing site*

**Approach:**

1. 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, for example, three hectares are now sufficient to provide the same service, the modern equivalent site will be three hectares, even if the actual site in operational use is five hectares. Unless there are areas of clearly identifiable vacant land at the actual site, no surplus land will be present to be valued.
2. The valuer will need to discuss and agree with the entity 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, it is not reflected in the DRC calculation arrived at by assuming a Modern Equivalent Asset (MEA).
3. Where land is categorized as surplus, it is valued as a separate asset as required by accounting standards.

*Scenario 4: A DRC valuation of a specialist building (school) due to (i) existing demographic changes and (ii) possible future demographic changes*

**Approach<sup>12</sup>:**

1. Sites of specialized properties such as schools often include areas of vacant land. This may be held for possible future expansion or as a safety or security cordon. The valuer will need to enquire with the entity 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.

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<sup>12</sup> The approach is as set out in RICS professional standards and guidance, UK, Depreciated replacement cost method of valuation for financial reporting, 1st edition, November 2018

2. Once the extent and location of the site that would be necessary to create the modern equivalent asset has been discussed and agreed with the entity, the next step is to estimate what it would cost to acquire that site in the market at the valuation date. Because many specialized 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 specialized school property, it would usually be appropriate to assume that land with a school planning consent (or where such permission could be anticipated) would provide the best comparable evidence.
3. The valuer has to determine with what other uses a buyer for the hypothetical site would need to compete in the market in the chosen location. This would be the range of uses that prevail in the locality of the chosen location. This will mean competing against other users.
4. Prevailing use involves the valuer considering the mix of planning uses in the chosen locality, not just that with the highest value, and also having regard to the general philosophy of the Planning Authority for the particular area. Planning permission for the proposed hypothetical development of the site can be assumed. 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. If land could be made available by using statutory powers, this might indicate the appropriate approach to the valuation.
5. 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.

*Note on existing location or alternative site<sup>13</sup>*

6. 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 should reflect the cost of a site suitable for a modern equivalent facility. While this may be a site of a similar size and in a similar location to the actual site, 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 to deliver the required operational capacity. The fundamental principle is that the hypothetical buyer for a modern equivalent asset would purchase the least expensive site that would realistically be suitable and appropriate for its proposed operations and the envisaged modern equivalent facility. How the actual site was obtained is irrelevant to the valuation. The valuer will need to discuss and agree with the entity the possible locations for the current defined service requirement.

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<sup>13</sup> This text is based on the RICS Guidance Note on Depreciated Replacement Cost.

7. 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 center 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 specialized industrial facility was originally located close to a source of raw materials that are now imported, thus rendering the original location irrelevant.
8. 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 to or close to a dock if material has to be imported by sea. In the public sector, particular issues can arise with specialized property that provides a service to a defined local community, such as schools, libraries, and health centers. One characteristic of such property is that the service requirement may be attached to a tightly defined geographical area, which places greater geographic constraint on the selection of alternative sites.

## **Instructions from June 2022 Meeting**

### **Question**

1. Does the IPSASB agree that the instructions provided by the IPSASB in the June 2022 meeting have been appropriately addressed?

### **Recommendation**

2. Staff recommend the non-conceptual instructions provided by the IPSASB be actioned as noted in paragraph 4.

### **Background**

3. The IPSASB instructed Staff to make updates to the guidance on the Current Operational Value basis, and the historical cost and transaction price definitions.

### **Analysis**

4. Staff have actioned all instructions issued by the IPSASB:

Instruction	<b>Agenda Item 4.2.2 of the June 2022 meeting:</b>  Communicate in the Basis of Conclusions why the IPSASB decided that the asset should be valued based on the physical items that comprise the asset.
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<b>Analysis</b>	The Basis of Conclusions was updated to note the IPSASB's decision that the public sector measurement basis is based on the value of the physical items that comprise the asset. See BC33A – BC33C.
<b>Update made to IPSAS [X], Measurement</b>	<p><b>Basis for Conclusions</b></p> <p>.....</p> <p><b>Current Operational Value (Appendix B)</b></p> <p>.....</p> <p><b>BC33A.</b> During the development of this Standard, the IPSASB discussed <u>alternative approaches to capture the value of public sector assets. Based on some responses to the Exposure Draft, the IPSASB considered whether measuring the asset based on the value of the service or benefits the asset provides, results in useful and relevant information when presenting an asset held for its operational capacity – i.e., to deliver direct services to the public, and/or to provide a wider community benefit.</u></p> <p><b>BC33B.</b> The IPSASB rejected the idea of measuring public sector assets based on the value of services or benefits they provide because:</p> <ul style="list-style-type: none"> <li>a.) <u>It is inconsistent with how all other non-financial assets are measured on the balance sheet;</u></li> <li>b.) <u>The IPSASB agreed that a public sector measurement basis that values the asset by valuing the services delivered to the public, or the wider community benefits to the public, would result in the asset recognition criteria not being satisfied, as there is no well-established method in practice to derive such a valuation in a relevant and reliable way.</u></li> </ul> <p><b>BC33C.</b> <u>The IPSASB agreed that the public sector measurement basis is based on the value of the physical items that comprise the asset.</u></p>

<b>Instruction</b>	<p><b>Agenda Item 4.2.3 of the June 2022 meeting:</b></p> <p>Review the Basis of Conclusions to ensure that it clearly explains why Fair Value is not applicable for assets held for their operational capacity, and why a public sector measurement basis is required.</p>
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<b>Analysis</b>	Staff reviewed the Basis of Conclusions and noted that paragraphs BC29 – BC32 clearly explain why a fair value measurement would not provide useful information for assets held for their operational capacity. See BC29 – BC32.
<b>Update made to IPSAS [X], Measurement</b>	<p><b>Basis for Conclusions</b></p> <p>.....</p> <p><b>Current Operational Value (Appendix B)</b></p> <p>.....</p> <p><b>BC29.</b> Most responses to the April 2019 Measurement Consultation Paper agreed with the IPSASB’s preliminary view that fair value is relevant and applicable in measuring some assets and liabilities in the public sector. Constituents’ concerns with fair value related to the fact that when an item is held for its operational capacity, as is often the case in the public sector, fair value is difficult and inappropriate to apply because the following concepts generally are not applicable:</p> <ul style="list-style-type: none"> <li>(a) Highest and best use; and</li> <li>(b) Maximizing the use of market participant data.</li> </ul> <p><b>BC30.</b> While respondents agreed the fair value definition proposed is applicable in some circumstances, they also noted the definition is unlikely to be appropriate as a current value measurement basis in most cases. Respondents expressed the view that a public sector specific measurement is required.</p> <p><b>BC31.</b> The IPSASB agreed with respondents’ views and developed a current value measurement basis unique to the public sector. Given fair value is applied to items held for their financial capacity, this basis was developed specifically for assets held for their operational capacity.</p> <p><b>BC32.</b> When assets are held for their operational capacity in the public sector, they are held to achieve a service delivery objective. Holding an asset to meet a service delivery objective often results in an asset being held in a capacity other than that of one that satisfies its highest and best financial use. For example, an entity may have a service delivery objective to provide medical services to citizens of a city centre. While operating a building the entity owns as a hospital may not be in the best financial interests of the entity, it does satisfy the service delivery objective.</p>
<b>Instruction</b>	<p><b>Agenda Item 4.2.6 of the June 2022 meeting:</b></p> <p>Convey the cost approach approximates fair value in paragraph BC 64A in <i>[draft] IPSAS [X], Measurement</i>.</p>



<b>Analysis</b>	The Basis of Conclusions was updated to note the IPSASB's decision to maintain consistency with IFRS 13, <i>Fair Value</i> adopting all measurement techniques set out in IFRS 13, <i>Fair Value</i> . See BC64A.
<b>Update made to IPSAS [X], Measurement</b>	<p><b>Basis for Conclusions</b></p> <p>.....</p> <p><b>Application of Measurement Techniques</b></p> <p>.....</p> <p><b>BC64A</b> In developing this Standard, the IPSASB decided to align with IFRS 13, <i>Fair Value</i>, adopting all measurement techniques set out in IFRS 13. The cost approach is considered an appropriate measurement technique to <u>approximate</u> Fair Value as the cost to replace an asset is consistent with an exit price definition of fair value. An entity's cost to replace an asset would equal the amount that a market participant buyer of that asset (that would use it similarly) would pay to acquire it <del>(i.e., the entry price and the exit price would be equal in the same market).</del></p>
<b>Instruction</b>	<p><b>Agenda Item 4.2.6 of the June 2022 meeting:</b></p> <p>Work with members to enhance the consistency of the "historical cost" and "transaction price" definitions proposed.</p>

<p><b>Analysis</b></p>	<p>The amendments to IPSAS CF 7.13 / IPSAS Measurement paragraph 6 and Implementation Guidance D.1 are being proposed for the following reasons:</p> <ul style="list-style-type: none"> <li>• In order to maintain consistency in the usage of the relevant terms between the definitions of 'historical cost' and 'transaction price',</li> <li>• Respondents to ED 77 have requested that the terms 'construct' and 'develop' be used consistently in the definition of 'historical cost' and 'transaction price', and</li> <li>• The terms 'construct or develop' have the same effect as 'create', which is used in the IASB Framework - Staff considers that the terms 'construct or develop' are clearer and also emphasizes that the IPSASB Framework is not an interpretation of the IASB Framework.</li> <li>• To clarify that the historical cost will be equal to the transaction price in some cases.</li> </ul> <p>See IPSAS CF 7.13 / IPSAS Measurement paragraph 6 and Implementation Guidance D.1.</p>
<p><b>Update made to IPSAS [X], Measurement</b></p>	<p><b>Definitions</b></p> <p>.....</p> <p><b>6.</b> Historical cost is the consideration given to acquire, <u>construct</u>, or develop an asset, which is the cash or cash equivalents, or the value of the other consideration given, at the time of its acquisition, <u>construction</u>, or development.</p> <p><b>6.</b> Transaction price is the price paid to acquire, <u>construct, or develop</u> an asset or received to assume a liability.</p> <p><b>Implementation Guidance</b></p> <p>.....</p> <p><b>Section D: Historical Cost</b></p> <p>D.1 Is there a difference between the transaction price and historical cost?</p> <p>Yes. Transaction price is determined on the date of initial recognition, whereas historical cost is a subsequent measurement basis that presents the consideration given to acquire, construct, or develop an asset, which is the cash or cash equivalents, or the value of the other consideration given, at the time of its acquisition, construction, or development. <u>In some cases, the</u> historical cost will be equal to the transaction price, and in some cases the historical cost is derived, at least in part, from the price of the transaction or other event that gave rise to the asset or liability.</p>

**Update made to The  
Conceptual  
Framework for  
General Purpose  
Financial Reporting  
by Public Sector  
Entities - Chapter 7:  
Measurement of  
assets and liabilities  
in Financial  
Statements**

**Chapter 7: Measurement of assets and liabilities in Financial Statements**

.....

**Measurement Bases for Assets**

**Historical Cost**

.....

**7.13.** Historical cost is the consideration given to acquire, construct, or develop an asset, which is the cash or cash equivalents, or the value of the other consideration given, at the time of its acquisition, construction, or development.

**Decision Required**

5. Does the IPSASB agree with the Staff [recommendation](#)?

## Approaches to Valuation - the Surveyor's Perspective

*This Agenda Item sets out the practical approaches to valuation from the perspective of a valuation specialist using International Valuation Standards.*

1. This paper provides some examples of a surveyor's approach to valuing different types of built assets.

Scenario	Type of built asset	Measurement technique <sup>14</sup>
1	A standard office block in a commercial district	Income/market
2	An office block outside a commercial district	Market/cost
3	A property complex in a rural area	Cost
4	A specialised building being used for non-specialised purposes	Cost
5	A depreciated replacement cost (DRC) valuation of a specialised building	Cost
6	An iconic building in a prime location used as offices	Income/market/cost
7	An iconic building such as a museum or art gallery and other historic or heritage assets	Cost
8	A valuation where there is a restricted market rather than an open market	Income/market/cost
9	Social housing	Income/market

*Scenario 1: a standard office block in a commercial district*

### Approach:

2. Investment/market approach to valuation (increasingly adopting a Discounted Cash Flow methodology) having regards to existing leases in place and market comparatives in respect of rents and yields and making allowances for running costs, letting voids, holding and management costs.

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<sup>14</sup> Measurement technique as described in [draft] IPSAS [X], Measurement

*Scenario 2: an office block outside a commercial district*

3. In this scenario, a public sector entity owns, occupies, and delivers its service objectives from a very large modern office block on the edge of a large town. The office block was sited there for social policy reasons (for example, regeneration or reduction in unemployment).
4. The building would cost CU40 million to reconstruct (including a small amount for land value). There would be no demand for the premises other than from the existing occupier. If the property were placed on the market, it is estimated that a market participant might pay CU15 million, reflecting the possibility of letting a small part and/or the remote possibility of a sale one day to another owner-occupier. This would also have to reflect the cost of holding and maintaining the whole, or the great majority, of the property empty in the meantime.

**Approach—analysis:**

5. Although this property is used for a conventional purpose, it is unusual in terms of both where it is sited and its size for the location. (This situation is not unusual in the public sector, with properties placed for economic, social, or political reasons in locations which would not be the choice of the market.) Where a property is in an unusual location or is oversized for its location, it would have a low market value but the cost of replacing the operational capacity would be significantly greater.
6. If the requirement for the current use ceased and the property was exposed to the market, the Market Value is expected to be about CU15 million. This is significantly lower than the replacement cost. It reflects the absence of a potential replacement owner-occupier for the whole premises and the likelihood of only partial future lets, potentially lengthy void periods and ongoing management, security, and marketing costs.
7. It would be wrong to suggest that a property ideally appropriate for the needs of that service delivery function should be recorded in the balance sheet as having a negligible value to the business due to its low demand in the open market. We are seeking to replace the existing operational capacity to enable the business function to continue being delivered in the same way.
8. That value can exceed Market Value. In this example, this is illustrated by having an office block purpose-built and located to deliver a specific function in a desired way at a cost of CU40 million. It makes no sense that, after incurring that amount of capital expenditure to meet a business need, the property would then have to be immediately down valued on the balance sheet to CU15 million.
9. The actual owner-occupier is to be regarded as not being in the market for the property, but for their service delivery function to continue to be delivered in the same way from that location. It is therefore useful to envisage a hypothetical owner-occupier purchaser in the market at the valuation date who will step into the shoes of the existing owner-occupier, taking over the whole operational entity for the purpose of carrying on delivery of the existing service function in the same way. If such a property could not be purchased, it would have to be constructed.
10. While a starting position is for the valuer to seek to identify comparable market evidence, either capital or investment transactions, from which one can extrapolate a value for the existing service delivery, there does come a point at which such extrapolation becomes overstretched and unreliable for some properties, with unusual location or size, or a combination of both, potentially being flags that this might be the case.

11. In this example, the issue is whether or not this is an asset that can be sensibly valued having regard to market criteria:
12. In terms of flexibility of location, for example, could the function be moved elsewhere? The public sector has chosen for policy reasons to locate this particular service delivery function in its existing location and to provide it in the existing operational way, so there is a presumption that this remains the case.
13. Alternatively, could the function be split without detriment between a number of smaller buildings in the locality for which comparable market evidence may be available? That would need careful discussion with the client to understand whether, in the client's view, their business needs could be equally met through being based across a small number of buildings rather than a single asset, and even if potentially possible, that would not enable the existing service delivery function to continue being provided in the same way.
14. The valuer in this example is likely to conclude that the asset would not have been developed in this location had there not been a specific requirement for the purpose; without a pre-let or an owner occupier, an office building of such a size would not have been developed in the location.
15. If the owner has developed the building for their own occupation, it may be reasonable to assume that this was a sound business decision, and that if deprived of the property the owner would rebuild it.
16. Where market evidence is lacking or reliable extrapolation from the evidence is not possible, the valuer may conclude that recourse to the DRC<sup>15</sup> method to assess the deprival value of the operational capacity is an appropriate way to arrive at a value.

**Approach—valuation:**

17. The value to the owner-occupier is not the possible market value of CU15 million.
18. The valuer is likely to conclude after due consideration of the market information that it is not practicable to prepare a reliable valuation based on comparable market transactions.
19. The appropriate approach will usually be to undertake the valuation using the DRC method, with the resulting value being at or close to the cost of a new replacement, less adjustments for obsolescence.
20. In addition to supplying this figure in their report, in order to assist their strategic asset management planning, the valuer should separately draw the attention of the client to the property having a lower Market Value should the existing operational requirement cease
21. A useful mantra in these circumstances could be: "if you can't rent it and can't buy it in the local market (for example, because it is oversized), use DRC."

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<sup>15</sup> The DRC method entails valuing the land for its existing use, plus the cost of erecting the building (or more specifically its modern equivalent offering the same service capacity), less allowances to reflect physical and functional obsolescence. DRC is a recognised method which may be used for the valuation of specialised property, and a specialised property is defined in the Red Book Global 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.' A property or asset may become 'specialised' 'by virtue of being of a size or in a location where there is no relevant or reliable evidence of sales involving similar property' (RICS Guidance note on DRC, paragraph 3.2).

*Scenario 3: a property complex in a rural area*

22. In this scenario, a public sector entity (a police force) owns a property complex in a rural location. Approximately 75% is used by the police force for operational purposes, and there are no external lettings. The bulk of the property (approximately 60%) comprises a purpose built 3 storey HQ office building, the remainder being various out buildings used for offices and storage. The property is generally in a poor to fair condition. Surrounding uses are predominantly rural and the nearest town offering any alternative office accommodation is some distance away, where modern office business rentals are circa CU15/sq. ft. Rebuild costs for business park style offices are circa CU250 per sq. ft.

**Approach—analysis:**

23. This example considers two issues, these being the situation where there is an absence of comparable evidence and the situation where the occupying entity is not using, and does not require, the full operational capacity which the property could otherwise offer a different occupier for delivery of a different purpose.
24. The valuer would begin by first considering whether there is appropriate market evidence available to inform what a hypothetical owner-occupier may pay for the property at the valuation date to step into the shoes of the actual occupier and carry on delivering the same service in the same way.
25. In this example, there is a scarcity of evidence in terms of proximity and direct applicability. The property is in an unusual location for its use, being remote from the office market, and is also oversized for its location. Given this, were the current occupation requirement to cease and the property be exposed for sale on the market, the market value would reflect either what may reasonably be expected to be a low demand for the vacant office space, or it may also have regard to alternative uses.
26. However, the premise is that the existing operational function to which the property is being put does not cease at the valuation date, but rather continues to require to be delivered for the foreseeable future.
27. In this example, the location of the property and its disproportionate size materially restricts the availability of comparable office transaction evidence from which a value can be reliably extrapolated. With unusual assets like this, it may be necessary to look further afield for evidence of similar configured assets, with it then being for the valuer to analyse that evidence, and make any adjustments necessary, such as for differences in size and location. However, it should be recognised that there are limits as to the extent to which available market information and market behaviours can be adapted and stretched to fit the specific owner occupation service delivery requirement.
28. Recognising that the asset has evolved to deliver its required operational capacity from such a location and mix of buildings, it may be decided that this property's value requires to be assessed using the DRC method. Where that is the valuer's intention, early discussion with the client about this is recommended as best practice.
29. This scenario additionally raises the issue of underutilisation, as only 75% of the existing space is occupied and required for delivery of the existing and continuing operational purpose. In assessing the value of the property in relation to service delivery needs using a DRC approach, those parts which are surplus would not feature in a replacement at least cost, the premise being that only

those parts of the property which are required for the requirements of the existing operational delivery function should be measured.

**Approach—valuation:**

30. Lack of relevant comparable evidence is likely to mean that the DRC approach is the only realistically feasible approach to estimating the value.
31. Regarding the unused 25% space, as it is not part of the operational capacity that would need to be replaced by the police authority, it should be disregarded for that purpose as it is surplus to requirements and will not materially impact on value.
32. The value would only reflect the value of the 75% of the existing space which is being used. If, for example, the DRC method is being used, a reduced floor area would be used for the modern equivalent asset in the calculation of the gross replacement cost.
33. If it is considered by the entity, potentially after dialogue with the valuer, that the surplus space could be disposed of by being either separately let or sold, that 25% space would be classified, respectively, as either investment property or 'held for sale' property and valued to Fair Value. This will depend in each instance upon the particular circumstances. In this example, given the identity of the owner-occupier is a police force, it may be that such separate occupation would be considered incompatible with their functions.

*Scenario 4: a specialised building (a hardened aircraft hangar) is being used for non-specialised purposes (a warehouse)*

**Approach:**

34. Unless there is evidence that a live 'market' exists for such a purpose and comparable evidence exists, then most likely the relevant valuation approach is likely to be a DRC approach. However, within this, the modern equivalent asset should reflect the cost of providing a warehouse rather than a hardened aircraft hangar.

*Scenario 5: a DRC valuation of a specialised building*

Example 1

35. In this scenario, the property is a 30-year-old fire station in a town centre with an estimated lifespan of 60 years. The building has a gross internal area of 14,500 sq. ft. The valuation is for the fire authority's financial statements.

**Approach:**

36. In this example, the client has asked the valuer to adopt 'instant build'. This is a special assumption that might be required by some jurisdictions. The calculation therefore excludes any interest calculations on the land or building element - the finance rate has been set to zero in the calculations.
37. The valuer starts by estimating the cost of a modern equivalent asset (MEA), which is slightly smaller than the actual building being valued. The total MEA cost is CU2,415,000.
38. The next step is to determine the obsolescence or depreciation factor to apply. The valuer has been explicit in the calculation by preparing a weighted-average approach.



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39. As the building is about halfway through its physical life, the valuer has attributed 50% on a straight-line basis.
40. The valuation calculations are then concluded with the addition of the land valuation.

<b>Town Centre Fire Station: 30 years old: instant build</b>		
	CU	CU
<b>MEA building</b>		
MEA build 12,000 sq. ft at CU175 per sq. ft	2,100,000	
Fees at 15%	315,000	
Finance costs	0	
Gross replacement cost	2,415,000	
Depreciation factor of 50% gives net replacement cost of		1,207,500
<b>Land</b>		
Land 0.5 acre at CU750,000 per acre		375,000
Total value for financial reporting purposes		CU1,582,500
Say		CU1,582,000

### Example 2

41. In this scenario, the property is an old (late 19<sup>th</sup> century) primary school with a gross internal area of 30,000 sq. ft. primary school. It has been refurbished in recent years, but the classroom sizes are too small for a modern school. The valuation is for financial reporting purposes.

### **Approach:**

42. In this example, the valuer estimates that it will take 2 years to build the school; finance fees are 7%.
43. The valuer has calculated that a modern school with the same operational capacity would be 25,000 sq. ft. The valuer then depreciates the modern equivalent asset to reflect the actual building. As the school is over 100 years old and has functionality issues due to classrooms being the wrong size, the depreciation is high.

<b>Late Victorian primary school</b>		
	CU	CU
MEA build 25,000 sq. ft at CU175 per sq. ft	4,375,000	
Fees at 10%	437,500	
Finance costs at 7% for 1 <sup>st</sup> year	336,875	
Gross replacement cost	5,149,375	
Depreciation factor of 80% gives net replacement cost of		1,029,875
Land 1.5-acre site at CU500,000 per acre	750,000	
Finance on land at 7% over the 2-year period	108,675	
Total cost of land		858,675
Total value for financial reporting purposes		CU1,888,550
Say		CU1,890,000

*Scenario 6: an iconic building in a prime location used as offices*

**Approach:**

44. In theory, the approach will be the same as set out in scenario 1 above, with the investment method being used.
45. However, the assessment of an appropriate yield can be complicated by the impact of the 'historical' factor. Restrictions on use, alteration and a perception of higher maintenance and repair costs may negatively impact an investor's attitude. It is not necessarily the case, however, that investment yields achieved in the market will be significantly lower for historic properties.
46. In assessing the appropriate yield to be applied to the income stream, evidence should be carefully evaluated and appropriately weighted to accurately reflect the overall quality of the investment. It can be the case that a listed property affords perceived prestige, which in turn increases marketability, and a consequential increase in value and attractiveness as an investment. Limited supply and good demand can also mean historic buildings hold their value. Conversely, limitations on physical alteration and potential future uses, combined with greater outlay on repair and maintenance costs, may lower the return. Even if a building is considered to enjoy 'trophy' status, its attractiveness as an investment may be reduced if the internal space and layout are not versatile and suitable for modern requirements.
47. Traditional investment valuation methodology does not always form an adequate basis on which to determine the value of a building. Discounted cash flow (DCF) techniques offer an alternative means of appraising the projected return from a property investment or development opportunity and have equal applicability to both historic and non-historic income-generating property. In the case of historic buildings, DCF can be utilised as a check to appraise its inherent worth. In this way,

the special elements affecting the value of historic buildings, such as physical deterioration and obsolescence or grant allowances can be included in the appraisal to create a true picture of worth.

48. The traditional comparison valuation approach could be made with similarly used properties to enable determination of an indicative rental value for some structures, but for others the task was much more difficult.
49. Valuing unusual properties is not confined to public sector properties or those for which the rental comparison method cannot be used because there are no relevant comparisons. In such cases, the use of the Receipts and Expenditure (R&E) or income method may be a more reliable guide to assessing the market rental value of a property.
50. If neither the comparison nor R&E methods can be used, then DRC will probably be the most appropriate approach to use.
51. As noted in earlier examples, the DRC approach attributes a gross cost to a modern equivalent asset, adjusts that cost for physical, functional, and external factors, and then adds the land cost. In considering the features of the modern equivalent asset for an iconic building, the valuer and the public sector client will need to determine, for example, the extent to which the modern equivalent asset needs to match the land area and perhaps replicate the façade of the existing asset in order to meet planning or other requirements. Alternatively, it might be possible to consider a modern equivalent asset that is, in itself, iconic (for example, having a distinctive design and built to a very high specification) without matching the land area or replicating the existing façade.

*Scenario 7: An iconic building such as a museum or art gallery and other historic or heritage assets*

52. The approach outlined in scenario 6 above may be relevant to this scenario. Although there may be situations where only a reproduction of the existing asset can meet the service delivery requirements, these situations are expected to be extremely rare.
53. Only where the historic nature of the building itself creates an intrinsic part of the benefit or operational capacity 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.
54. 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 a historic asset is to be capitalised is a matter for the reporting entity, although the valuer may be asked to comment upon the practicability or otherwise of valuing the asset.

*Scenario 8: A valuation where there is a restricted market rather than an open market*

55. Valuations using the market approach are normally carried out in the context of there being an open and orderly market. This is not always the case—for example, transactions might be relatively few, or the type of asset is such that the number of participants in the market might be restricted.

**Approach:**

56. Some kind of market or comparable approach would likely still be relevant assuming that some form of basic market exists (even if it is restricted) along with the existence of some comparable evidence. The valuation would ultimately be a product of valuer judgement in the circumstances and the valuation outcome may need to be caveated by the valuer drawing light to any matters that

give rise to material valuation uncertainty which may arise from a lack of market evidence, restricted marketing and so on.

57. A DRC approach should only be used as a valuation approach where no market exists at all and only as a means of last resort.

*Scenario 9: Social housing*

58. Social housing is generally housing that is rented out at lower than market rentals. A public sector entity that holds social housing will need a valuation for financial reporting purposes.

**Approach (United Kingdom):**

59. At present there are two valuation bases in use in the UK for loan security. One is market value – subject to tenancy (MV-STT), which is used when it is assumed that homes may be sold outside the regulated social housing sector. The second is existing use value – social housing (EUV-SH), which specifically assumes retention of stock in the social sector.
60. The established methodology for arriving at an opinion of EUV – SH (+ MV – STT) is a discounted cashflow discounting the net annual rental income which allows the valuer to capture explicitly the many variables affecting the rental: discount rate, inflation rate, management and maintenance costs, rent increases, voids and bad debts, and major repairs.
61. However, this is not the only or prescribed method of arriving at such a valuation and valuers should have regards to comparable transactions where evidence is available.