SPLIT DECISION - Determining the land and buildings split in local authority asset valuations

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As a response to the Editor's awareness of a confusion amongst valuers about land and buildings split for valuations for capital accounting purposes, Susan and Chris provide compelling useful guidance.

Local authority valuers who undertake asset valuations for the balance sheet will often be requested by their finance colleagues to provide a land and buildings split of their valuation. Many valuers struggle with this concept and because they do not understand the purpose of the split, corners can sometimes be cut.

The purpose of this article is therefore to:

- Explain the purpose of undertaking a land and buildings split
- Set out which assets require a land and buildings split and which do not
- Clarify what should be included within the 'building' part of the split
- Outline the risks of getting the split wrong
- Describe some of the approaches in general use by local authority valuers and which of these is 'compliant'

Why is a land and buildings split necessary?

The principle purpose of undertaking property asset valuations for local authority balance sheets is to ensure that the Financial Statements of the authority give a true and fair view of the financial performance and cash flows of an authority. A true and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the CIPFA Code.

One element of these transactions is the depreciation charge relating to an asset. Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. Put simply, an asset wears out over time and this must be reflected in the balance sheet of the authority. An asset is depreciated in the financial statements to the extent that is appropriate given the estimated remaining useful life of that asset to the authority. Where an authority does not have any future plans for the asset and it is fair to assume that the asset will continue in its current use for the foreseeable future then the useful life is often determined by reference to the physical life of the asset.

If an asset was not subject to depreciation then the carrying amount of that asset would not change; however the asset would be depreciating in value as it is wearing out and becoming less fit for purpose. This would result in the value of the asset being misstated in the financial statements. This is an important aspect of the financial statements and is as critical as ensuring that valuations are kept up to date.

Which asset valuations require a land and buildings split?

A land and buildings split is necessary where depreciation relating to one part of an asset is significantly different to another part of that asset. Many valuers will have become familiar in recent years with componentisation of building assets. Componentisation of a building asset takes place when there are significant components that are wearing out over a shorter period than the main asset. This is done so that each significant part can be depreciated separately and the balance sheet remains robust. Undertaking a land and buildings split is nothing more than an

earlier form of componentisation.

Depreciation applies to all property, plant and equipment (PP&E) assets, whether held at historical cost or re-valued amount, with certain exceptions. Firstly, land is not depreciated where it can be demonstrated that the land has an unlimited useful life, which will be the case with most land assets. But there could be circumstances, for example land subject to depletion (i.e., quarries and landfill sites) where there is a determinable life and the land should be depreciated. In these circumstances the life of the land asset is often measured in units of consumption (e.g., tonnes of rock in the case of a quarry) rather than measured in years.

Buildings however rarely have an unlimited life and will wear out physically over time, simply through age, usage and general obsolescence. But not all buildings are subject to depreciation. For example heritage and community assets that have an indefinite life are not depreciated and neither is Investment Property. The reason that Investment Property is not depreciated is simply that the assets are investments and intended to provide an investment return, either through rental income or capital appreciation, or both.

An asset is not depreciated until it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. This means that where there is an asset under construction and the carrying amount in the balance sheet is the aggregate of the bills of quantities, this figure is not depreciated until the asset is brought into use.

If an asset becomes an 'asset held for sale' (in accordance with s4.9 of the CIPFA Code, see also IFRS5) then the asset is no longer depreciated.

In effect all this means is that apart from Community Assets, Heritage Assets, Assets Held for Sale, Assets under Construction and Investment Property, depreciation applies and a land and buildings split of the asset valuation must be undertaken.

What should be included within the 'building' part of the split?

Anything that has a life that can be determined should be included in the 'building' part of the split. It is not simply a case of splitting away any buildings on the land. The 'building' element should include any improvements to the bare land, including external areas such as hard surfacing, hard landscaping, access roads, retaining walls etc. This should include items such as boundary walls and fencing. It should also include utility connections and drainage if these are significant and capable of being measured.

What are the risks of getting the split wrong?

There are 2 high level risks:

1. Qualification of the accounts if errors are regarded by auditors as being material

2. Censure from RICS Regulation if the approach to determining the land and buildings split does not meet professional standards expected.

In terms of the first risk, this is naturally going to be of greatest concern to the accountants, as qualification of the accounts is a serious matter to them and to the authority. It reflects badly on their professional standards and also upon the reputation of the organisation.

The second risk area will be of greater interest and concern to the valuer. As we have mentioned in earlier Terrier articles, RICS Regulation is becoming more active in the regulation of local authority valuers following the introduction of valuer registration. Their role is to ensure professional and ethical standards are being maintained. We do not at the moment have any intelligence that suggests that RICS Regulation is specifically examining how local authority valuers are approaching land and buildings split in asset valuations.

However, it should be remembered that such valuations, including the land and buildings split are covered by RICS professional standards. As RICS Regulation is generally more concerned with approaches and processes, if you were to receive a regulatory visit from the RICS then they could quite easily ask to see your approach to the land and buildings split. If there are flaws in your approach that place your professional standards in question then you could find yourself in an uncomfortable situation.

What approaches are being taken and are they 'compliant'?

We deliver quite a number of valuation training events and workshops each year for local authority valuers, and from these events we have a fairly good idea of the practices in use for arriving at the land and buildings split. Sadly not all of these approaches are either compliant with the CIPFA Code nor, in our humble opinion, meeting RICS professional standards.

The 4 principle approaches we have come across are as follows:

- Land comparison method
- Residual valuation
- % split
- The £1 approach.

We will discuss the relative merits of these in turn. We should just make the point at this stage that the methods we are about to describe and discuss relate to asset valuations where there is a 'market', in other words those asset valuations that are undertaken other than the DRC approach. As readers will be aware, where DRC is used to arrive at the opinion of value, there is a ready land and buildings split produced as part of the process and no further consideration of land and buildings is necessary for such valuations.

Land comparison method

The asset valuation will have been undertaken by reference to market comparables for the asset as a whole. But the big question for the valuer is how much of this value to allocate to which element - land or buildings. One

fairly safe route is through the use of the comparison method using market transactions for land sales, if there are any available. This is a simple task of calculating the land value from the available comparables, and deducting this from the overall asset valuation to provide the proportion appropriate to the buildings element.

Residual valuation

However, where there is a shortage of land comparables that can be relied upon, it is possible to estimate land value on a residual basis, using the cost of construction as a means of arriving at land value. By estimating the construction cost of the buildings and other improvements to the land, and allowing for obsolescence factors, as in the case of a DRC valuation, it is thereby possible to estimate the land value. This is a basic valuation technique and should be well within the skillset of a competent local authority valuer.

% split

An approach that we find in common use is the % split approach. This approach has serious weaknesses and raises some significant concerns about accounting and valuation standards.

In discussions we have had with local authority valuers that have adopted this method it is quite often difficult to ascertain how any percentage split was actually arrived at, who arrived at it and what it is based upon. The method is predicated on the assumption that the relationship between the value of land and the value of improvements to the land will always follow the same approximate percentage split. In some authorities the adopted percentage split is the same for all asset valuations. In other authorities, the adopted percentage varies depending upon the asset type.

This approach is difficult to defend adequately in our view. The only possible defence is that the percentages that have been adopted are the result of a detailed examination of relative land values and build costs, and are reviewed as necessary to keep up-to-date with movement in land values and construction inflation.

We would suggest that if such detailed work is being undertaken, to the degree necessary to maintain robustness of the valuations, that there is no need to 'assume' a percentage split as the data needed to perform a 'proper' valuation in each case is available to the valuer. Nevertheless, this percentage approach we suspect, is the approach that the majority of local authority valuers adopt. **We would caution against its use, and would advocate one of the 'proper' valuation methods described further in this article.**

Let us examine one of the problems with this approach. If one considers an asset that has an asset value of, say £2m the % split adopted could make a significant difference to the depreciable amount that the accountants need. At 75% this would be £1.5m whilst at 60% it would only be £1.2m. This difference of £300,000 is equivalent to 20% of the 75% depreciable figure and 25% of the 65% depreciable figure. This means that adopting a fixed percentage that is incorrect can make a proportionately significant difference to the deprecation in the financial statements.

Finally we turn to probably the least acceptable approach of all - the £1 approach.

The £1 approach

It may come as a surprise to many, but we still do encounter local authorities that are effectively not undertaking a land and buildings split at all, as they are simply splitting the asset value by allocating £1 to the land and the remainder to the 'building'.

It is very difficult indeed to image many circumstances when such an approach will be justified, and where this approach is taken it presumably is adopted due to one of the following:

- Inability to understand the requirement and how to apply valuation expertise to the situation
- A sacrifice to speed of completing the annual valuation programme, or
- Pure laziness

Whichever is the case, this approach does not comply with the CIPFA Code nor the RICS professional standards. It understates the value of the land, overstates the value of the 'building' element, results in higher depreciation than should be applied and could result in material misstatement of the accounts.

In valuation terms in our opinion it is not possible to justify.

In conclusion

When undertaking the land and building splits on your asset valuations, consider very carefully the approach you are intending to take. It should go without saying, but as with all valuations, it is dangerous indeed to simply adopt an approach because that was the approach adopted by the person who last valued the asset. It must always be remembered that this is your valuation and you are accountable both to your client and to the RICS to ensure that each valuation meets professional standards and complies with the relevant accounting code.

Our advice would be as follows:

- Look to move towards an appropriate balance of comparable and residual valuation approaches
- If you are still using the £1 approach then find a way to ditch this as soon as possible
- If you are using a fixed % split which is the same for all asset valuations, then you should again look to find a better method
- If you are using a fixed percentage split by asset type, again this would be something we recommend you move away from. If you still believe in your approach we would recommend you at the very least undertake some pilot valuations across a number of assets in the asset type to validate your arrangements as a defence through the audit or RICS Regulation inspections.