# RICS Valuation – Professional Standards

Incorporating the International Valuation Standards

March 2012

RICS

the mark of property professionalism worldwide

**Global edition**

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## Global edition

March 2012

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property
professionalism
worldwide

Please note: references to the masculine include, where appropriate, the feminine.

Published by the Royal Institution of Chartered Surveyors (RICS)

Surveyor Court

Westwood Business Park

Coventry CV4 8JE

UK

www.ricsbooks.com

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Produced by the Valuation Professional Group of the Royal Institution of Chartered Surveyors.

ISBN 978 1842 19 781 3

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# Preface

## March 2012

This edition of the Red Book incorporates a number of changes to the existing standards to make them fully compliant with the new International Valuation Standards (IVS). Published in July 2011 and taking effect from 1 January 2012, the IVS is adopted and, in some instances, supplemented by the RICS standards.

To assist users, the whole of the IVS 2011 is reproduced in its entirety as an annex in both hard copy and digital versions.

A material change in the IVS is the extension of its application beyond property to all types of asset, with the word 'asset' also being deemed to include 'liability' where appropriate. Consequently, some references have been changed in this edition to accord with the IVS usage. However, the RICS standards continue to cover in considerable detail the valuation of assets in the form of *real estate* (land, buildings and interests therein), and so the word 'property' has been retained where it is necessary for clarity.

Readers should be aware that this edition has been issued as an interim measure to ensure that the existing material complies with the new IVS. A comprehensive review of the Red Book is currently being undertaken and will include, among other developments, new material relating to business valuation and intangibles. Publication following the review is planned for 2013.

The full details of the changes made to the standards, together with explanations, are set out in the following table.

| Reference | Changes made |
|---|---|
| **Introduction** | Paragraph 1 has been reordered.<br><br>New text has been added to paragraph 2 to align the RICS standards with the IVS and to explain the effect of the change from 'property' to 'assets' in parts of these standards. In addition, the paragraph has been revised to reinforce the principle that compliance with these standards will ensure compliance with the IVS.<br><br>Paragraph 5.2 has the addition of the web address of the Red Book section, where the exposure draft is posted along with other Red Book related material.<br><br>Paragraph 6.1 has been revised to confirm that this edition of the Red Book applies to valuations where the valuation date is on or after the effective date of this edition. This text change had already been implemented on the web-based standards. |

| Reference | Changes made *(continued)* |
|---|---|
| **Glossary** | A number of revisions have been made to adopt the IVS 2011 definitions:<br>• 'basis of value' now refers to 'assumptions', not 'principles';<br>• 'cost approach' is a new definition;<br>• the definition of 'fair value' has been revised;<br>• 'income approach' is a new definition;<br>• 'goodwill' is a new definition;<br>• 'investment property' is a new definition;<br>• the definition of 'investment value' has been extended;<br>• 'market approach' is a new definition;<br>• the definition of 'market rent' has been revised;<br>• the definition of 'market value' has been revised;<br>• 'real estate' and 'real property' are two new definitions;<br>• the definition of 'special assumption' has been revised;<br>• 'special purchaser' has been revised to refer to 'a particular buyer';<br>• the definition of 'synergistic value' has been revised; and<br>• 'valuation date' has been included as the preferred reference, while 'date of valuation' is now only cross referenced to this definition. |
| **VS 1.1** | For greater clarity, the exceptions have been numbered. New text has been added to paragraph 5 that draws attention to the need to consider IVS application even if the purpose falls within the exceptions.<br><br>The extract from the IRRV Code of Conduct has been extended to include the reference to the RICS code of practice, *Rating consultancy*, 3rd edition (2010). |
| **VS 1.2** | A new paragraph has been inserted to explain how these standards comply with the IVS. |
| **VS 1.7** | A new paragraph has been added requiring that notes on resolutions of conflicts of interest must be retained in the working papers. |
| **VS 2.1** | The standard has been extended to confirm that it incorporates all the requirements of IVS 101 Scope of Work. The list has been revised to incorporate specific phrases within the IVS, which are:<br>• (a) a reference to 'other intended users';<br>• (e) a replacement of the word 'property' by 'assets or liabilities';<br>• (i) wording that requires the responsible valuer to be named;<br>• (p) a requirement to confirm compliance with IVS where appropriate.<br><br>A statement has been added that the list of minimum terms includes all the similar terms in IVS 101. |

| Reference | Changes made *(continued)* |
|---|---|
| **VS 2.3** | In paragraph 4 the reference to 'forced sale' has been revised to be the same as in IVS Framework. |
| **VS 3.1** | Paragraph 2 refers to the commentary on basis of value in the IVS Framework. |
| **VS 3.2** | This standard now links directly to the IVS Framework. |
| **VS 3.3** | The explanation of market rent has been revised and is quoted in full. |
| **VS 3.4** | This standard now links directly to the IVS Framework. |
| **VS 3.5** | This standard has been completely rewritten to highlight the different definitions of 'fair value': that adopted by the IVS; and that adopted by the International Accounting Standards Board (IASB). The standard also now links directly to the IVS Framework. |
| **VS 4** | This section has been completely rewritten to incorporate references to two IVS applications (financial statements and secured lending). The IVS material has not been reproduced, but the standard indicates its content. |
| **VS 5.1** | This standard has been extended to strengthen the requirement for the valuer to retain adequate notes relating to the valuation. |
| **VS 6.1** | The standard has been extended to confirm that it incorporates all the requirements of IVS 103 Reporting. The list has been revised to incorporate specific requirements of the IVS, which are:<br>• (a) a reference to 'other intended users';<br>• (e) a replacement of the word 'property' by 'assets or liabilities';<br>• (i) wording that requires the responsible valuer to be named;<br>• (p) a requirement to confirm compliance with the IVS where appropriate.<br>A statement has been added that the list of minimum terms includes all the similar terms in IVS 103. |
| **VS 6.9** | The reference to 'state' has been revised to 'country'. |
| **Appendix 2** | This appendix has been revised to incorporate additional material and rephrasing in IVS 101 as follows:<br>• (a) This item has been extended to refer to 'other intended users'.<br>• (c) A reference to assets held as a group or portfolio is now included.<br>• (f) The revision reinforces the need to identify the correct basis of value when adopting fair value. |

| Reference | Changes made *(continued)* |
|---|---|
| **Appendix 2 *(continued)*** | • (h) A reference to VS 1.7.4 has been added.<br>• (i) An important note here confirms that, unlike the IVS, the Red Book does not allow a valuation to be prepared by a *firm*. The valuer responsible must always be identified.<br>• (m) The words 'without further verification' have been added.<br>• (p) This item has been extended to require a comment, as appropriate, that the valuation complies with the IVS. |
| **Appendix 6** | The introduction has been revised to explain the relationship of this appendix to IVS 103. This appendix now incorporates additional material and rephrasing contained in IVS 103 and in IVS 101. The latter is reflected as follows:<br>• (a) This item has been extended to refer to 'other intended users'.<br>• (c) A reference to assets held as a group or portfolio is included.<br>• (f) The revision reinforces the need to identify the correct basis of value when adopting fair value.<br>• (h) A reference to VS 1.7.4 has been added.<br>• (i) An important note here confirms that, unlike the IVS, the Red Book does not allow a valuation to be prepared by a *firm*. The valuer responsible must always be identified.<br>• (p) This item has been extended to require a comment, as appropriate, that the valuation complies with the IVS.<br>• (q) The requirements to note the valuation reasoning are revised to be similar to those in the IVS.<br>• (s) Comment on material changes after the valuation date has been added, together with a reference to the RICS user guide, *Reflecting uncertainty in valuations for investment purposes* (2011).<br>• (t) The commentary confirms that reports may not be signed 'by the firm'. |
| **Appendix 7** | A new paragraph (2.4) draws attention to the disclosure requirements of VS 1.9. |
| **Appendix 9** | A new appendix has been added that provides a detailed comparison between the IVS 2011 and this edition. |
| **GN 4** | The list of terms has been revised to be the same as that in VS 2.1. |
| **GN 7** | This guidance note has been withdrawn and will be published separately as a standalone publication. |
| **International Valuation Standards** | The full IVS issued on 1 January 2012 is reproduced in both printed and electronic copies of the Red Book. |

# Acknowledgments

The *RICS appraisal and valuation manual* was originally published as two separate titles:

- *Guidance notes on the valuation of assets*, 1st (1976), 2nd (1981) and 3rd (1990) editions, published under the title, *Statement of asset valuation practice and guidance notes*; and
- *Manual of valuation guidance notes*, 1st (1980), 2nd (March 1981) and 3rd (April 1992) editions.

The *RICS appraisal and valuation manual* was reprinted in 1993, 1996 (twice), 1998, 2000 and 2002.

The *RICS Appraisal and Valuation Standards* were first published in 2003. Nine amendments were published between March 2003 and April 2007.

The *RICS Valuation Standards*, 6th edition, was first published in 2008, amended in September 2008, reprinted in March 2009, amended in July 2009 and reprinted in April 2010. The 7th edition of the *RICS Valuation Standards – Global and UK* was published in April 2011.

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Published in association with:

The Professional Body for Local Taxation, Benefits and Valuation
Northumberland House, 5th Floor, 303-306 High Holborn, London WC1V 7JZ, UK
Tel: 020 7691 8988
Fax: 020 7831 2048
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The Institute of Revenues Rating and Valuation is the largest UK professional body operating in the field of revenues, benefits and valuation. IRRV valuer members usually have dual membership of RICS and IRRV.

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# Introduction

## 1 Purpose of these standards

**1.1** The purpose of the RICS standards is to provide users of valuation services with confidence that a valuation provided by an RICS qualified valuer has been undertaken in compliance with the highest professional standards. It also assures users that the valuation is independent, objective and consistent with internationally recognised standards set by the International Valuation Standards Council (IVSC, see paragraph 2).

**1.2** These standards set out procedural rules and guidance for valuers within the RICS Rules of Conduct. They also set a framework for best practice in the execution and delivery of valuations for different purposes but do not instruct valuers on how to value in individual cases. There is a mandatory obligation placed on the individual valuer or firm registered for regulation by RICS to follow these standards and an effective sanction if there is a material breach.

**1.3** These standards require and define:

- appropriate qualification of the valuer for the task, judged against clear criteria;
- independence and objectivity in the valuer's approach;
- clarity regarding conditions of engagement, including matters to be addressed and disclosures to be made;
- clarity regarding basis of value, including any assumptions or material considerations to be taken into account;
- minimum standards regarding content of valuation reports; and
- proper and adequate disclosure of relevant matters where valuations may be relied on by a third party.

**1.4** This is the 2012 edition of the *RICS Valuation – Professional Standards (incorporating the International Valuation Standards)*. The original standards were published in 1976 and have become generally known as the 'Red Book'.

## 2 The International Valuation Standards (IVS)

**2.1** The IVSC – of which the RICS is a sponsor – publishes and periodically reviews the *International Valuation Standards* (IVS) that set out internationally accepted, high-level valuation principles and definitions. These have been adopted, supplemented (where appropriate) by RICS and reflected in successive Red Book editions as part of RICS' overall framework of standards, which is backed by a comprehensive scheme of regulation to ensure effective implementation and delivery.

**2.2** For the first time, the full IVS is published together with the Red Book. While some RICS standards are occasionally presented in a different way than the IVS, the

principles, objectives and defined terms are the same. Thus RICS considers that a valuation that is undertaken in accordance with the Red Book is also compliant with the IVS.

**2.3** An important change in the IVS 2011 is the extension of its application to all types of asset, with the word 'asset' also being deemed to include 'liability' where appropriate (see IVS 2011, Introduction, for further details). The RICS standards are primarily directed at the valuation of *real estate* (land, buildings and interests therein), personal property, and plant and equipment. Therefore, the word 'property' has been retained where it is necessary for clarity.

**2.4** Members undertaking business valuations or valuations of intangible assets are reminded that they should follow IVS 200 or 210, as well as comply with other general requirements of the RICS standards. RICS expects to issue further guidance in relation to these specific classes of asset over time.

**2.5** The RICS standards incorporate the full publication of IVS 2011 that became effective from 1 January 2012. Any amended or new standards that become effective after January 2012 will be available on the IVSC website (www.ivsc.org).

## 3 Publication

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

**3.2** All versions of these standards are available directly from RICS. They are published in separate volumes as:

- *RICS Valuation – Professional Standards, incorporating the International Valuation Standards*, Global edition (March 2012);
- *RICS Valuation – Professional Standards, incorporating the International Valuation Standards*, Global and UK edition (March 2012 – this publication includes UK valuation standards and UK guidance notes); and
- *RICS Valuation – Professional Standards, incorporating the International Valuation Standards*, Global and India edition (April 2012 – this publication includes India specific guidance notes).

**3.3** Translations of the RICS standards in Chinese, Dutch, French, German, Italian, Russian, Spanish, Brazilian Portuguese, European Portuguese, Polish, Hungarian and Greek are available online only.

**3.4** National association valuation standards are available for Hong Kong, Ireland, the Netherlands and France, as well as for the UK.

## 4 Arrangement of these standards

**4.1** The arrangement of these standards is:

**Introduction**

**Glossary**

**Valuation standards**

VS 1 Compliance and ethical requirements

VS 2 Agreement of terms of engagement

VS 3 Basis of value

VS 4 Applications

VS 5 Investigations

VS 6 Valuation reports

**Appendices**

**Guidance notes**

**The International Valuation Standards 2011.**

**4.2** Valuation standards are denoted by the use of a VS reference number (e.g. VS 1.1). Each valuation standard comprises a short statement or 'rule' followed, as appropriate, by a commentary giving additional information to assist in its interpretation and application.

**4.3** Each appendix contains supporting information for the commentaries to the valuation standards and will help towards understanding the context of the specific standard to which it relates.

**4.4** The guidance notes provide advice in the specified instances and embody 'best practice' – that is, procedures that in the opinion of the RICS meet a high standard of professional competence.

**4.5** Where a standard uses a term defined in the Glossary it will be shown in *italic* font. Where quotes from other publications are included they will appear as follows:

> 4. Members shall carry out their professional work with due skill, care and diligence and with proper regard for the technical standards expected of them.
>
> © RICS Rules of Conduct for Members 2010, paragraph 4

## 5 Amendments and exposure drafts

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

**5.2** Where amendments may have a substantial effect, for instance the rewriting of an appendix or a guidance note, they may be published as an exposure draft. An exposure draft will contain the text authorised for public comment by the RICS Valuation Standards Board (see www.rics.org/redbook).

**5.3** The purpose of an exposure draft is to enable members to comment on the

approved text, and possibly identify flaws, before incorporation into the Red Book. The text of an exposure draft will, after consideration of any comments made and final approval of the RICS Valuation Standards Board, become mandatory on the effective date of the next Red Book update following its publication.

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

## 6 Effective date

**6.1** The RICS standards in this edition come into effect on 30 March 2012 and apply where the valuation date is on or after that day. Where amendments subsequent to 30 March 2012 have been made, the relevant effective date will be shown immediately following each valuation standard, appendix or guidance note.

**6.2** Copies of the text extant at any specific date may be obtained from the RICS Library.

# Glossary

This glossary defines various terms used in the RICS standards that have a special or restricted meaning. Terms not appearing in the glossary follow their common dictionary meanings. Where a term is used as defined, it will be identified in the text with *italic* font. Where this glossary includes terms that are defined in the IVS, the IVS wording has been adopted.

National association *valuation standards* may have additional terms, and these will be defined in the context of the specific national association *valuation standard*.

| | |
|---|---|
| **assumption** | A supposition taken to be true. It involves facts, conditions or situations affecting the subject of, or approach to, a valuation that by agreement does not need to be verified by the valuer as part of the valuation process. Typically, an *assumption* is made where specific investigation by the valuer is not required in order to prove that something is true. |
| **basis of value** | A statement of the fundamental measurement *assumptions* of a valuation. |
| **cost approach** | An approach that provides an indication of value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or construction. |
| **date of the report** | The date on which the valuer signs the report. |
| **date of valuation** | See *valuation date.* |
| **departure** | Special circumstances where the mandatory application of the *valuation standards* may be inappropriate or impractical, or where the valuer may be required to comply with standards outside the Red Book. |
| **depreciated replacement cost (DRC)** | The current cost of replacing an asset with its modern equivalent asset, less deductions for physical deterioration and all relevant forms of obsolescence and optimisation. |
| **external valuer** | A valuer who, together with any associates, has no material links with the client, an agent acting on behalf of the client or the subject of the assignment. |

**fair value**

1. The estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties (IVS 2011).
2. The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date (IFRS 13).

(For more detailed explanation of these definitions see VS 3.5 and VS 4.1.)

**financial statements**

Written statements of the financial position of a person or a corporate entity, and formal financial records of prescribed content and form. These are published to provide information to a wide variety of unspecified *third-party* users. *Financial statements* carry a measure of public accountability that is developed within a regulatory framework of accounting standards and the law.

**firm**

The organisation for which the valuer works, or through which the *member* trades.

**goodwill**

Any future economic benefit that arises from a business, from an interest in a business or from the use of a group of assets that is not separable.

**guidance notes**

Further material and information on good practice that are appropriate for particular types of circumstances. Where procedures are recommended for specific professional tasks, they are intended to embody ‘best practice’ and, in the opinion of RICS and IRRV, *members* should normally adopt them in order to demonstrate the required level of professional competence.

**income approach**

An approach that provides an indication of value by converting future cash flows to a single current capital value.

**inspection**

A visit to a property to examine it and obtain relevant information, in order to express a professional opinion of its value.

**intangible asset**

A non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and economic benefits to its owner.

**internal valuer** A valuer who is in the employ of either the enterprise that owns the assets, or the accounting *firm* responsible for preparing the enterprise's financial records and/or reports. An *internal valuer* is generally capable of meeting all the requirements of independence and professional objectivity required under VS 1.5 to VS 1.8 but, for reasons of public presentation and regulation, may not always be able to satisfy any additional criteria for independence under VS 1.9 in certain types of assignment.

**International Financial Reporting Standards (IFRS)** Standards set by the International Accounting Standards Board (IASB) with the objective of achieving uniformity in accounting principles. The standards are developed within a conceptual framework so that elements of *financial statements* are identified and treated in a manner that is universally applicable. These standards were previously known as International Accounting Standards (IAS).

**investment property** Property that is land or a building (or part of a building) or both, held by the owner to earn rentals or for capital appreciation or both, rather than:

- for use in the production or supply of goods or services, or for administrative purpose; or
- for sale in the ordinary course of business.

**investment value, or worth** The value of an asset to the owner or a prospective owner for individual investment or operational objectives. (May also be known as *worth*.)

**market approach** An approach that provides an indication of value by comparing the subject asset with identical or similar assets for which price information is available.

**market rent (MR)** The estimated amount for which a property would be leased on the *valuation date* between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

**market value (MV)** The estimated amount for which an asset or liability should exchange on the *valuation date* between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

**marriage value** See *synergistic value*.

| | |
|---|---|
| **member** | A Fellow, professional *member*, associate *member* or honorary *member* of the Royal Institution of Chartered Surveyors (RICS), or a Fellow, *member* (diploma holder) or *member* (honours) of the Institute of Revenues Rating and Valuation (IRRV). |
| **open market value (OMV)** | A *basis of value* supported by the first four editions of the Red Book, but no longer used as a defined term. Its application provides the same result as *market value*. |
| **real estate** | Land and all items that are a natural part of the land (e.g. trees, minerals) and that have been attached to the land – such as buildings, site improvements and all permanent building attachments (e.g. mechanical and electrical plant providing services to a building) that are both below and above the ground. |
| **real property** | All rights, interests and benefits related to the ownership of *real estate*, including any negative rights, interests or benefits (i.e. obligations, encumbrances or liabilities) relating to the interest being valued. |
| **registered for regulation/ registered by RICS** | (a) A *firm* that is *registered for regulation by RICS* under the RICS bye-laws.<br>(b) A *member* who is registered as a valuer under the Valuer Registration Scheme (VRS). |
| **special assumption** | An *assumption* that either assumes facts that differ from the actual facts existing at the *valuation date*, or that would not be made by a typical market participant in a transaction on the *valuation date*. |
| **special purchaser** | A particular buyer for whom a certain asset has *special value* because of advantages arising from its ownership that would not be available to general buyers in the market. |
| **special value** | An amount that reflects particular attributes of an asset that are only of value to a *special purchaser*. |
| **specialised property** | A property that is rarely, if ever, sold in the market, except through 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. |
| **synergistic value, or marriage value** | An additional element of value created by the combination of two or more interests where the combined value is more than the sum of the separate values. (May also be known as *marriage value*.) |

| | |
|---|---|
| **terms of engagement** | Written confirmation of the conditions that either the *member* proposes, or that the *member* and client have agreed shall apply to the undertaking and reporting of the valuation. |
| **third party** | Any party, other than the client, that may have an interest in the valuation or its outcome. |
| **trade related property** | Any type of *real property* designed for a specific type of business where the property value reflects the trading potential of that business. |
| **trading stock** | Stock held for sale in the ordinary course of business, e.g. in relation to property, land and buildings held for sale by builders and development companies. |
| **valuation date** | The date on which the opinion of value applies. |
| **valuation standard** | A statement of the highest professional standards that are of mandatory application to *members* when providing written valuations. |
| **worth** | See *investment value*. |

# Valuation standards

# VS 1 Compliance and ethical requirements

## VS 1.1 Application of these standards: extent and exceptions

**All *members* of RICS and IRRV, and *firms regulated by RICS*, must comply with VS 1 when undertaking any instruction that requires a written valuation.**

**The circumstances where VS 2 to VS 6 are not of mandatory application (although the principles of these *valuation standards* should still be followed wherever practicable) are set out below:**

- **(a) the advice is expressly in preparation for, or during the course of, negotiations or possible litigation;**
- **(b) the valuer is performing a statutory function or has to comply with prescribed statutory or legal procedures;**
- **(c) the valuation is provided solely for internal purposes;**
- **(d) the valuation is provided in connection with certain agency or brokerage work; and**
- **(e) a replacement cost figure is provided for insurance purposes, whether separately or within a valuation report.**

**The commentary to each *valuation standard* should be considered to have mandatory status when it requires the valuer to take a specific action. The material in the appendices is mandatory where this is indicated in the *valuation standard* to which it relates, but otherwise it is advisory.**

### Commentary

**1.** These standards, which incorporate IVS, have been approved by both the RICS Knowledge Board and IRRV as a comprehensive set of technical standards for the practice and delivery of valuation work by their *members*.

**2.** They set out mandatory requirements and guidance on the application of the RICS Rules of Conduct and the IRRV Code of Conduct to the provision of valuations that ensure valuers achieve and maintain defined levels of qualification, knowledge,

skill and experience. Therefore they provide assurance to those requesting or relying on valuations that they have been undertaken to high standards of competence and integrity, and are fully in accord with recognised and relevant national association and international *valuation standards*.

**3.** These standards are of mandatory application to any *member* of RICS or IRRV involved in undertaking valuation services, unless specifically set out as an exception in paragraph 5. The phrase 'undertaking valuation services' includes any person who is responsible, or accepts responsibility, for calculating and ascribing a written opinion of value. This may include individuals who produce but do not sign valuation reports within their organisation, and conversely individuals who sign but do not produce valuation reports within their organisation.

**4.** These standards have been written as they apply to the valuer. Where it is necessary to consider the application of a standard to a *firm registered for regulation by RICS*, it is to be interpreted accordingly.

## *Exceptions*

**5.** The circumstances where VS 2 to VS 6 are not of mandatory application are:

*(a) The advice is expressly in preparation for, or during the course of, negotiations or possible litigation.*

This exception relates to valuation advice that is provided on the probable outcome of current or impending negotiations, or to requests for figures to be quoted in connection with such negotiations. If the negotiations relate to a matter that may eventually be subject to determination by a tribunal or court, valuers are alerted to the comments in paragraph (b).

It also includes giving advice where the client is considering the action to be taken for a statutory or legal procedure – for instance, a rent review, a proposed challenge to a local property tax value or the initiation of rights of acquisition. This exception does not apply where the valuation is provided for inclusion in a statutory return – for example, self assessment of a tax liability.

*(b) The valuer is performing a statutory function or has to comply with prescribed statutory or legal procedures.*

The exceptions under this heading include:

- the preparation of lists of values that provide a basis for local or national taxation (e.g. a property tax);
- a valuation prepared in anticipation of giving evidence as an expert witness before a court, tribunal or committee. Such valuations may have to comply with statutory requirements or *assumptions* and may also be governed by prescribed procedures. Subject to those overriding requirements, the adoption of the principles and definitions in these standards that are relevant should give the evidence credibility and help the valuer to withstand cross-examination; and
- the decisions and reports of arbitrators, independent experts and mediators appointed with a view to the settlement of disputes.

This exception does not apply where the purpose falls within VS 4, Applications, or VS 1.3, RICS national association valuation standards.

*(c) The valuation is provided solely for internal purposes.*

This exception applies to the provision of an opinion of value that is restricted to the internal use of the recipient's organisation and where no part of the report, including the valuation figure, is to be seen by or communicated to any *third party*.

When adopting this exception the valuer should take care to ensure that the advice given is suitably qualified and that its limited scope and use, as well as the fact that it is without liability, are expressly recognised and agreed as part of the terms of its provision.

*(d) The valuation is provided in connection with certain agency or brokerage work.*

This exception applies to valuations provided in the expectation or course of an agency instruction to dispose of, or acquire, an interest in property, including advice on whether a particular offer should be accepted or made. This exception includes work that falls within the RICS *guidance note*, *Real estate agency and brokerage standards*, effective from July 2011. This exception does not apply if the client requires a purchase report that includes a valuation.

*(e) A replacement cost figure is provided for insurance purposes, whether separately or within a valuation report.*

This exception applies where the provision of a replacement cost for insurance purposes is provided either within, or independent of, a valuation report. Where such a figure is provided within a valuation report, most commonly in valuations for residential mortgage purposes, the *terms of engagement* should include an explanation of the basis on which the figure is calculated. This exception does not apply to the provision of a valuation of personal property for insurance purposes (see GN 4).

In some circumstances there may be a requirement to comply with the IVS even though the purpose of the valuation falls under one of the aforementioned exceptions. In such cases it should be confirmed that the advice complies with the IVS although the application of VS 2 to VS 6 may not be mandatory.

**6.** Whether or not VS 2 to VS 6 apply in a particular case, *members* and *firms registered for regulation by RICS* remain bound by the RICS Rules of Conduct (revised 2011) and the IRRV Code of Conduct, from which the following key requirements are extracted:

**Extract from the RICS Rules of Conduct**

**Application to *members*:**

**Ethical behaviour**

3. Members shall at all times act with integrity and avoid conflicts of interest and avoid any actions or situations that are inconsistent with their professional obligations.

**Competence**

4. Members shall carry out their professional work with due skill, care and diligence and with proper regard for the technical standards expected of them.

**Service**

5. Members shall carry out their professional work in a timely manner and with proper regard for standards of service and customer care expected of them.

**Application to *firms*:**

**Professional behaviour**

3. A Firm shall at all times act with integrity and avoid conflicts of interest and avoid any actions or situations that are inconsistent with its professional obligations.

**Competence**

4. A Firm shall carry out its professional work with due skill, care and diligence and with proper regard for the technical standards expected of it.

**Service**

5. A Firm shall carry out its professional work with expedition and with proper regard for standards of service and customer care expected of it.

**Extract from IRRV Code of Conduct:**

2. Members shall conduct themselves with diligence, integrity and honesty and in such a manner as to promote the good professional standing of the Institute and its members.

7. Members shall ensure that they keep fully up-to-date with the knowledge, skills and competences required to carry out their professional work to the highest standards, and shall comply with any continuing professional development requirements that are imposed upon them, as appropriate, by the Institute.

8. Members shall comply with the professional conduct rules of any other professional bodies to which they belong, and the Institute may take action itself in respect of any conduct which is both a breach of this Code as well as a breach of the rules of another body to which the member belongs.

10. Members shall comply with technical guidance and practice statements laid down from time to time, where these have been issued or endorsed by the Institute or any of its faculties, including (without limitation) those listed in the Annex.

**Annex: Technical guidance and practice statements members are required to comply with (see clause 10 of the Code)**

1.The Rating Consultancy Code of Practice issued jointly by the Institute, the Royal Institution of Chartered Surveyors and the Rating Surveyors' Association, which came into effect on 1 April 2004, and any successor to that Code of Practice.

2. 'Valuation Standards – the Red Book', issued jointly by the Institute and the Royal Institution of Chartered Surveyors.

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# VS 1.2 Compliance, regulation and the requirement to disclose departures

**All RICS and IRRV *members* undertaking valuations, whether practising individually or within an RICS regulated or a non-regulated *firm*, are required to comply with these standards.**

**Valuers who are *members* of RICS must also comply with the requirements of the RICS Valuer Registration Scheme (VRS) where VS 2 to VS 6 are of mandatory application.**

## Commentary

### *Compliance within firms*

**1.** There is an individual responsibility on all RICS and IRRV *members* to comply with these standards. How this responsibility is put into practice will depend, to a certain extent, on the *firm* for which the *member* works. The impact on the valuer depends on whether or not the *firm* is *regulated by RICS*:

- **RICS regulated *firm***: The *firm* and all RICS *members* within the *firm* must ensure that all processes and valuations are fully compliant with these standards. This includes valuations that are not the responsibility of an RICS *member*.
- **Non-RICS regulated *firm***: While it is understood that such *firms* may have their own corporate processes over which RICS cannot exert control, individual *members* in these *firms* who are responsible for the valuation are required to comply with these standards.

Where RICS standards are more rigorous than those of the *firm*, they must be complied with; however, there may be circumstances where the *firm's* processes expressly prevent compliance with a particular aspect of a *valuation standard*. In such cases the valuer is entitled to depart from the specific *valuation standard*, but must:

- be satisfied that the non-compliance does not lead to clients being misled or to unethical behaviour;
- identify in the report the specific areas where compliance with any *valuation standards* has been precluded, together with the reason for this non-compliance; and
- make best effort to comply with all the other aspects of these standards.

Where the *member* contributes to a valuation, it is expected that the contribution will comply with these standards as far as possible.

### *Compliance with other valuation standards*

**2.** The valuer may be requested to provide a report that complies with the IVS. These RICS standards are consistent with the principles and definitions of the IVS (as at 1 January 2012). RICS considers that a valuation that complies with these standards will also comply with the IVS, and a statement to that effect may be made in the report (see Appendix 6(p)). The IVS comprises:

- Definitions
- The IVS Framework
- General Standards
- Asset Standards
- Valuation Applications.

The IVS publication effective from January 2012 is included in its entirety within the *RICS Valuation – Professional Standards (incorporating the International Valuation Standards)*. It is presented exactly as it was published on 1 July 2011. Because the RICS standards include additional material, parts are occasionally presented in a different way from the IVS. However, Appendix 9 includes a detailed comparison between both sets of standards that will assist the valuer when responding to questions concerning compliance with a specific IVS.

**3.** RICS recognises that the valuer may be requested to provide a report that complies with standards other than these standards. In all cases the valuer must include a statement that the valuation complies with the Red Book (see VS 2.1(p) and VS 6.1(p)) and it also complies with any specific requirement(s) within any other named standards.

## *Departures*

**4.** Where the valuer has departed from these standards a clear statement to that effect must be included in the *terms of engagement* and the report.

**5.** If there are special circumstances where the application, in whole or in part, of a specific *valuation standard* is considered to be inappropriate, this must be confirmed and agreed with the client as *departures* before reporting.

**6.** A valuer who makes a *departure* may be required to justify the reasons for this to RICS or IRRV. If either body is not satisfied with the reason(s) given and/or the manner in which the *departure* is declared or evidenced, it will be entitled to take disciplinary measures.

**7.** The use of a *basis of value* not recognised in these standards will constitute a *departure* that must be clearly set out in the *terms of engagement* and the report. The report must also include an indication of the difference between the basis used and the nearest equivalent recognised basis.

## *Regulation: monitoring compliance with these valuation standards*

**8.** *Members* undertaking valuations to which VS 2 to VS 6 of these standards apply must join the RICS Valuer Registration Scheme (VRS) in accordance with the timescale and process specified. Full details of the scheme can be found at www.rics.org/vrs.

**9.** As a self-regulatory body, RICS has a responsibility to monitor and seek assurance of compliance by its *members* and regulated *firms* with these standards. It has the right under its bye-laws to seek information from *members* or *firms*. The procedures under which such powers will be exercised in relation to valuations are within the Regulation section of the RICS website (www.rics.org/regulation).

### *Application to members of IRRV*

**10.** IRRV Code of Conduct (www.irrv.net) requires *members* to comply with technical guidance where this has been issued or endorsed by the institute. These standards have been issued jointly by the RICS and IRRV, and are therefore binding on valuers who are *members* of the IRRV. The enforcement of the IRRV Code of Conduct is a matter for its Professional Conduct Committee, which provides guidance on what is expected of *members* and deals with complaints received. Sanctions for proven breaches of the Code include suspension or removal from membership. IRRV and RICS may request each other to deal with alleged breaches of these standards by those who are *members* of both bodies, and may share information with a view to ensure compliance.

## VS 1.3 RICS national association valuation standards

***Valuation standards* published or adopted by an RICS national association have mandatory status in the states to which they apply.**

### Commentary

**1.** RICS national association *valuation standards* are intended to expand or amend the global *valuation standards* to meet local statutory or regulatory requirements. In the event of conflict between these standards, the national association *valuation standards* take precedence and may not be interpreted as imposing a lesser standard than the global standards.

**2.** Where the valuation involves assets in two or more states with different *valuation standards*, the valuer must agree with the client which standards will apply to the instruction.

## VS 1.4 Terms of engagement

**The *member* must always confirm to the client, before any report is issued, the terms on which the valuation will be undertaken.**

### Commentary

**1.** It is fundamental that by the time the valuation is concluded, but prior to the issue of the report, all the matters have been fully brought to the client's attention and appropriately documented. This is to ensure that the report does not contain any revision of the initial *terms of engagement* of which the client is unaware.

**2.** The standards for *terms of engagement* for a purpose not falling within the exceptions in VS 1.1 are set out in VS 2. In particular VS 2.1 sets out the minimum terms that must be included. Where the valuation is for a purpose within the exceptions in VS 1.1, abbreviated *terms of engagement* may be used.

**3.** As disputes may arise many years after the completion of a valuation, it is essential that the agreement of the *terms of engagement* is contained in, or evidenced by, comprehensive documentation.

## VS 1.5 Qualifications of the valuer

**Each valuation to which these standards apply must be prepared by, or under the supervision of, an appropriately qualified valuer who accepts responsibility for it.**

### Commentary

**1.** The test of whether an individual is appropriately qualified to accept responsibility for a valuation combines:

- academic/professional qualifications, demonstrating technical competence;
- membership of a professional body, demonstrating a commitment to ethical standards;
- practical experience as a valuer;
- compliance with any state legal regulations governing the right to practise valuation; and
- where the valuer is a *member* of RICS, registration in accordance with VRS (see VS 1.2).

**2.** *Members* of RICS have to achieve and maintain defined standards of training and competence. However, as *members* are active across a wide range of specialisms and markets, membership of RICS or registration as a valuer does not imply that an individual has the necessary practical experience of valuation in a particular sector or market.

**3.** In some states valuers are required to be certified or licensed to undertake certain valuations, and in such cases VS 1.2.2 will apply. In addition, either the client or RICS national association *valuation standards* may stipulate more stringent requirements.

## VS 1.6 Knowledge and skills

**The valuer must have sufficient current local, national and international (as appropriate) knowledge of the particular market, and the skills and understanding necessary, to undertake the valuation competently.**

### Commentary

**1.** If the valuer does not have the required level of expertise to deal with some aspect of the commission properly then he or she should decide what assistance is needed. The valuer should then assemble and interpret relevant information from other professionals, such as specialist valuers, environmental surveyors, accountants and lawyers.

**2.** The personal knowledge and skill requirements may be met in aggregate by more than one valuer within a *firm*, provided that each meets all the other requirements of this *valuation standard*.

**3.** The client's approval must be obtained if the valuer proposes to employ another *firm* to provide some of the valuations that are the subject of the instruction (see also VS 6.10, Incorporation of other valuations).

**4.** To provide an audit trail for compliance or monitoring purposes, where more than one valuer has undertaken or contributed to the valuation, a list of those valuers must be retained with the working papers, together with a confirmation that each named valuer has complied with the requirements of VS 1.

## VS 1.7 Independence and objectivity

**Valuers undertaking valuations must act with independence, integrity and objectivity.**

### Commentary

**1.** The RICS Rules of Conduct state that *members* shall at all times act with integrity and avoid any actions or situations that are inconsistent with their professional obligation. The IRRV code imposes similar obligations (see VS 1.1.6).

**2.** Valuers are required to exercise independence and objectivity in all instructions, and consider the possible impact of any potential conflicts of interest. Compliance with this *valuation standard*, and VS 1.8 if appropriate, will mean that the valuer will be able to confirm that he or she is acting as an independent valuer.

**3.** Guidance on confidentiality, identifying threats to independence and objectivity, and identifying and managing conflicts of interest specifically related to valuations is in Appendix 1. If a valuation instruction is confirmed after a *member* discloses a potential conflict, the disclosure must be referred to in the *terms of engagement* (see VS 2.1 and VS 6.1).

**4.** In making any disclosures of past or current involvement, valuers must also have regard to the requirement of maintaining client confidentiality. Effective disclosure can usually be made without revealing confidential information, but if this is not possible then the instruction must be declined.

**5.** A valuer may be asked to act for both parties to a proposed transaction. Careful consideration must be given as to whether it is desirable to accept such an instruction, such as weighing the possibility of a conflict of interest arising in the future because of divergence of the clients' respective interests. If the valuer concludes that it is not inappropriate or unwise, the written consent of both parties should be obtained before accepting the commission and reference to that consent must be included in the report.

**6.** To provide an audit trail for compliance or monitoring purposes, a note of all conflict of interest checks and their resolutions must be retained with the working papers.

**7.** A threat to the valuer's objectivity can arise where the outcome of a valuation is discussed before its completion with either the client or another party with an interest in the valuation. While such discussions are not improper, and indeed may be beneficial to both the valuer and the client, the valuer must be alert to the potential

influence that such discussions may have on his or her fundamental duty to provide an objective opinion. Where such conversations take place, the valuer must make a written record of any meetings or discussions, and whenever the valuer decides to alter a provisional valuation as a result, the grounds for doing so must be carefully noted. (See also VS 6.11.)

## VS 1.8 Additional criteria for independence

**Where the valuation is for a purpose that sets specific criteria for independence, valuers must establish the criteria required and confirm that they meet them in the *terms of engagement* and the report.**

### Commentary

**1.** For some purposes, statutes, regulations, rules of regulatory bodies or client's special requirements may set out specific criteria that the valuer must meet in order to achieve a defined state of independence. Frequently such additional criteria provide a definition of the acceptable level of independence and may use terms such as 'independent expert', 'expert valuer', 'independent valuer', 'standing independent valuer' or 'appropriate valuer'. It is important that the valuer confirms compliance with these criteria both when confirming acceptance of the instruction and in the report, so that the client and any *third party* relying on the report can be assured that the additional criteria have been satisfied.

**2.** Although the valuer may meet the stipulated criteria for the particular appointment, the general requirements in VS 1.6 and VS 1.7 still apply. It is therefore necessary for the valuer to identify any threats to his or her independence and objectivity, and take the appropriate action before accepting the instruction.

## VS 1.9 Additional disclosures for valuations in which the public has an interest or upon which third parties may rely

**Where the valuation is provided for inclusion in a published document in which the public has an interest, or upon which *third parties* may rely, the valuer shall make the following disclosures:**

1. **where a valuation is of property that has previously been valued by the valuer, or the valuer's *firm*, for the same purpose:**
   - **in the *terms of engagement*, a statement about the *firm's* policy on the rotation of the valuer responsible for the valuation; and**
   - **in the report, and any published reference to it, a statement of the length of time the valuer has continuously been the signatory to valuations provided to the client for the same purpose as the report and, in addition, the length of time the valuer's *firm* has continuously been carrying out the valuation instruction for the client;**
2. **the extent and duration of the relationship of the valuer's *firm* with the client for any purpose;**

3 **where the report, and any published reference to it, includes one or more properties acquired by the client within the 12 months preceding the *valuation date*, and the valuer, or the valuer's *firm*, has in relation to those properties:**
   - **received an introductory fee; or**
   - **negotiated that purchase on behalf of the client; and**

4 **in the report, and any published reference to it, a statement that the proportion of the total fees payable by the client during the preceding year relative to the total fee income of the valuer's *firm* during the preceding year are minimal, significant or substantial.**

## Commentary

**1.** This *valuation standard* applies to valuations that may be relied upon by parties other than the client that either commissioned the report or to which it is addressed. Examples of this type of valuation would include those for:

(a) a published *financial statement*;
(b) a stock exchange, or similar body;
(c) publication, prospectus or circular;
(d) investment schemes; or
(e) takeovers or mergers.

**2.** Although the wider requirement for the valuer to act with independence, integrity and objectivity in VS 1.7 is clear, it does not require disclosure of the working relationships between the valuer and the client. When making the above additional disclosures, the valuer is not expected to establish and evaluate every possible set of circumstances, but should reflect the principles and their spirit. In cases of doubt it is recommended that a disclosure is made.

**3.** The principles of this *valuation standard* may be extended by requirements that apply to a specific state, and those amendments will be incorporated into the relevant national association *valuation standard* (see VS 1.3).

### *Rotation policy*

**4.** The obligation to disclose the *firm's* rotation policy will arise only where the valuer has provided a series of valuations over a period of time. Where it is a first or one-off instruction, it is clear that it would be inappropriate to comment on a rotation policy.

**5.** Where the valuer responsible for the valuation in accordance with VS 1.5 holds that responsibility for many years the familiarity, with either the client or the property valued, could lead to the perception that the valuer's independence and objectivity has been compromised. This may be minimised by arranging for the rotation of the valuer who accepts responsibility for the valuation.

**6.** The method by which a *firm* arranges for any rotation of those responsible for valuations is for the *firm* to decide, after discussion with the client if appropriate. However, RICS recommends that the individual responsible for signing the report, no matter the standing of that valuer in the *firm*, has that responsibility for a limited

number of years. The exact period will depend on the frequency of valuation; any control and review procedures in place such as 'valuation panels', which assist both the accuracy and objectivity of the valuation process; and good business practice. RICS considers it good practice to rotate the valuer responsible at intervals of not more than seven years.

**7.** If a *firm* is of insufficient size to rotate the signatory, or has in place 'valuation panels' as suggested in paragraph 6, other arrangements could be made to comply with the principles of this standard. For example, where the same valuation instruction is undertaken on a regular basis, an arrangement for the valuation to be periodically review at intervals not greater than seven years by another valuer would assist in demonstrating that the valuer is taking steps to ensure that objectivity is maintained and thus may retain the confidence of those relying upon the valuation.

## *Time as signatory*

**8.** The purpose of this requirement is to provide any *third party* with information on the length of time that a valuer has continuously been the signatory to valuations for the same purpose. It also requires a similar disclosure as to the length of time the valuer's *firm* has been carrying out valuations of that property for the same client, and the extent and duration of their relationship.

**9.** In relation to the valuer, the disclosure should relate to the continuous period of responsibility for the valuation up to the *date of the report*. It is possible that the valuer was the signatory to previous reports for the same purpose, but due to the *firm's* rotation policy (as set out earlier) there was a period of time when the valuer did not have that responsibility. There is no requirement to include that earlier period in the disclosure.

**10.** The valuer is not required to provide a comprehensive account of all work ever undertaken by the valuer's *firm* for the client. A simple, concise statement that discloses the nature of other work done and the duration of the relationship is all that is required. If there is no relationship other than the valuation instruction in question, a statement to that effect should be made.

## *Previous involvement*

**11.** The purpose of this requirement is to expose any potential conflict of interest where the valuer, or the valuer's *firm*, has been involved with the purchase of the same property for the client within the year preceding the *valuation date*.

**12.** National association *valuation standards* or local regulation may extend this requirement by applying additional requirements.

## *Proportion of fees*

**13.** A proportion of fees less than 5% may be considered to be 'minimal'. Between 5 and 25% may be considered to be significant, and above 25% is substantial.

**14.** National association *valuation standards* or local regulation may extend this requirement by applying additional standards.

## *Identity of the client and firm*

**15.** In considering the disclosures required by this *valuation standard* it is necessary to identify the 'client' and '*firm*'.

**16.** There are many different relationships that may be considered to fall within the identification of the client and *firm*. It is considered that to be consistent with the minimum *terms of engagement* (see VS 2.1(a)) and reporting (see VS 6.1(a)), the client is the entity that agrees the *terms of engagement* and to which the report is addressed. The *firm* is the entity that is identified in the confirmation of the *terms of engagement* and the report.

**17.** Closely connected companies within a group should be properly regarded as a single client or *firm*. However, due to the complex nature of modern business it is frequently the case that the other entities have only a remote legal or commercial connection with the client for which the valuer's *firm* also act. There may also be practical difficulties in identifying such relationships, for example, between other states' associates of the valuer's *firm* and the client. Sometimes it is the valuer's commercial relationship with a party other than the client that could create a perceived threat to independence. The valuer is expected to make reasonable enquiries but it is not necessary to establish every potential relationship that there may be, provided the valuer adheres to the principles of this standard.

**18.** The following are examples of where the disclosure requirements will relate to and include parties other than the entity giving the valuation instruction:

- subsidiaries of an instructing holding company;
- where instructions are from a subsidiary company, those other companies connected by the same holding company; or
- a *third party* issuing valuation instructions as agent for different legal entities, for example, the manager of a property fund.

**19.** Similar considerations apply in identifying the extent of the valuer's *firm* for disclosure purposes, where there may be separate legal entities in different locations or undertaking different types of work. It may not be relevant to include all organisations connected with the *firm* undertaking the valuation where the activities are remote or immaterial – for example, they do not involve the provision of property advice. However, if there is a series of closely connected entities trading under a common style, the extent of the client's relationship with all those entities should be disclosed.

# VS 2 Agreement of terms of engagement

## VS 2.1 Confirmation of terms of engagement

**The *terms of engagement* provided in compliance with VS 1.4 must be in writing and, at a minimum, include the following terms:**

**(a) identification of the client and any other intended users;**

**(b) the purpose of the valuation;**

**(c) the subject of the valuation;**

**(d) the interest to be valued;**

**(e) the type of asset or liability and how it is used or classified by the client;**

**(f) the *basis*, or *bases*, *of value*;**

**(g) the *valuation date*;**

**(h) disclosure of any material involvement, or a statement that there has not been any previous material involvement;**

**(i) the identity of the valuer responsible for the valuation and, if required, a statement of the status of the valuer;**

**(j) where appropriate, the currency to be adopted;**

**(k) any *assumptions*, *special assumptions*, reservations, special instructions or *departures*;**

**(l) the extent of the valuer's investigations;**

**(m) the nature and source of the information to be relied on by the valuer;**

**(n) any consent to, or restrictions on, publication;**

**(o) any limits or exclusion of liability to parties other than the client;**

**(p) confirmation that the valuation will be undertaken in accordance with these standards and that it also complies with the IVS, where appropriate;**

**(q) confirmation that the valuer has the knowledge, skills and understanding to undertake the valuation competently;**

**(r) the basis on which the fee will be calculated;**

**(s) where the *firm* is *registered for regulation by RICS*, reference to the *firm's* complaints handling procedure, with a copy available on request; and**

**(t) a statement that compliance with these standards may be subject to monitoring under the institution's conduct and disciplinary regulations.**

**Items (a) to (q) in this list of minimum terms and VS 2.2 to VS 2.6 contain all the requirements of IVS 101, Scope of Work. For a detailed comparison between the two lists, see Appendix 9. Items (r) to (t) are additional requirements that apply specifically to RICS *members*.**

## Commentary

**1.** Further guidance on the list of minimum terms is provided in Appendix 2.

**2.** Normally the *terms of engagement* will be settled between the client and the valuer when instructions are first received and accepted (the initial confirmation of instructions). However, it is recognised that a valuation commission may range from a single property to a substantial portfolio, thus the extent to which all the minimum *terms of engagement* can be settled in the initial confirmation may also vary.

**3.** It is fundamental that by the time the valuation is concluded and prior to the issue of the report, all the matters have been fully brought to the client's attention and appropriately documented. This is to ensure that the report does not contain any revision of the initial *terms of engagement* of which the client is unaware.

**4.** *Firms* may have a standard form of *terms of engagement*, or standing *terms of engagement*, in place which may include several of the minimum terms required by this standard. The valuer may need to amend this form to refer to any matters that will be clarified at a later date.

**5.** The valuer will need to discuss and agree with the client the extent of the investigations and *assumptions* or *special assumptions* that are appropriate for the circumstances and purpose of the valuation and record them in the *terms of engagement*. Any matter that has been identified after the settlement of the original *terms of engagement* and that will be included in the report must be agreed with the client before the report is issued and recorded in the revised *terms of engagement*.

**6.** As disputes may arise many years after the completion of a valuation it is important to ensure that the agreement between the parties is contained in, or evidenced by, comprehensive documentation.

**7.** Guidance on the *assumptions* that are applicable to most valuations is contained in Appendix 3.

# VS 2.2 Special assumptions

**Where *special assumptions* are necessary in order to adequately provide the client with the valuation required, these must be agreed and confirmed in writing to the client before the report is issued. *Special assumptions* may only be made if they can reasonably be regarded as realistic, relevant and valid for the particular circumstances of the valuation.**

## Commentary

**1.** To make certain that the valuer and the client both understand the exact nature of an agreed *special assumption*, the valuer must ensure that it is confirmed in writing to the client before the report is issued.

**2.** The valuer may include in the report some comment or assessment of the likelihood of the *special assumption* being fulfilled. For example, a *special assumption*

that permission had been granted to develop land may have to reflect the impact on value of any conditions that might be imposed.

**3.** If a client requests a valuation on the basis of a *special assumption* that the valuer considers unrealistic, the instruction should be declined.

**4.** Guidance on the use of *special assumptions* can be found in Appendix 4.

## VS 2.3 Marketing constraints and forced sales

**Wherever the valuer or the client identifies that a valuation may need to reflect an actual or anticipated marketing constraint, details of that constraint must be agreed and set out in the *terms of engagement*. The term 'forced sale value' must not be used.**

### Commentary

**1.** If a property cannot be freely or adequately presented to the market, the price is likely to be adversely affected. Before accepting instructions to advise on the likely effect of a constraint, the valuer should ascertain whether this arises from an inherent feature of the property or interest being valued, or from the particular circumstances of the client.

**2.** If an inherent constraint exists at the *valuation date*, it is normally possible to assess its impact on value. The constraint should be identified in the *terms of engagement*, and it should be made clear that the valuation will be provided on this basis. It may also be appropriate to provide an alternative valuation on the *special assumption* that the constraint did not exist at the *valuation date* in order to demonstrate its impact.

**3.** Greater care is needed if an inherent constraint does not exist at the *valuation date*, but is a foreseeable consequence of a particular event or sequence of events. Alternatively, the client may request a valuation to be on the basis of a specified marketing restriction. In either case the valuation would be provided on the *special assumption* that the constraint had arisen at the *valuation date*. The precise nature of the constraint must be included in the *terms of engagement*. It may also be appropriate to provide a valuation without the *special assumption* in order to demonstrate the impact that the constraint would have if it arose.

**4.** Forced sales arise where there is pressure on a particular vendor to sell at a specific time – for example, because of the need to raise money or extinguish a liability by a given date. The fact that a sale is 'forced' means that the vendor is subject to external legal or commercial factors, and therefore the time constraint is not merely a preference of the vendor. The nature of these external factors and the consequences of failing to conclude a sale are just as important in determining the price that can be achieved within the length of time available.

**5.** While a valuer can assist a vendor in determining a price that should be accepted in forced sale circumstances, this is a commercial judgment and a reflection of the *worth* to that particular vendor. Any relationship between the price achievable on

a forced sale and the *market value* is coincidental; it is not a valuation that can be determined in advance. Consequently, although advice may be given on the likely realisation in forced sale circumstances, the term is a description of the situation under which the sale takes place, and so it must not be used as a *basis of value*.

**6.** A *special assumption* that simply refers to a time limit for disposal without stating the reasons for that limit would not be a reasonable *assumption* to make. Without a clear understanding of the reasons for the constraint, the valuer would be unable to determine the impact that it may have on marketability, sale negotiations and the price achievable, or to provide meaningful advice. Further guidance on *special assumptions* and forced sale circumstances is provided in Appendix 4.

## VS 2.4 Restricted information

**Where a valuer is requested to undertake a valuation on the basis of restricted information the nature of the restriction must be agreed, and the possible valuation implications of the restriction confirmed in writing to the client, before the valuation is reported.**

### Commentary

**1.** A client may require a restricted service; for example, a short timescale for reporting may make it impossible to establish facts that would normally be verified by *inspection*, or by making normal enquiries or providing a valuation based on an automated valuation model (AVM).

**2.** It is accepted that a client may sometimes require this level of service, but it is the duty of the valuer to discuss the needs of the client prior to reporting. Such instructions are often referred to as 'drive-by', 'desk-top' or 'pavement' valuations.

**3.** The valuer should consider if the restriction is reasonable with regard to the purpose of the valuation. The valuer may consider accepting the instruction subject to certain conditions, for example, that the valuation is not to be published or disclosed to *third parties*.

**4.** The valuer must make it clear when confirming acceptance of such instructions that the nature of the restrictions and any resulting *assumptions*, and the impact on the accuracy of the valuation, will be referred to in the report. (See also VS 6.)

**5.** The instruction should be declined if the valuer considers that it is not possible to provide a valuation on the basis of restricted information.

## VS 2.5 Revaluation without re-inspection

**A revaluation without a re-*inspection* of property previously valued by the valuer or *firm* must not be undertaken unless the valuer is satisfied that there have been no material changes to the physical attributes of the property or the nature of its location since the last *inspection*.**

## Commentary

**1.** It is recognised that the client may need the valuation of its property updated at regular intervals, yet re-*inspection* on every occasion may be unnecessary. Provided that the valuer has previously inspected the property, and the client has confirmed that there have been no material changes to the physical attributes of the property and the area in which it is situated, a revaluation may be undertaken. The *terms of engagement* must state that this *assumption* has been made.

**2.** The valuer must obtain from the client information of changes in rental income from investment properties and any other material changes to the non-physical attributes of each property, such as lease terms, planning consents, statutory notices and so on.

**3.** Where the client advises that there have been material changes, or if the valuer is otherwise aware that such changes may have taken place, the valuer must inspect the property.

**4.** Irrespective of any changes to the property, the interval between *inspections* is a matter for the professional judgment of the valuer, who will, among other considerations, have regard to its type and location.

**5.** The valuer may decide that it is inappropriate to undertake a revaluation without re-*inspection* because of material changes, the passage of time or other reasons. Even so, the valuer may accept such an instruction, provided the client confirms in writing, prior to the delivery of the report, that it is required solely for internal management purposes and that no publication will be made to *third parties*. A statement declaring this position must be set out unequivocally in the report.

# VS 2.6 Critical reviews

**A valuer must not undertake a critical review of a valuation prepared by another valuer that is intended for disclosure or publication, unless the valuer is in possession of all the facts and information upon which the first valuer relied.**

## Commentary

**1.** This statement applies to circumstances where a valuer is provided with a valuation report prepared by another valuer and asked to provide a critical review that may be used by the client to publicly challenge the original valuation. For example, a party in a hostile takeover situation may wish to commission a report criticising a valuation commissioned by the opposing party, rather than produce a separate independent valuation.

**2.** Unless the second valuer has full knowledge of the first valuer's instructions and is in possession of the same facts, a review in these circumstances could be grossly misleading to *third parties*. It might also result in unjustified damage to the first valuer's reputation.

**3.** It is important that a clear distinction is made between a critical review of a valuation and an audit of a valuation, or an independent valuation of property included in another valuer's report.

**4.** *Members* may legitimately be involved in reviews of files, audits of methods, investigations of the support for valuations provided (including selective valuations of a sample of properties), or discussions with other valuers about their approach to a valuation. However, if a review is for anything other than the internal purposes of the client, *members* should exercise considerable caution before consenting to their work being referred to in any published document or circular.

# VS 3 Basis of value

## VS 3.1 Basis of value

**The valuer must determine the *basis of value* that is appropriate for every valuation to be reported.**

### Commentary

**1.** A *basis of value* is a statement of the fundamental measurement *assumptions* of a valuation, and for many common valuation purposes these standards stipulate the *basis* (or *bases*) *of value* that is appropriate.

**2.** Paragraphs 27–29 of the IVS Framework outline the common *bases of value* and distinguish them from the approach or method of valuation, the type and state of the asset, and *special assumptions*.

**3.** It will almost always be necessary to couple a *basis of value* with appropriate *assumptions* or *special assumptions* that describe the assumed status or condition of the asset at the *valuation date*. A typical *assumption* might concern occupation, for example, 'the *market value* subject to a lease'. A typical *special assumption* might be that a property has been altered in some defined way, for example, 'the *market value* on the *special assumption* that the works had been completed'. The use of *assumptions* and *special assumptions* is described in detail in Appendices 3 and 4.

**4.** For most valuation purposes it will be appropriate to use one of the bases recognised in the IVS Framework and identified in these standards. RICS does not encourage the use of a basis that is not recognised by these standards. However, if no recognised *basis of value* is suitable for a particular assignment, *members* should clearly define the basis adopted and explain in the report why use of a basis recognised by these standards is considered inappropriate. *Members* are cautioned that the use of an unrecognised or bespoke *basis of value* without good reason could result in breach of the requirement that the valuation report should be not be ambiguous or misleading (see VS 2.1).

**5.** The following *bases of value* are recognised in these standards:

- *market value* (see VS 3.2);
- *market rent* (see VS 3.3);
- *worth* (*investment value*) (see VS 3.4); and
- *fair value* (see VS 3.5).

**6.** *Market value* is the *basis of value* that is most commonly required. Because it describes an exchange between parties that are unconnected and operating freely in the marketplace, and ignores any price distortions caused by *special value* or *synergistic value*, it represents the price that would most likely be achievable for a

property across a wide range of circumstances. *Market rent* applies similar criteria for estimating a recurring payment rather than a capital sum.

**7.** However, *members* may be legitimately instructed to provide valuation advice based on other criteria, and therefore other *bases of value* may be appropriate. A valuer may be required to provide advice on the value of a particular property to a specific client, and may therefore need to account for criteria that are particular to that client, rather than those applicable in the market at large. This will involve the assessment of the *investment value*, or *worth*, of the property to that client. *Fair value* (except in the context of the *International Financial Reporting Standards* (*IFRS*)) may be used where the valuer needs to estimate the price that would be fair in an exchange between two specific parties, without necessarily having to disregard criteria that would not be replicated in the wider market – for example, where *special value* or *synergistic value* would impact that price.

**8.** It is important to note that these *bases of value* are not necessarily mutually exclusive. The *worth* of a property to a specific party, or the *fair value* of a property in exchange between two specific parties, may match the *market value* even though different assessment criteria are used.

**9.** Because bases other than *market value* may produce a value that could not be obtained on either an actual sale, or on a sale in the general market, the valuer must clearly distinguish the *assumptions* that are different from, or additional to, those that would be appropriate in an estimate of *market value*. Typical examples of such *assumptions* are discussed under the appropriate heading.

## VS 3.2 Market value

**Valuations based on *market value* shall adopt the definition and the conceptual framework settled by the International Valuation Standards Council (IVSC):**

> **The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.**

### Commentary

**1.** In applying *market value*, regard must also be had to the conceptual framework set out in paragraphs 31–35 of the IVS Framework, including the requirement that the valuation amount reflects the actual market state and circumstances as of the effective *valuation date*.

**2.** The basis of *market value* is an internationally recognised definition. It represents the figure that would appear in a hypothetical contract of sale at the *valuation date*. Valuers need to ensure that in all cases the basis is set out clearly in both the instructions and the report.

**3.** *Market value* ignores any existing mortgage, debenture or other charge over the property.

**4.** Notwithstanding the disregard of *special value* (see definition in paragraphs 44–47 of the IVS Framework) where the price offered by prospective buyers generally in the market would reflect an expectation of a change in the circumstances of the property in the future, this element of 'hope value' is reflected in *market value*. Examples of where the hope of additional value being created or obtained in the future may have an impact on the *market value* include:

- the prospect of development where there is no current permission for that development; and
- the prospect of *synergistic value* (see definition in paragraph 48 of the IVS Framework) arising from merger with another property, or interests within the same property, at a future date.

**5.** GN 2, GN 4 and GN 5 contain guidance on the application of *market value* to the specified types of asset.

## VS 3.3 Market rent

**Valuations based on *market rent* shall adopt the definition settled by the IVSC:**

> **The estimated amount for which a property would be leased on the valuation date between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.**

### Commentary

**1.** The definition of *market rent* is a modified definition of *market value*; paragraphs C10 and C11 in IVS 200 provide additional commentary.

**2.** *Market rent* will vary significantly according to the terms of the assumed lease contract. The appropriate lease terms will normally reflect current practice in the market in which the property is situated, although for certain purposes unusual terms may need to be stipulated. Matters such as the duration of the lease, the frequency of rent reviews and the responsibilities of the parties for maintenance and outgoings will all impact the *market rent*. In certain states, statutory factors may either restrict the terms that may be agreed, or influence the impact of terms in the contract. These need to be taken into account where appropriate.

**3.** Valuers must therefore take care to set out clearly the principal lease terms that are assumed when providing *market rent*. If it is the market norm for lettings to include a payment or concession by one party to the other as an incentive to enter into a lease, and this is reflected in the general level of rents agreed, the *market rent* should also be expressed on this basis. The nature of the incentive assumed must be stated by the valuer, along with the assumed lease terms.

**4.** *Market rent* will normally be used to indicate the amount for which a vacant property may be let, or for which a let property be may re-let when the existing lease terminates. *Market rent* is not a suitable basis for settling the amount of rent payable

under a rent review provision in a lease, where the actual definitions and *assumptions* have to be used.

## VS 3.4 Investment value

**Valuations based on *investment value* shall adopt the definition settled by IVSC:**

> ***Investment value* is the value of an asset to the owner or a prospective owner for individual investment or operational objectives.**

### Commentary

**1.** Paragraph 38 of the IVS Framework provides further commentary on this definition.

**2.** *Investment value* may also be known as *worth*.

## VS 3.5 Fair value

**Valuations based on *fair value* shall adopt one of two definitions:**

**1 the definition adopted by the IVSC:**

**'The estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties'.**

**2 the definition adopted by the International Accounting Standards Board (IASB):**

**'The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date'.**

### Commentary

**1.** It is important to recognise that the two definitions of *fair value* are not the same. When adopting the basis of *fair value* it is essential that the valuer establishes the correct definition for the purpose and sets it out in full in the *terms of engagement* and the report.

**2.** In applying the IVS definition, reference should be made to paragraphs 39–43 of the IVS Framework.

**3.** The guidance in IFRS 13 includes:

**The fair value measurement approach**

B2 The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all the following:

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

© IASB, IFRS 13

**4.** The references in IFRS 13 to market participants and a sale make it clear that for most practical purposes, *fair value* is consistent with the concept of *market value*.

**5.** For more detailed guidance on the application of *fair value* for *financial statements*, see VS 4.1.

# VS 4 Applications

## VS 4.1 Valuations for inclusion in financial statements

**Valuations undertaken for inclusion in *financial statements* shall be provided to comply with the applicable financial reporting standards adopted by the entity.**

### Commentary

**1.** Where the entity has not adopted *IFRS*, the valuer must comply with the financial reporting standards that are applicable. In some countries the RICS national association may have published standards explaining the valuation requirements (see VS 1.3).

**2.** General guidance on valuations for this purpose is given in IVS 300, Valuation for Financial Reporting.

**3.** Where the entity has adopted *IFRS* the *basis of value* will be *fair value* (see VS 3.5) and IFRS 13 will apply.

**4.** IFRS 13 details the valuation approach to *fair value*. It is essential that the valuer is familiar with the requirements and especially the disclosure requirements to ensure that the valuation is compliant with the applicable IFRS. The following matters are discussed:

- definition of *fair value*;
- the asset or liability;
- the transaction;
- market participants;
- the price;
- application to non-financial assets;
- *fair value* at initial recognition;
- valuation techniques;
- inputs to valuation techniques;
- *fair value* hierarchy; and
- disclosure.

An appendix containing application guidance is also included. IFRS 13 may be obtained from www.iasb.org.

**5.** IVS 300 contains guidance on the application of IFRS under the following headings:

- Fair Value
- Aggregation

- Valuation Inputs and Fair Value Hierarchy
- Liabilities
- Depreciation
- Leases
- Purchase Price Allocation
- Impairment Testing.

## VS 4.2 Valuations for secured lending

**Valuations of *real property* for secured lending shall have regard to IVS 310.**

### Commentary

**1.** IVS 310, Valuations of Real Property Interests for Secured Lending, provides that the *basis of value* will normally be *market value*. It also covers *special assumptions* and additional reporting requirements.

**2.** The commentary to IVS 310 provides application guidance on:

- The Property Interest
- Incentives
- Valuation Approaches
- Property Types
- Investment Property
- Owner-occupied Property
- Specialised Property
- Trade related Property
- Development Property
- Wasting Assets.

**3.** Appendix 5 provides additional requirements when providing a valuation for secured lending purposes.

**4.** Major banks and other lenders are subject to regulations that limit the total amount they can lend as a proportion of their assets. This is known as the 'solvency ratio'. In the international context, the Basel Committee on Banking Supervision issues Accords that set out agreed minimum solvency ratios to be maintained by lending institutions and how those ratios are to be calculated. These are enforced through national laws and, in the case of the European Union, in accordance with EU directives. The value of assets over which the lender holds security is used in calculating the solvency ratio.

**5.** The Accords provide that one of two valuation approaches, to which different risk criteria apply, may be adopted to assess the value of security represented by commercial *real estate*:

- the *market value* of the secured assets; or
- mortgage lending value (MLV).

**6.** MLV is a long-term risk assessment technique, and as such is not a *basis of value* – that is, an estimate of the value in an assumed transaction on a specific date. MLV is used by banks in a number of European countries. An explanatory paper prepared by the European Mortgage Federation is provided in Appendix 8.

**7.** The detailed application of MLV may vary from state to state. Therefore before accepting an instruction to calculate MLV, *members* should ensure that they are familiar with any relevant requirements in national legislation, including any restrictions on who may undertake this work. For example, MLV is particularly common in Germany, where banks require individuals calculating MLV to be certified in accordance with a national scheme and to apply methods set out under federal regulations.

## VS 4.3 Valuations of public sector assets for financial reporting

**Valuations for public sector assets for financial reporting shall be in accordance with the annex to IVS 300.**

### Commentary

**1.** The annex to IVS 300, Property, Plant and Equipment in the Public Sector, effectively adopts the International Public Sector Accounting Standards (IPSAS) as the appropriate standards for public sector entities. It specifically notes that IPSAS may change over time and reference should be made to the current standards on www.ifac.org/publicsector.

**2.** Legislative, regulatory, accounting or jurisprudence requirements may require the modification of this application in some countries or under certain conditions. Any *departure* due to such circumstances must be referred to and clearly explained in the report.

# VS 5 Investigations

## VS 5.1 Inspections and investigations

***Inspections* and investigations must always be carried out to the extent necessary to produce a valuation which is professionally adequate for its purpose.**

### Commentary

**1.** In settling the *terms of engagement* the valuer must agree the extent to which the subject property (or properties) is to be inspected and any investigation is to be made. Where a property is inspected the degree of on-site investigation that is appropriate will vary, depending upon the nature of the property, the purpose of the valuation and the *terms of engagement* agreed with the client.

**2.** A valuer meeting the criteria in VS 1.6 will be familiar with, if not expert on, many of the matters affecting either the type of property or the locality. Where a problem, or potential problem, that could affect value is evident from an *inspection* of the property, the immediate locality or routine enquiries, an unconsidered *assumption* by the valuer that no such problem exists could be grossly misleading.

**3.** A client may request, or consent to, an *assumption* that no problems exist. If, following an *inspection*, the valuer considers that this is an *assumption* that would not be made by a prospective purchaser, it then becomes a *special assumption* and should be treated as such (see VS 2.2). However, these matters can rarely be disregarded completely, and the discovery of adverse on-site factors that may affect the valuation should be drawn to the attention of the client before the report is issued.

**4.** Where it is agreed that *inspections* and investigations may be limited, it is likely that the valuation will be on the basis of restricted information and VS 2.4 will apply.

**5.** Many matters which become apparent during the *inspection* may have an impact on the market's perception of the value of the property. These can include:

- (a) characteristics of the surrounding area, and the availability of communications and facilities which affect value;
- (b) characteristics of the property;
- (c) dimensions and areas of the land and buildings;
- (d) construction of any buildings and their approximate age;
- (e) uses of the land and buildings;
- (f) description of the accommodation;
- (g) description of installations, amenities and services;
- (h) fixtures, fittings and improvements;

(i) any plant and equipment that would normally form an integral part of the building;

(j) the apparent state of repair and condition;

(k) environmental factors, such as abnormal ground conditions, historic mining or quarrying, coastal erosion, flood risks, proximity of high-voltage electrical equipment;

(l) contamination, such as potentially hazardous or harmful substances in the ground or structures on it (e.g. heavy metals, oils, solvents, poisons or pollutants that have been absorbed or integrated into the property and cannot be readily removed without invasive or specialist treatment, such as excavation to remove subsoil contaminated by a leaking underground tank) or the presence of radon gas;

(m) hazardous materials, such as potentially harmful material present in a building or on land, but which has not contaminated either and can be readily removed if the appropriate precautions and regulations are observed – e.g, the removal of fuel (gas) from an underground tank, or the removal of asbestos or ozone depleting substances in insulating materials;

(n) deleterious materials, such as building materials that degrade with age, causing structural problems, e.g. high alumina cement, calcium chloride or woodwool shuttering; and

(o) any physical restrictions on further development, if appropriate.

**6.** Other information may include:

- improvements to leasehold properties: when valuing leases and reversions, where the property originally included in the letting may have been altered or improved, care needs to be taken to ascertain what is to be valued. The valuation of the particular interest may not be simply what is seen and measured on the ground. If the valuer is unable to inspect the lease, or due to the absence of documented licences the extent of alterations or improvements cannot be confirmed, the valuer should proceed on the basis of stated *assumptions*;
- planning (zoning) controls: these will vary between states and the extent of the enquiries that need to be made will be governed by the valuer's knowledge of the area. The valuer must consider the nature of the property, the purposes of the valuation, the extent of the property and the size of the undertaking when determining the extent to which the regulatory measures that can, or might, affect it should be investigated;
- the incidence of local or state property taxes;
- information on any substantial outgoings and running costs, and the level of recovery from the occupier;
- information relating to any quotas imposed or other trading restrictions that may be made by the state in which the property is located; and
- information revealed during the normal legal enquiry processes before a sale takes place.

**7.** While the valuer is under a duty to take reasonable care to verify any information provided or obtained, the limitations on this duty must be clearly stated.

**8.** To respond effectively to a future enquiry, legible notes (which may include photographs) of the findings and, particularly, the limits of the *inspection* and the circumstances in which it was carried out must be made and retained. The notes should also include a record of the key inputs and all calculations, investigations and analyses considered when arriving at the valuation.

## VS 5.2 Verification of information

**The valuer must take reasonable steps to verify the information relied upon in the preparation of the valuation and, if not already agreed, clarify with the client any necessary *assumptions* that will be relied upon.**

### Commentary

**1.** The valuer has a responsibility to state clearly the information that is relied upon and, where appropriate, its source.

**2.** In each individual case the valuer must judge the extent to which the information supplied is reliable. If there is no option but to accept information that may not be reliable, an appropriate *assumption* needs to be set out in the *terms of engagement*.

**3.** When preparing a valuation for *financial statements* the valuer should be prepared to discuss the appropriateness of any *assumptions* that were made with the client's auditor, other professional adviser or a regulator.

**4.** The client will expect the valuer to express an opinion (and, in turn, the valuer will wish to express an opinion) on legal issues which affect the valuation. The valuer must therefore make clear in the report any information which must be verified by the client's or other interested party's legal advisers before the valuation can be relied upon or published.

# VS 6 Valuation reports

## VS 6.1 Minimum content of valuation reports

**The report must clearly and accurately set out the conclusions of the valuation in a manner that is not ambiguous or misleading, and does not create a false impression. It must also deal with all the matters agreed between the client and the valuer in the *terms of engagement* and include the following minimum information, except where the report is to be provided on a form supplied by the client:**

- **(a) identification of the client and any other intended users;**
- **(b) the purpose of the valuation;**
- **(c) the subject of the valuation;**
- **(d) the interest to be valued;**
- **(e) the type of asset or liability and how it is used, or classified, by the client;**
- **(f) the *basis*, or *bases*, *of value*;**
- **(g) the *valuation date*;**
- **(h) disclosure of any material involvement, or a statement that there has not been any previous material involvement;**
- **(i) the identity of the valuer responsible for the valuation and, if required, a statement of the status of the valuer;**
- **(j) where appropriate, the currency that has been adopted;**
- **(k) any *assumptions*, *special assumptions*, reservations, special instructions or *departures*;**
- **(l) the extent of the valuer's investigations;**
- **(m) the nature and source of information relied on by the valuer;**
- **(n) any consent to, or restrictions on, publication;**
- **(o) any limits or exclusion of liability to parties other than the client;**
- **(p) confirmation that the valuation accords with these standards and that it also complies with the IVS, where appropriate;**
- **(q) a statement of the valuation approach and reasoning;**
- **(r) a statement that the valuer has the knowledge, skills and understanding to undertake the valuation competently;**
- **(s) the opinions of value in figures and words;**
- **(t) signature and *date of the report*.**

**Items (a) to (t) in this list of minimum terms contain all the requirements of IVS 103, Reporting. For a detailed comparison between the two lists, see Appendix 9.**

### Commentary

1. The report should convey a clear understanding of the opinions being expressed

by the valuer and should be couched in terms that can be read and understood by someone with no prior knowledge of the subject property.

**2.** The format and detail of the report is a matter for the valuer's discretion, provided it contains the minimum required information.

**3.** The table in Appendix 6 contains further information on the minimum matters to be included in a report.

**4.** Notwithstanding the provisions of these standards, the valuer is reminded that any valuation advice provided, in whatever format, creates a potential liability to the client or, under certain circumstances, to a *third party*.

**5.** The valuer is discouraged from referring to any valuation or report as either 'formal' or 'informal', as these terms may give rise to the misunderstanding of unstated *assumptions* applicable in either case.

**6.** The valuer must exercise great caution before permitting valuations to be used for purposes other than those originally agreed. It is possible that a recipient or reader will not fully appreciate the restricted character of the valuation and of any qualifications in the report, and that it may be misquoted out of context.

## VS 6.2 Description of a report

**A report prepared in accordance with these standards must not be described as a certificate or statement.**

### Commentary

**1.** The terms 'certificate of value', 'valuation certificate' and 'statement of value' have specific meanings in certain states in designating statutory documents. One common factor is that these documents require a simple confirmation of price or value, without any requirement to understand the context, fundamental *assumptions* or analytical processes behind the figure provided. A valuer who has previously provided a valuation or advised on a transaction involving the property may prepare such a document in certain circumstances, for example, where the client is required to provide it by statute. Otherwise, a valuer should avoid becoming involved.

**2.** RICS considers that the terms noted in paragraph 1 should not be used in connection with the provision of valuation advice, as they imply either a guarantee or a level of certainty that is often inappropriate.

**3.** However, a valuer may use the term 'certified', or similar words, in the body of a report where it is known that the valuation is to be submitted for a purpose that requires formal certification of a valuation opinion.

## VS 6.3 Reporting the basis of value

**The *basis of value*, together with its definition, must be stated in full in the report. Where the *basis of value* is not a market-based figure and the valuation is materially different from *market value*, a statement to that effect must be made.**

## Commentary

**1.** It is recognised that although *market value* is the most appropriate *basis of value* for a wide range of applications, it may be appropriate to adopt alternative *bases of value* in specific circumstances (see VS 3).

**2.** It is essential that both the valuer and the valuation user clearly understand the distinction between *market value* and other *bases of value* and the effects, if any, that the differences between bases may have on the applicability of the valuation.

**3.** Where the *basis of value* is not market-based the user of the valuation is alerted to the possibility that, although relevant for the specified purpose, the valuation may not bear any relation to the price that could be obtained if the property were placed on the market. Unless agreed otherwise in the *terms of engagement* the valuer is not required to provide a valuation on any alternative *basis of value*.

# VS 6.4 Special assumptions

**Where a report includes a valuation made on the basis of a *special assumption*, the *special assumption* shall be set out in full, together with a statement that it has been agreed with the client.**

## Commentary

**1.** The purpose of this statement is to ensure that the report expressly refers to any *special assumptions* that have been agreed in accordance with VS 2.2.

# VS 6.5 Depreciated replacement cost in the private sector

**A valuation of a property in the private sector using a *depreciated replacement cost* method should be accompanied by a statement that it is subject to the adequate profitability of the business, paying due regard to the value of the total assets employed.**

## Commentary

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

**2.** The *market value* of an asset derived by reference to the sales of similar assets will usually approximate to the sum that the entity could obtain from the retirement and sale of the asset. If the value in use of the asset is lower than a *market value*

based on sales comparisons, the latter figure can safely be relied upon as the base figure for inclusion in the accounts. This figure is an amount recoverable by the entity regardless of whether it continues to use or retire the asset.

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

**4.** The possibility that a valuation derived using a *DRC* method would be materially affected by a cessation of operations is covered by the disclosure requirement in VS 6.7. However, the requirement to indicate additionally that the valuation is subject to 'adequate profitability' emphasises to the entity that even if the value in use of the asset is lower than the reported *market value*, it may still be higher than the net realisable value on cessation. It may therefore be necessary to write the reported *market value* down to the value in use in an impairment review.

## VS 6.6 Depreciated replacement cost in the public sector

**A valuation of a property in the public sector using a *depreciated replacement cost* method should be accompanied by a statement that it is subject to the prospect and viability of the continued occupation and use.**

### Commentary

**1.** The need to consider impairment (see the commentary for VS 6.5) is also a requirement of public sector accounting. However, in the public sector, assets are held for service delivery rather than profit, so the caveat in VS 6.5 is inappropriate. It is therefore necessary for the valuer to make it clear that the validity of a valuation derived using the *DRC* method depends upon a continuing requirement to use the asset for the provision of the service in question. Combined with any appropriate disclosure under VS 6.7, this emphasises to users that the valuation cannot be relied upon as an indication of the amount that could be recovered if the service was discontinued and the asset retired.

## VS 6.7 Comparison of depreciated replacement cost valuations and alternative market values

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

- **(a) the *market value* for any readily identifiable alternative use, if higher; or**
- **(b) if appropriate, that the *market value* on cessation of the business would be materially lower.**

## Commentary

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

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

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

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

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

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

# VS 6.8 Negative values

**Where a property has a negative value, that value must be reported separately and must not be set off against a positive value on other properties.**

## Commentary

**1.** Properties that do not constitute an asset, but are a liability, are said to have a negative value.

**2.** Negative values may arise in the case of leasehold interests where the rent reserved under the lease exceeds the *market rent* and/or there are onerous

covenants on the lessee's part. Negative values could also arise on a freehold property where the expenses of meeting statutory or contractual obligations exceed the value of the property that is free of such obligations.

**3.** There will be occasions where it would be correct to indicate a nil value for a property, for example, where the expense of meeting a liability outweighs the positive value but there is no legal liability on the owner to incur this expense.

## VS 6.9 Properties in more than one country

**Where the properties are located in more than one country the report must list the properties within each country separately, and the valuation must be reported in the currency (or currencies) that has been agreed with the client.**

### Commentary

**1.** Where the properties are located in more than one country the report should be arranged so that all the properties in one country are grouped together.

**2.** An entity will usually require valuations to be expressed in the currency of the country in which it is based. For *financial statement* purposes, this is known as the 'reporting currency'. Irrespective of the location of the client, valuations are to be made in the currency of the country in which the property is located. Where the client requires the valuation to be translated into a different currency (for example, into the reporting currency), unless agreed otherwise the exchange rate to be adopted is the closing rate (also known as the 'spot rate') on the *valuation date*.

**3.** The report must also declare, in respect of each country within which the property is situated, whether the valuer has made allowance for existing or proposed local legislation relating to taxation on the realisation of the property asset.

## VS 6.10 Incorporation of other valuations

**Where the valuer incorporates into the report a valuation prepared by another valuer or *firm*, it must be confirmed that such valuations have been prepared in accordance with these standards, or other standards that may apply in the particular circumstances.**

### Commentary

**1.** Circumstances may arise where the valuer wishes to obtain a valuation from another valuer or *firm* (for example, a plant and equipment valuation, or a valuation of a property in another state where local expertise is required). When this situation occurs, the client must agree to the employment of valuers or *firms* not connected with the valuer, and reference to this should be included in the *terms of engagement*.

**2.** The valuer may be requested to incorporate a valuation commissioned directly by the client. In such cases the valuer must be satisfied that any such report has been prepared in accordance with these standards or other standards identified in accordance with VS 1.2.2 (compliance with other *valuation standards*).

## VS 6.11 Preliminary valuation advice

**During the course of preparation for a report that complies with these standards, the valuer may provide the client with preliminary advice, or a draft report or valuation in advance of its completion. This may include the amount of the valuation, provided the document also states that:**

- **it is a draft, subject to the completion of the final report;**
- **the advice is provided for the client's internal purposes only; and**
- **the draft is, on no account, to be published or disclosed.**

**If matters of fundamental importance are not included, their omission must also be declared.**

### Commentary

**1.** It is recognised that while the valuation is being prepared, the valuer may need to discuss various matters, such as the verification of facts and other relevant information (for example, confirming the outcome of rent reviews or clarifying the boundaries of a property), before forming a preliminary opinion of value. At any stage in the valuation process, such discussions give the client an opportunity to understand the valuer's viewpoint and evidence. However, once a preliminary opinion of value has been reached and is conveyed to the client, it is essential that the action required by this *valuation standard* is taken.

**2.** It is important that such discussions do not, and can be shown not to, lead to any perception that the valuer's opinion has been influenced by those discussions, other than to correct inaccuracies or incorporate any further information provided. The valuer should keep file notes of discussions with the client on draft reports or valuations. This record should note:

- the information provided, or the suggestions made, in relation to the valuations;
- how that information was used to justify a change in value; and
- the reasons why the valuation has not been changed.

The aim is to provide a transparent audit trail that will demonstrate that the discussions have not compromised the valuer's independence. If requested, this record should be made available to auditors or any other party with a legitimate and material interest in the valuation.

## VS 6.12 Publication statement

**Where the purpose of the report requires a published reference to it, the valuer must provide a draft statement for inclusion in the publication.**

### Commentary

**1.** A report may be published in full, for instance in the annual accounts of a company, but it is more common for only a reference to be made to it. In this case

it is essential that the valuer has a close involvement in the publication statement to ensure that all the references are accurate and that the reader is not misled.

**2.** If the whole report is not to be published, the draft statement should be prepared as a separate document and provided to the client at the same time as the report. The content of the statement may be governed by rules issued by local regulatory bodies, but it should contain the following minimum information:

- the name and qualification of the valuer, or the valuer's *firm*;
- an indication of whether the valuer is an *internal* or *external valuer*, or where required, that the specific criteria relating to this status has been met;
- the *valuation date* and *basis* (or *bases*) *of value*, together with any *special assumptions*;
- comment on the extent to which the values were determined directly by reference to market evidence or were estimated using other valuation techniques;
- confirmation that the valuation has been made in accordance with these standards, or the extent of and reason(s) for *departure* from them; and
- a statement indicating any parts of the report prepared by another valuer or a specialist.

Examples of published references to valuation reports are provided in Appendix 7.

**3.** 'Publication' does not include making the report or the valuation figure available to a mortgage applicant or borrower.

**4.** The valuer should check the accuracy of any other relevant material referring to the properties or to the valuation that is to be published.

**5.** The valuer is also advised to read the whole document in which the report or reference is to be published to ensure that there is no misstatement of any other matter or opinion of which the valuer may have knowledge.

**6.** The valuer should insist that a copy of the final proof of the document or the reference is supplied before issue, and attach that proof to the letter of consent. Any pressure by other parties or persuasion to delegate power to sign should be resisted.

**7.** The valuer is permitted to exclude information of a commercially sensitive nature from a report that is published in full, subject to any legal requirements which may apply in a particular state.

**8.** An opinion may be expressed which, if included in a public document, might have some effect on a matter that is in dispute, under negotiation or subject to certain rights between the owner and a *third party* (for example, an opinion of the rental or capital value of a property with an imminent rent review). The report may also include information about a company's trading which would not usually be in the public domain. Such information is commercially sensitive and the client must decide, subject to the approval of the auditors and any regulatory body, whether it should be included in the publication.

**9.** In the published reference the valuer must refer to the omission(s) and state that this has been done upon the expressed instructions of the client and with the

approval of the regulatory body and/or auditors. Without this note the valuer may be inadvertently placed in a situation where there is unjustifiable criticism.

## VS 6.13 Published references to departures and special assumptions

**The valuer must ensure that any reference to the report in any published document includes a reference to any *departures* or *special assumptions*.**

### Commentary

**1.** This statement applies where the valuer has made:

- a valuation subject to a *special assumption* (in accordance with VS 2.2); or
- a valuation with any *departures* (in accordance with other relevant *valuation standards*; see VS 1.2).

**2.** Where the full report is not published, the publication statement required under VS 6.12 must refer to any *special assumption* made and any additional valuation provided. Similarly, sufficient reference to any *departures* should be made in any published document.

**3.** In each case the onus is upon the valuer to determine what constitutes a ‘sufficient reference’. A reference would not be regarded as ‘sufficient’ if it failed to alert the reader to matters of fundamental importance as to the basis or amount of the valuation, or if there was any risk that the reader might be misled.

# Appendices

# Appendix 1
# Confidentiality, threats to independence and objectivity, and conflicts of interest



## 1 Introduction

**1.1** This appendix provides additional guidance on the application of the Rules of Conduct specifically related to valuations regarding confidentiality, threats to independence and objectivity, and managing conflicts of interest that could threaten or compromise a valuer's integrity and impartiality.

## 2 Duty of confidentiality

**2.1** There is a general duty to treat information relating to a client as confidential where that information becomes known as a result of the professional relationship and is not in the public domain.

**2.2** The risk of disclosure of confidential information is a material factor that the valuer should consider in assessing whether or not he or she can act where there is a potential conflict. It is also a factor that should be borne in mind should it be necessary to disclose some details of the valuer's involvement with the subject of the valuation. If an adequate disclosure cannot be made without breaching the duty of confidentiality, then the instruction should be declined.

**2.3** The possession of confidential information may create an irresolvable conflict. An example illustrating this is where passing on that information would be a breach of the original duty of confidentiality, but failing to pass on materially relevant information to a subsequent client, or to use it to that client's advantage, might lead to a claim of negligence or breach of contract.

**2.4** The duty of confidentiality is not only confined to clients where there is a current fee-earning relationship, but also to previous clients and even potential clients. The duty to a client is continuous and ongoing. Over time, the potential relevance of information and the potential for a conflict arising will decrease, but there is no fixed period that can be used to determine whether the duty of confidentiality still creates

a conflict with the general duty in a subsequent instruction. The nature and extent of the information held will be a key determinant of whether it is possible to act for another client. In addition, the nature of the original job, the time which has elapsed since doing it and the existence of any 'retainers' still held from the original client will all be of relevance.

**2.5** For instance, if a valuer or *firm* is asked by Company A to advise on a possible takeover of Company B, a thorough check should be made on whether work has been carried out previously for Company B. If it is decided that the nature or timing of any past work for Company B permits the acceptance of the new instruction, then the valuer should keep a detailed file note recording the reason for the decision. If, however, it is decided that past work for Company B means there is a conflict of interest, then the new instruction (from Company A) may have to be declined without disclosing the reasons for that decision.

**2.6** The duty of confidentiality also extends to any references to transactions in reports where confidentiality agreements may apply.

## 3 Threats to independence and objectivity

**3.1** It is not possible to provide a definitive list of situations where a threat to a valuer's independence or objectivity may arise. However, the following are examples of where it will usually be necessary for the valuer to make an appropriate disclosure or, where it is considered that any conflict that might arise cannot be resolved or managed in a satisfactory way and therefore the valuer should decline to act:

- acting for the buyer and the seller of a property in the same transaction;
- acting for two or more parties competing for an opportunity;
- valuing for a lender where advice is also being provided to the borrower;
- valuing a property previously valued for another client;
- undertaking a valuation for *third-party* consumption where the valuer's *firm* has other fee-earning relationships with the client; and
- valuing both parties' interests in a leasehold transaction.

**3.2** The extent to which any of the preceding examples will compromise the valuer's overriding obligation to act with independence and objectivity will depend upon the circumstances of each case. For example, such contributing factors will be the purpose of the valuation, the client's objectives and the practicality of managing conflicts through either disclosure or the operation of 'Chinese walls'. The interest of any *third parties* in the valuation, and the reliance they may place on it, will also be a relevant consideration. If the valuer doubts his or her ability to avoid or manage any threat to independence, the instruction should be declined.

## 4 Managing a conflict of interest

**4.1** The valuer and the *firm* have a duty to identify any actual or potential conflict of interest in the course of their business, and need to be satisfied that they are truly in a position to manage the potential conflict in the future. This can normally be established in one of two ways:

(a) if the conflict arises because of the valuer's own interest in the property concerned, by proper disclosure of this to interested parties; or
(b) if the conflict arises because of loyalty to different clients, by creating a Chinese wall between those acting for the respective clients.

**4.2** Fundamentally, one of three courses can be followed:

(a) it is established that an irresolvable conflict exists and instructions will be declined;
(b) a potential conflict is disclosed in writing to the client(s), an agreement is sought and obtained as to how it will be managed, and that agreement is confirmed in writing; or
(c) where a conflict, or potential conflict, arises from former clients, consideration should be given to informing the former clients (in writing) of the current circumstances in order to obtain their confirmation that they have no objection to the valuer or the *firm* acting.

**4.3** In all cases, however, it remains the responsibility of the valuer or the *firm* to determine if there is an irresolvable conflict or not.

**4.4** Where a conflict, or potential conflict, is identified, consideration has to be given as to whether the instruction should be accepted or declined. There is no stipulation that the valuer cannot accept the instruction under any given set of circumstances, as it is recognised that in many cases a conflict, or potential conflict, either is of no concern or relevance to a client, or can be effectively managed.

**4.5** With regard to taking the action, as noted earlier in paragraph 4.2(b) it will be necessary to obtain the client's agreement to the proposals for managing the conflict. Th agreement must disclose, subject to the advice in section 2 of this appendix, the possibility and nature of the conflict, the circumstances surrounding it and any other relevant facts.

**4.6** In choosing to explain and seek agreement to the proposals for managing the conflict, the valuer must consider the standing and nature of the client, or prospective client. A large corporate client will find it easier to give an informed consent than a small business or an individual who rarely employs professionals. The valuer may have reason to believe that a prospective client does not have sufficient awareness of the issues to make an informed decision on the implications of any potential conflict, or the proposals for its management. In such case, the valuer should either decline the instruction, or advise the prospective client to take advice from another professional (for example, a lawyer or accountant) about the situation.

## 5 Third parties

**5.1** Where a duty of care is owed to a *third party*, prompt disclosure must be made in writing concerning any interest that the valuer or the *firm* will gain from the appointment that goes beyond a normal fee or commission. Many valuations are relied upon by *third parties*, and if the valuer or the *firm* has other significant fee-earning involvement with the client or the property, this may need to be disclosed to any *third parties*. In cases where *third parties* are identifiable at the outset, there is a requirement that the disclosure is made promptly – that is before the valuation

is undertaken. This would thus give *third parties* the opportunity to object to the appointment if they felt that the valuer's independence and objectivity may be compromised.

**5.2** However, in many cases the *third parties* will be a class of individuals, for example, the shareholders of a company, for which disclosure at the outset to all interested *third parties* would clearly be impractical. In such cases the earliest practical opportunity for disclosure will be in the report or any published reference to it. A greater onus thus lies on the valuer to consider, before accepting the instruction, whether those *third parties* relying on the valuation will accept that any involvement requiring disclosure does not unduly compromise the valuer's objectivity and independence.

**5.3** Valuations in the public domain, or which will be relied on by *third parties*, are frequently subject to statute or regulation. There are often specific stipulations that the valuer must meet in order to be deemed suitable to provide a truly objective and independent view. For certain purposes RICS standards may also impose specific restrictions or conditions on the valuer providing valuation advice where there was previous involvement with either the property or a party with an interest in it. However, there are no specific criteria for most valuations, and the onus is on the valuer to ensure that there is an awareness of potential conflicts and other threats to independence and objectivity.

## *Chinese walls*

**5.4** RICS has strict guidelines on the minimum standards which must be adopted by organisations when separating the advisers acting for 'conflicting' clients. Any Chinese wall setup must be robust enough to offer no chance of information passing through it. This is a strict test; taking 'reasonable steps' to operate an effective wall is not sufficient. Accordingly, any Chinese wall set up and agreed to by affected clients must ensure that:

- the individual(s) acting for conflicting clients must be different – note that this extends to secretarial and other support staff;
- such individuals or teams must be physically separated, at least to the extent of being in different parts of a building, if not in different buildings altogether;
- any information, however held, must not be accessible to 'the other side' at any time and, if in a written form, must be kept secure in separate, locked accommodation to the satisfaction of the compliance officer, or another senior independent person, within the *firm*;
- the compliance officer, or other senior independent person, should oversee the setting up and maintenance of the Chinese wall while it is in operation, adopting appropriate measures and checks to ensure it is effective; must have no involvement in either of the instructions; and should be of sufficient status within the organisation to be able to operate without hindrance; and
- there should be appropriate education and training within the *firm* on the principles and practices relating to the management of conflicts of interest.

**5.5** Chinese walls are unlikely to work without considerable planning, as their management needs to be an established part of a *firm's* culture. It will therefore be more difficult, and often impossible, for smaller *firms* or offices to operate them.

# Appendix 2
# Settling the terms of engagement



## 1 Introduction

**1.1** There is an extensive range of purposes for which clients will require valuation advice. In addition, the knowledge of clients will range from some who have a deep understanding of the market in which assets are traded, to others who are unfamiliar with the market, the terms used and the concepts embraced by valuers.

**1.2** *Members* should take care that they understand their clients' needs and requirements fully, and appreciate that there will be occasions when they may need to guide clients to choose the most appropriate advice for the given circumstances. Even in the most unusual situations clients can usually be provided with appropriate advice in accordance with the RICS standards, for example, by making appropriate *special assumptions*.

**1.3** *Members* may wish to establish checklists of questions to ask or matters to discuss with clients, the answers to which may influence their subsequent investigations and reporting. In all cases the *members'* papers must make clear what has been agreed and record the reasons for any restrictions, *special assumptions* or *departures*.

**1.4** *Members* must bear in mind any requirements of their professional indemnity insurance (PII) and, if in doubt, refer to their insurer before accepting instructions.

## 2 Guidance on minimum terms of engagement

**2.1** The headings in this table are same as those in VS 2.1.

| Item | Comment |
|---|---|
| (a) Identification of the client and any other intended users | Requests for valuations will frequently be received from representatives of the client, and the *member* should ensure that the client is correctly identified. This is particularly relevant where:<br>• the request is made by the directors of a company, but the client is the company and the directors have a separate legal standing;<br>• a valuation is required for loan purposes and, although commissioned by the borrower, the report may be for the lender, the true client (see also (o)). |

| | |
|---|---|
| (b) The purpose of the valuation | Valuations are required for many purposes, and it is essential that the valuer has this information so that the appropriate *basis of value* is adopted.<br><br>If the client declines to reveal the purpose of the valuation and the *member* is willing to proceed with the valuation, the client must be advised in writing that this omission will be referred to in the report. In this case the report must not be published or disclosed to *third parties*.<br><br>If an unusually qualified valuation is to be provided, the terms must state that it is not to be used for any other the purpose than that originally agreed with the client. |
| (c) The subject of the valuation | Where the valuation is of a single asset its identification will usually be straightforward. However, complications may arise in the case of land where there are not clearly defined boundaries. The valuer must make certain that such matters are resolved before reporting.<br><br>Assets may be held in conjunction with other assets as a group or a portfolio. In such case it is important to define how they have been considered in the valuation. GN 3 provides detailed guidance where the valuation is of a portfolio of properties.<br><br>Unless valuing an interest in a property as part of an operational entity, it is usual to exclude trade fixtures, machinery, furnishings and other equipment from the valuation, although this should also be clarified with the client. GN 2 provides guidance on the valuation of individual *trade related properties*.<br><br>For a tenanted property, it may be necessary to identify any improvements undertaken by tenants and to clarify whether or not these improvements are to be disregarded upon renewal or review of the lease. In some cases, they may even give rise to a compensation claim by the tenant when vacating the property.<br><br>Where a valuation of plant and equipment is carried out concurrently with a valuation of an interest in land, it is essential that the valuer of plant and equipment liaises with the valuer of the interest in the land. This is to ensure that items of this nature are neither omitted from, nor duplicated in, the valuation. It will be necessary to agree with the client any items of plant and equipment to be valued separately. GN 5 provides guidance on the identification of plant and equipment. |
| (d) The interest to be valued | It must always be borne in mind that it is a particular ownership or interest in an asset or liability that is being valued. Therefore the *member* must agree with the client on the interest to be valued. |

| | |
|---|---|
| (e) The type of asset or liability and how it is used or classified by the client | As different valuation approaches and *assumptions* are required for different types of asset or liability, it is important that the valuer ascertains not only the type of asset or liability involved, but also how it is used or classified by the client.<br><br>Examples of different classes and categories include assets that are:<br>• freehold or leasehold;<br>• owner-occupied;<br>• held as an investment;<br>• *specialised property*; and<br>• property held for specified purposes (mineral-bearing land or waste management assets).<br><br>The agreement should also state the format in which the valuation of portfolios should be presented. GN 3 provides guidance on this aspect. |
| (f) The *basis*, or *bases*, *of value* | The *member* must stipulate the *basis*, or *bases*, *of value* that will be reported. For certain purposes or classes of asset these statements stipulate that a specific basis is used. In other cases the correct basis, or bases, to use is a matter for the *member's* professional judgment.<br><br>Where the *basis of value* is *fair value*, care must be taken to select the correct definition, in the light of the specific purpose or context of the valuation, which is to be set out in full (see VS 3.5).<br><br>It is recognised that for some purposes a prospective valuation may be required in addition to a current value (such as *market value*). Any such valuation should comply with the applicable jurisdictional and/or national association standards. |
| (g) The *valuation date* | The *valuation date* will need to be agreed with the client. A specific date must be agreed, as an *assumption* that it is the *date of the report* is not acceptable.<br><br>(See also IVS 103.5(f) and IVS Framework, paragraph 31(c).) |
| (h) Disclosure of any material involvement, or a statement that there has not been any previous material involvement | In considering the extent of any material previous involvement (whether past, current or future), the valuer must have regard to the requirements of VS 1.<br><br>Where there has not been any previous material involvement a statement to that effect must be made. (See also Appendix 1 relating to the resolution of conflicts of interest.) |

| | |
|---|---|
| (i) The identity of the valuer responsible for the valuation and, if required, a statement of the status of the valuer | A valuation is the responsibility of an individual valuer (see VS 1.5). RICS does not allow a valuation to be prepared by a 'firm' as stated in IVS 101(a). The use of 'for and on behalf of' is an acceptable substitution.<br><br>For some purposes the valuer may be required to state if he or she is acting as an *internal* or *external valuer*.<br><br>Where the valuer is obligated to comply with additional requirements of independence, VS 1.8 will apply.<br><br>In some states the national association *valuation standards* may require certain disclosures to be made in the *terms of engagement*. The valuer should also indicate that additional disclosures with regard to the status of the valuer, as outlined here, may be included in the report (see Appendix 6(i)). |
| (j) Where appropriate, the currency to be adopted | If there is a possibility that a valuation has to be translated into a currency other than that of the country in which the asset is located, the basis of the exchange rate is to be agreed with the client. |
| (k) Any *assumptions*, *special assumptions*, reservations, special instructions or *departures* | It is very rare for a valuation to be reported without express or implied *assumptions*. Even when these *assumptions* are those that would usually be made in undertaking a valuation for that particular purpose, the client must still be notified that the valuer will produce and report the valuation on this basis.<br><br>Many of the *assumptions* are made to limit the valuer's liability where full investigation has been impossible or impractical within the context of the instruction. Even so, unless they are notified to, and accepted by, the client in advance, they may have no legal standing.<br><br>Further guidance on *assumptions* and *special assumptions* can be found in Appendices 4 and 5, respectively.<br><br>Reference must be made to any *departures* from the *valuation standards* that the *member* considers both necessary and justifiable in the circumstances. |
| (l) The extent of the valuer's investigations | The extent of the valuer's investigations is discussed in VS 5. To avoid misunderstandings it is good practice to agree with, or at least tell, the client the scope of the task envisaged, which defines the extent of the *member's* duty to obtain or verify information that may be material.<br><br>If the client wishes to restrict the scope of the *member's* investigations, VS 2.4 will apply. |

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| (m) The nature and source of the information to be relied on by the valuer | If the client plans to supply information relating to the asset, or directs the valuer to obtain it from a *third party*, then an agreement that the valuer can safely rely upon this information without further verification should be recorded in the *terms of engagement*. |
| (n) Any consent to, or restrictions on, publication | The *member* must stipulate in the *terms of engagement* that the *member's* prior consent in writing will be required for any reproduction or public reference to the valuation or report (see VS 6.12). |
| (o) Any limits or exclusions of liability to parties other than the client | Limitations are only effective if notified to the client in advance. The *member* should keep in mind that any insurance protecting against claims for negligence under PII policies may require the valuer to have particular qualifications, and to include certain limiting clauses in every report and valuation. If this is the case the relevant words should be repeated, unless the insurer agrees to either a modification or a complete waiver.<br><br>Some valuations will be for purposes where the exclusion of *third-party* liability is either forbidden by law, or unacceptable to the client or an external regulator. In many cases it may be preferable to exclude any limitation on liability, rather than include a clause specifically extending liability to a specified group or category of *third parties*. However, this is a matter for the commercial judgment of the *member*.<br><br>Where the client is a lender, it may be part of a syndicate or, having lent on property, may sell on tranches of the loan to other lenders. Although the *third-party* limitation clause may provide some protection, the valuer may become exposed to the risk of a duty of care to unknown *third parties*. It may therefore be wise, particularly in the case of valuations for lending on commercial property, for the *member* to add to the usual limitation clause a statement to the following effect:<br><br>In the event of a proposal to place the loan on the subject property in a syndicate, the client must notify the valuer, with a view to agreeing responsibility to the further named parties. |
| (p) Confirmation that the valuation will be undertaken in accordance with these standards and that it also complies with the IVS, where appropriate | The standards must be referred to by their full title: for example, the *RICS Valuation – Professional Standards*. Where the valuation has to comply with either the IVS or other standards (see VS 1.2.2 and 1.2.3) a statement should be made, where appropriate, that either (i) compliance with the RICS standards also gives assurance of compliance with the IVS; or (ii) the other specified standards will complied with.<br><br>All agreed *departures* from the RICS standards should be referred to within this confirmation, but the details will be set out in the information required under (k). |

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| (q) Confirmation that the valuer has the knowledge, skills and understanding to undertake the valuation competently | This statement may be limited to a confirmation that the valuer has sufficient current local, national and international (as appropriate) knowledge of the particular market, and the skills and understanding to undertake the valuation competently. It is not necessary to provide any details. Where the provisos in VS 1.5.1 and VS 1.5.2 apply, an appropriate disclosure is to be made. |
| (r) The basis on which the fee will be calculated | The level of the fee is a matter to be settled with the client, unless there is a fee basis prescribed by an external body that binds both parties. RICS does not publish any scale of recommended fees. |
| (s) Where the *firm* is *registered for regulation by RICS*, reference to the *firm's* complaints handling procedure, with a copy available on request | This requirement is included to emphasise the need for *firms registered for regulation by RICS* to comply with the RICS Rules of Conduct for Firms, paragraph 7. |
| (t) A statement that compliance with these standards may be subject to monitoring under the institution's conduct and disciplinary regulations. | Guidance on the operation of the RICS monitoring regime, including matters relating to confidentiality, is available from www.rics.org/regulation.<br><br>The purpose of this statement is to draw the attention of the client to the possibility that the valuation may be investigated for compliance with these standards. |

# Appendix 3 Assumptions



## 1 Introduction

**1.1** The appendix provides additional guidance on an *assumption*, as defined in the Glossary. An *assumption* is made where it is reasonable for the valuer to accept that something is true without the need for specific investigation.

**1.2** An *assumption* is often linked to a limitation on the extent of the investigations or enquiries that should be undertaken by the valuer. Therefore all *assumptions* that are likely to be included in the report must be agreed with the client and included in the *terms of engagement*.

**1.3** The definition of *market value* (see VS 3.2) also incorporates various *assumptions*, so this appendix deals with the other *assumptions* that *members* may wish to make.

**1.4** If after *inspection* or investigation the valuer considers that an *assumption* agreed in advance with the client either has proven to be inappropriate, or should be a *special assumption*, the revised *assumptions* and approach must be discussed with the client prior to the conclusion of the valuation and the delivery of the report.

## 2 Information and guidance on assumptions

**2.1** Information and guidance is given on the following *assumptions*:

(a) title;
(b) condition of buildings;
(c) services;
(d) planning (zoning);
(e) contamination and hazardous substances;
(f) environmental matters; and
(g) sustainability.

This list is not exclusive and care should be taken to identify any *assumptions* that may have to be made in order to fulfil a particular instruction. There are no 'standard' *assumptions* that do not need to be stated.

### *(a) Title*

**2.2** The valuer must have information on the essential details of the interest being valued. This may take the form of a synopsis obtained from the client or a *third party*,

or copies of the relevant documents. However, unless provided with a current detailed report on title by the client's lawyers, the valuer must state what information has been relied on and what *assumptions* have been made. For example, the valuer would state that apart from anything revealed in the information provided, it is assumed that there are no encumbrances on title.

**2.3** In order to assist the client in the particular circumstances giving rise to the valuation or appraisal, the valuer may have to make *assumptions* about the interpretation of legal documents. However, it must be appreciated that this is a matter for lawyers. Therefore the valuer must state that the *assumptions* made must be checked by the client's legal advisers and that no responsibility or liability will be accepted for the true interpretation of the client's legal title in the property. Otherwise, the valuer will assume no less a burden than the law imposes upon a competent lawyer if legal advice is given expressly or by implication.

### *(b) Condition of buildings*

**2.4** Even if competent to do so, a valuer would not normally undertake a building survey to establish the details of any building defects or disrepair. However, it would also be wrong for the valuer to ignore obvious defects that would have an impact on the value, unless a *special assumption* to that effect has been agreed. The valuer must therefore clearly state that the *inspection* will not be a building survey. In addition the limits that will apply to the valuer's responsibility to investigate and comment on the structure or any defects must be defined. It should also be stated that an *assumption* will be made that the building(s) is in good repair, except for any defects specifically noted.

### *(c) Services*

**2.5** The presence and efficiency of building services and any associated plant and equipment will often have a significant impact on value, however, detailed investigation will normally be outside the scope of the valuation. The valuer will need to establish what sources of information are available, and the extent upon which these can be relied, in undertaking the valuation. It is usual to agree on an *assumption* that the services and any associated controls or software are in working order or free from defect.

### *(d) Planning (zoning)*

**2.6** The valuer needs to establish whether the property has the necessary statutory consents for the current buildings and use, and whether there are any policies or proposals by statutory authorities that could impact the value positively or adversely. This information will often be readily available, but delays or expenses may be incurred in obtaining definitive information. The valuer should state what investigations are proposed, or what *assumptions* will be made, where verification of the information is impractical within the context of the valuation.

### *(e) Contamination and hazardous substances*

**2.7** A valuer will not normally be competent to advise on the nature or risks of contamination or hazardous substances, or on any costs involved with their removal.

However, where a valuer has prior knowledge of the locality and experience of the type of property being valued, the valuer can reasonably be expected to comment on the potential that may exist for contamination, and the impact which this could have on value and marketability. It will therefore be necessary for the valuer to state the limits on the investigations that will be undertaken and any sources of information or *assumptions* that will be relied upon.

**2.8** For further guidance on contamination see the RICS *guidance note*, *Contamination, the environment and sustainability: implications for chartered surveyors and their clients*, 3rd edition (2010).



### *(f) Environmental matters*

**2.9** Some property will be affected by environmental factors that are an inherent feature of either the property itself, or the surrounding area, and could have an impact on the value of the property interest. Examples include historic mining activity, flooding risk or electricity transmission equipment. Although detailed commentary on their effects will normally be outside the realm of the valuer's expertise, their presence, or potential presence, is something that can often be established in the course of a valuation *inspection* through normal enquiries or by local knowledge. The valuer should state the limits that will apply to the extent of the investigations and the *assumptions* that will be made in relation to environmental matters.

### *(g) Sustainability*

**2.10** Not only does property itself have an impact on the environment throughout its whole life cycle, but conversely environmental and social aspects of sustainability may also have an impact on property performance.

**2.11** RICS has an online section dedicated to its involvement in sustainability projects, research and events: www.rics.org/sustainability.

**2.12** The RICS information paper, *Sustainability and commercial property valuation* (2009), discusses some of the key issues that may be, or may become, relevant when undertaking valuations of commercial buildings. Similarly, there is the RICS information paper, *Sustainability and residential property valuation* (2011), focusing on residential properties.

# Appendix 4
# Special assumptions

Appendices

## 1 Introduction

**1.1** This appendix contains information on *special assumptions*. Circumstances where it may be appropriate to make *special assumptions* include the following examples:

- a situation where a bid from a *special purchaser* has been made, or can be reasonably anticipated;
- a situation where the interest being valued cannot be offered freely and openly in the market;
- a past change in the physical aspects of the property where the valuer has to assume those changes have not taken place;
- an impending change in the physical aspects of the property, for example, a new building to be constructed or an existing building to be refurbished or demolished; or
- an anticipated change in the mode of occupation or trade at the property.

**1.2** Some examples of *special assumptions* are that:

- planning consent has been, or will be, granted for development (including a change of use) at the property;
- a building or other proposed development has been completed in accordance with a defined plan and specification;
- the property has been changed in a defined way (for example, removal of process equipment);
- the property is vacant when, in reality, at the *valuation date* it is occupied;
- it is let on defined terms when, in reality, at the *valuation date* it is vacant; or
- the exchange takes place between parties where one or more has a special interest and that additional value, or *synergistic value*, is created as a result of the merger of the interests.

## 2 Valuations reflecting an actual or anticipated market constraint

**2.1** Examples of features inherent to a property that may prevent it from being openly or adequately exposed to the market include:

- the interest being valued is controlled by a *third-party* interest, and that party's co-operation in any sale cannot be guaranteed;

- the interest being valued may be subject to particular easements or restrictive covenants that prevent a sale in the open market, for example, a restriction on assignment or a right of pre-emption; or
- plant and equipment may have to be removed from a leasehold property at short notice as the lease is about to be determined or forfeited.

**2.2** A marketing constraint should not be confused with a forced sale. A constraint may result in a forced sale, but it can also exist without compelling the owner to sell. Care must therefore be taken in identifying and wording any *special assumption*.

**2.3** Other than in exceptional circumstances, a forced sale of freehold property is only likely when the particular vendor will suffer some financial penalty if the property is not disposed of within a period that is too short to ensure proper marketing. The valuer must have a full understanding of the nature of the penalty or commercial constraint on the vendor in order to give sensible advice on the impact that this is likely to have on the price achievable. As this price will reflect the vendor's particular circumstances, it will be an assessment of *worth* rather than a valuation.

**2.4** A common misconception is that in a poor or falling market there are few 'willing sellers' and that, as a consequence, most transactions in the market are the result of 'forced sales'. Accordingly, the valuer may be asked to provide forced sale advice on this basis. However, this argument has little merit because it suggests that the valuer should ignore the evidence of what is happening in the market. The commentary for *market value* in VS 3.2 makes clear that a willing seller is motivated to sell at the best terms available in the market after proper marketing, whatever that price may be. The valuer should be careful not to accept instructions on this basis and should explain to the client that, in absence of a defined constraint affecting either the property or the vendor, the appropriate basis is *market value*.

**2.5** In a depressed market a significant proportion of sales may be made by vendors that are obliged to sell, such as liquidators and receivers. However, such vendors are normally under a duty to obtain the best price in the current circumstances and cannot impose unreasonable marketing conditions or constraints of their own volition. These sales will normally comply with the definition of *market value*.

## 3 Damaged property

**3.1** Where a property has been damaged the *special assumptions* may include:

- treating the property as having been reinstated (reflecting any insurance claims);
- valuing as a cleared site with development permission assumed for the existing use; or
- refurbishment or redevelopment for a different use reflecting the prospects of obtaining the necessary development permissions.

## 4 Trade related property

**4.1** In the case of a *trade related property* (see GN 2) the *special assumptions* may include that:

- accounts or records of trade would not be available to, or relied upon, by a prospective purchaser;
- the business is open for trade when it is not, or is closed when it is actually trading from the property;
- the inventory has been removed, or is assumed to be in place when it is not;
- the licenses, consents, certificates and/or permits required in order to trade from the property are lost or are in jeopardy;
- the business will continue to trade on its present terms, including any ties to the landlord for supply of liquor, gaming machines or other goods and services; or
- the valuation reflects the least cost to replace all elements of the service potential of the property to the owner of the interest being valued, which may include the margin gained from tied wholesale supplies of goods or the supply of services.



## 5 General points

**5.1** The treatment of alterations and improvements carried out under the terms of a lease may warrant the adoption of a *special assumption*.

**5.2** The adoption of some of these *special assumptions* may qualify the application of *market value*. They are often particularly appropriate where the client is a lender and *special assumptions* are used to illustrate the potential effect of changed circumstances on the value of a property as a security.

**5.3** Where valuations are prepared for *financial statements* the normal *basis of value* will exclude any additional value attributable to *special assumptions*. However, if such a *special assumption* is made, this must be referred to in any published reference. (See VS 6.13.)

# Appendix 5 Valuations for commercial secured lending



## 1 Introduction

**1.1** This appendix is applicable where the valuer is to provide services for a client that is considering whether to lend or extend commercial loan facilities on the security of land or buildings. It does not apply to the valuation of individual residential units, either for owner occupation or for letting as an investment, where simplified procedures may apply. Although this appendix refers to land and buildings, the underlying principles can be adopted for secured lending valuations of other asset types.

**1.2** The following are the most common examples of security where a valuer's advice is likely to be sought:

- property that is, or will be, owner-occupied;
- property that is, or will be, held as an investment;
- property that is fully equipped as a trading entity and valued with regard to trading potential; and
- property that is, or is intended to be, the subject of development or refurbishment.

Each example is discussed further in paragraph 5 of this appendix.

**1.3** This appendix deals with the following matters that are specific to valuations for secured lending:

- taking instructions and disclosures;
- objectivity and conflicts of interest;
- *basis of value* and *special assumptions*; and
- reporting and disclosures.

**1.4** There is wide variety of property offered as a security and a range of lending products available, and so each case will require a slightly different approach. It is therefore open to the valuer and lender to agree variations, subject to VS 1.2.3 to VS 1.2.6. The overriding objective is that the valuer should understand the lender's needs and objectives, and the lender should understand the advice that is given.

**1.5** Where a financial institution has a valuation department that provides valuation advice as an *internal valuer*, this appendix will not be of mandatory application (see VS 1.1). However, it is considered good practice to adopt the principles where

appropriate. If the valuation advice is intended to be provided to a *third party* this appendix will apply.

## 2 Taking instructions and disclosures

**2.1** The *terms of engagement* must incorporate the minimum requirements of VS 2.1, Confirmation of the terms of engagement. Where the lender has additional or alternative requirements, they will need to be confirmed and particular care must be taken to agree and record any *special assumptions* that have to be made.

**2.2** In some circumstances a valuation for secured lending may be commissioned by a party that is not the intended lender, for example, a prospective borrower or broker. If the party does not know, or is unwilling to disclose, the identity of the intended lender, it must be stated in the *terms of engagement* that the valuation may not be acceptable to a lender. This may be because some lenders do not accept that a valuation procured by a borrower or an agent is sufficiently independent, or because that particular lender has specific reporting requirements.

**2.3** The valuer should enquire if there has been a recent transaction or a provisionally agreed price on any of the properties to be valued. If such information is revealed, further enquiries should be made, for example, the extent to which the property was marketed, the effect of any incentives, the price realised or agreed and whether it was the best price obtainable.

**2.4** The valuer must ensure that all the relevant disclosures required by the instructions, in compliance with VS 2.1 and the following section, are made.

## 3 Objectivity and conflicts of interest

**3.1** Under the RICS Rules of Conduct 'members shall at all times act with integrity, independence and objectivity, and avoid conflicts of interest and any actions or situations that are inconsistent with their professional obligations' (see VS 1.1). In the RICS regulation guidance it is noted that 'members should declare any potential conflicts of interest, personal or professional, to all relevant parties'.

**3.2** Valuers who comply with the general provisions for independence and objectivity under VS 1.7, as well as any additional criteria for independence under VS 1.8, may confirm that they are acting as 'independent valuers'.

**3.3** The lender may specify additional criteria for independence for a valuation for secured lending. In the absence of any specification, the additional criteria shall be deemed to include a stipulation that the valuer has had no previous, current or anticipated involvement with the borrower, or prospective borrower, the property to be valued or any other party connected with a transaction for which the lending is required. 'Previous involvement' would normally be anything within the past two years, but under certain circumstances it could be longer.

**3.4** Any previous, current or anticipated involvement with the borrower or the property to be valued must be disclosed to the lender. (References to 'borrower'

include a prospective borrower or any other party connected with the transaction for which the lending is required.) Examples of such involvement that may result in a conflict of interest include situations where the valuer or *firm*:

- has a long-standing professional relationship with the borrower or the owner of the property;
- is introducing the transaction to the lender or the borrower, for which a fee is payable to the valuer or *firm*;
- has a financial interest in the property or in the borrower;
- is acting for the owner of the property in a related transaction;
- is acting (or has acted) for the borrower on the purchase of the property;
- is retained to act in the disposal or letting of a completed development on the subject property;
- has recently acted in a market transaction involving the property;
- has provided fee earning professional advice on the property to current or previous owners or their lenders; and/or
- is providing development consultancy for the current or previous owners.



**3.5** The valuer must consider whether any previous, current or anticipated involvement with either the property or related parties is sufficient to create a conflict with the valuer's duty to be independent and objective. Matters such as the quantum of any financial interest in a connected party, the scope for the valuer or *firm* to benefit materially from a particular valuation outcome and the level of fees earned from any connected party as a proportion of total fee income may all be material.

**3.6** If the valuer considers that any involvement creates an unavoidable conflict with his or her duty to the potential client, the instruction should be declined.

**3.7** If the client considers that any disclosed involvement does create a conflict, the valuer should decline the instruction. If the valuer and the client agree that any potential conflict can be avoided by introducing arrangements for managing the instruction, those arrangements must be recorded in writing, included in the *terms of engagement* and referred to in the report.

**3.8** Although a valuer may take into account the views of the prospective client in deciding whether a recent, current or anticipated involvement creates a conflict, it remains the valuer's professional responsibility to decide whether or not to accept the instruction having regard to the principles of the RICS Rules of Conduct. If the instruction is accepted where material involvement has been disclosed, the valuer may be required to justify this decision to RICS. If a satisfactory justification is not provided, RICS may take disciplinary measures.

**3.9** General guidance on conflicts of interest can be found in Appendix 1.

## 4 Basis of value and special assumptions

**4.1** *Market value* is the appropriate *basis of value* that should be used for all valuations or appraisals undertaken for secured lending.

**4.2** Any *special assumptions* (see VS 2.2) made in arriving at the *market value* must be agreed in writing with the lender in advance and referred to in the report.

**4.3** Circumstances that often arise in valuations for secured lending where *special assumptions* may be appropriate include the following examples:

- planning consent has been granted for development at the property;
- there has been a physical change to the property, for example, new construction or refurbishment;
- a new letting on given terms, or the settlement of a rent review at a specific rent, has been completed;
- there is a *special purchaser*, which may include the borrower;
- a constraint that could prevent the property being either brought or adequately exposed to the market is to be ignored;
- a new economic or environmental designation has taken effect;
- any contamination or other environmental hazards are to be ignored; and
- any unusual volatility in the market as at the *valuation date* is to be discounted.

This list is not exhaustive, and the appropriate *special assumptions* will depend on the circumstances under which the valuation is requested and the nature of the property to be valued.



## 5 Reporting and disclosures

**5.1** In addition to the matters set out in VS 6.1, Minimum content of valuation reports, the report must include the following:

- disclosure of any involvement (see paragraph 3) identified in the *terms of engagement* that has subsequently been discovered, or any arrangements agreed for avoiding a conflict of interest. If the valuer has had no involvement, a statement to that effect is to be made;
- the valuation methodology adopted, supported (where appropriate or requested) with the calculation used;
- where a recent transaction on the property has occurred or a provisionally agreed price has been disclosed, the extent to which that information has been accepted as evidence of *market value*. Where the enquiry made under paragraph 2.3 does not reveal any information, the valuer will make a statement to that effect in the report, accompanied by a request that if such information comes to light before the loan is finalised, the matter must be referred back to the valuer for further consideration;
- comment on the suitability of the property as security for mortgage purposes, bearing in mind the length and terms of the loan being contemplated. Where the terms are not known, the comment can relate to assumed normal lending terms;
- any circumstances of which the valuer is aware that could affect the price. These must also be drawn to the attention of the lender, and an indication of their effect must be provided; and

- any other factor that potentially conflicts with the definition of *market value* or its underlying *assumptions*. As set out in the supporting commentary in VS 3.2, this must be noted and its effect explained.

**5.2** Other matters that may be referred to and commented on in the report, subject to the exact circumstances of the proposed loan and the detailed requirements of the lender, include:

- potential and demand for alternative uses, or any foreseeable changes in the current mode or category of occupation;
- the potential occupational demand for the property;
- disrepair, or whether any deleterious or harmful materials have been noted;
- contamination or environmental hazards noted;
- past, current and future trends, and any volatility in the local market and/or demand for the category of property;
- the current marketability of the interest and whether it is likely to be sustainable over the life of the loan;
- details of any significant comparable transactions relied upon and their relevance to the valuation;
- comment on any environmental or economic designation;
- any other matter revealed during normal enquiries that might have a material effect on the value currently reported; and
- if the property is, or is intended to be, the subject of development or refurbishment for residential purposes, the impact of giving incentives to purchasers.

**5.3** The following paragraphs indicate matters that it may be appropriate to include when valuing different categories of property, as listed in paragraph 1.2.

## *Property that is, or will be, owner-occupied*

**5.4** Typical *special assumptions* that may arise when valuing this category of property include the following:

- planning consent has been, or will be, granted for development, including a change of use of the property;
- a building or other proposed development has been completed in accordance with a defined plan and specification;
- all necessary licences are in place;
- the property has been changed in a defined way (for example, removal of equipment or fixtures); and
- the property is vacant when, in reality, at the *valuation date* it is occupied.

## *Property that is, or will be, held as an investment*

**5.5** Additional report contents include:

- a summary of occupational leases, indicating whether the leases have been read or not, and the source of any information relied on;

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- a statement of, and commentary on, current rental income, and comparison with current market rental value. Where the property comprises a number of different units that can be let individually, separate information should be provided on each;
- an *assumption* as to covenant strength where there is no information readily available, or comment on the market's view of the quality, suitability and strength of the tenant's covenant;
- comment on sustainability of income over the life of the loan, with particular reference to lease breaks or determinations and anticipated market trends; and
- comment on any potential for redevelopment or refurbishment at the end of the occupational lease(s).



**5.6** Typical *special assumptions* that may arise in valuing this category of property include whether:

- a different rent has been agreed or determined, for example, after a rent review;
- any existing leases have been determined, and the property is vacant and to let; or
- a proposed lease on specified terms has been completed.

## *Property that is fully equipped as a trading entity and valued with regard to trading potential*

**5.7** The closure of the business could have a significant impact on the *market value*. The valuer should therefore report on this impact, either individually or as a combination of one or more of the following *special assumptions*:

- the business has been closed and the property is vacant;
- the trade inventory has been depleted or removed;
- the licences, consents, certificates and/or permits have been lost or are in jeopardy; and/or
- accounts and records of trade are not available to a prospective purchaser.

**5.8** Typical *special assumptions* that may arise in valuing this category of property include:

- *assumptions* made on the trading performance; and
- projections of trading performance that materially differ from current market expectations.

## *Property that is, or is intended to be, the subject of development or refurbishment*

**5.9** Additional report contents include:

- comment on costs and contract procurement;
- comment on the viability of the proposed project;
- if the valuation is based on a residual method, an illustration of the sensitivity of the valuation to any *assumptions* made; and
- the implications on value of any cost overruns or contract delays.

**5.10** Typical *special assumptions* that may arise in valuing this category of property include whether:

- the works described had been completed in a good and workmanlike manner, in accordance with all appropriate statutory requirements;
- the completed development had been let, or sold, on defined terms; or
- a prior agreed sale or letting has failed to complete.

Where a valuation is required on the *special assumption* that the work had been completed, the value reported should be on the market conditions current at the *valuation date* rather than a projection or a valuation forecast of the likely value at the end of the development period.

**5.11** It is good practice to refer and attach any instruction letter and the *terms of engagement* to the report.

# Appendix 6 Minimum contents of valuation reports



## 1 Introduction

**1.1** This table provides further information on the minimum matters to be included in valuation reports as set out in VS 6.1. Additional contents may be specified by any *valuation standard* that applies to either a specific valuation purpose or type of property. The headings in the first column of this table are the same as those listed in VS 6.1.

**1.2** Although there is not a direct correlation with the list in IVS 103, the table below includes all the reporting requirements in that standard. For a detailed comparison between the standards, see Appendix 9.

| Item | Comment |
|---|---|
| (a) Identification of the client and any other intended users | The report must be addressed to the client or its representatives. The source of the instructions and the identity of the client must be stated, if different from the addressee. Other known users of the report are to be named (see also (o)). |
| (b) The purpose of the valuation | The purpose of the valuation must be stated clearly and unambiguously. Where the purpose is not disclosed the report must include an appropriate statement. |
| (c) The subject of the valuation | Where the valuation includes a separate valuation for plant and equipment this may also be included in a schedule, which should identify the items as agreed with the client (see GN 5). Where a number of assets are valued it may be convenient to list them in a schedule that identifies each unit of valuation (see also VS 6.9). Where the asset is identified as a portfolio, see GN 3. |
| (d) The interest to be valued | The legal interest in each asset or liability should be stated. Where the asset is a property, the extent to which vacant possession is, or may be, available (if required) should also be noted. |
| (e) The type of asset or liability and how it is used or classified by the client | For some purposes the uses, categories or classes of asset or liability will have been agreed with the client. Where formal agreement is not required it is recommended that the report contain a brief description of these matters (see Appendix 2(e) and GN 3). |

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| (f) The *basis*, or *bases*, *of value* | The *basis*, or *bases*, *of value* must be stated (see VS 6.1 and VS 6.3) and the definition must be provided in full.<br><br>Where the *basis of value* is *fair value*, care must be taken to set out the correct definition from the two available (see VS 3.5).<br><br>A *depreciated replacement cost* valuation for inclusion in a *financial statement* must be expressed as being subject to the test of adequate profitability (private sector, VS 6.5), or continuing viability or occupation (public sector, VS 6.6).<br><br>Where the report includes a valuation using *depreciated replacement cost* or where the value for an alternative use on cessation of the business is materially different, a statement to this effect must be included in the report (see VS 6.7). |
| (g) The *valuation date* | The *valuation date* (see VS 3.2 and IVS Framework, paragraph 31(c)) must be stated. This may be different from the date on which the valuation report is to be issued or the investigations are to be undertaken or completed. Where relevant, these dates need to be clearly distinguished in the report.<br><br>Where a valuation is prospective, any limitations on use of the valuation and the conditions and *assumptions* that applied in developing the opinion must be clearly set out. |
| (h) Disclosure of any material involvement, or a statement that there has not been any previous material involvement | Any disclosures or statement made in accordance with VS 2.1(h) must be repeated in the report. (See also Appendix 1 relating to the resolution of conflicts of interest.) |
| (i) The identity of the valuer responsible for the valuation and, if required, a statement of the status of the valuer | A valuation is the responsibility of an individual valuer. RICS does not allow a valuation to be prepared by a 'firm' as stated in IVS 103(a), although the use of 'for and on behalf of' is an acceptable substitution.<br><br>Where it is a requirement, the valuer will state if he or she is acting as an *internal* or *external valuer*. Where other criteria have been adopted they must be confirmed, together with a statement that the valuer meets them.<br><br>In some countries the national association *valuation standards* may require additional disclosures to be made with regard to the status of the valuer. |
| (j) Where appropriate, the currency to be adopted | If some valuations have been translated into a currency other than that of the country in which the property is located, the exchange rate adopted and its source is to be noted (see VS 6.9). |

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| (k) Any *assumptions*, *special assumptions*, reservations, special instructions or *departures* | All *assumptions* made must be stated, together with any reservations that may be required (see Appendix 3). Where the *assumptions* vary in different states the report must make this clear.<br><br>*Special assumptions* must also be clearly stated (see VS 2.2).<br><br>Where the valuation is undertaken on the basis of restricted information, or is a revaluation without an *inspection*, the report must include full particulars of the restriction (see VS 2.4 and VS 2.5).<br><br>Any *departures* from the standards must be stated and explained (see VS 1.2).<br><br>A statement must be made as to whether or not any allowance has been made for liability for taxation, whether actual or notional, that may arise on disposal and whether or not the valuation reflects costs of acquisition or realisation. In some countries VAT or similar taxes, acquisition, and sale costs can be substantial.<br><br>Where statements rely upon the prospect of future growth in rental and/or capital values, a statement must be made to the effect that such growth may not occur, and that values can fall as well as rise. |
| (l) The extent of the valuer's investigations | The report must record the date and extent of any *inspection*, including reference to any part of the property to which access was not possible (see VS 5.1).<br><br>The valuer must make it clear if the valuation has been made without an opportunity to carry out an adequate *inspection* (see VS 2.4).<br><br>In the case of a revaluation, the report should refer to any agreement that further *inspections* are unnecessary (see VS 2.5).<br><br>Where a substantial number of properties are being valued, a generalised statement of these aspects is acceptable, provided that it is not misleading. |
| (m) The nature and source of the information to be relied on by the valuer | The valuer must make it clear if the valuation has been carried out without the information normally available. The valuer must indicate in the report if verification (where practicable) is needed of any information or *assumptions* on which the valuation is based, or if any information considered material has not been provided.<br><br>If any such information or *assumption* is material to the amount of the valuation, the valuer must make clear that the valuation should not be relied on, pending verification (see VS 5.2). In the case of a revaluation, a statement of any material changes advised by the client, or a stated *assumption* that there have been no material changes, should be included. |

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| | The report should state any additional information that has been available to, or established by, the valuer, and is believed to be crucial to the client's ability to understand and benefit from the valuation, with regard to the purpose for which it has been prepared. |
| (n) Any consent to, or restrictions on, publication | Where a statement for inclusion in a publication is required, this should be provided as a separate document, which may be annexed to the report (see VS 6.12).<br><br>Where the valuer has either provided a valuation on the basis of a *special assumption*, or has made a *departure* from any of the *valuation standards*, a statement must be included that no reference is to be made to the report in any published document without an adequate contemporaneous reference to the *special assumption* or *departure* (see VS 6.13). |
| (o) Any limits or exclusion of liability to parties other than the client | For some purposes valuers may be unable to exclude liability to *third parties* (see Appendix 2(o)).<br><br>Any limitation on disclosure of a valuation based on restricted information or instructions should be included (see VS 2.4). |
| (p) Confirmation that the valuation will be undertaken in accordance with these standards and that it also complies with the IVS, where appropriate | This statement must be unequivocal, but may include a cross-reference to any agreed *departures* referred to under item (k). This confirmation will include any statement required under VS 1.2.2. Statements concerning valuations by other valuers that have been included in the report should also be referred to (see VS 6.10).<br><br>Where necessary, a statement should be made that RICS considers that a valuation complying with these standards also complies with the IVS. Appendix 9 provides a comparison between the two sets of standards, should it be necessary to confirm compliance with a specific IVS. |
| (q) A statement of the valuation approach and reasoning | To understand the valuation figure in context, the report must make reference to the approach(es) adopted, the key inputs used and the principal reasons for the conclusions reached. This requirement does not apply if it has been specifically agreed and recorded in the *terms of engagement* that a valuation report will be provided without reasons or other supporting information. |
| (r) A statement that the valuer has the knowledge, skills and understanding to undertake the valuation competently | This statement may be limited to a confirmation that the valuer has sufficient current local, national and international (as appropriate) knowledge of the particular market, and the skills and understanding to undertake the valuation competently. Where more than one valuer within a *firm* has contributed, confirmation that VS 1.6.4 has been satisfied is needed, though it is not necessary to provide any details. Where VS 6.10 applies an appropriate disclosure must be made. |

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| (s) The opinions of value in figures and words | In the main body of the report the opinion of value is required in words, as well as in figures.<br><br>Where the valuation instruction includes a number of properties falling into different categories, it would normally be inappropriate to produce an aggregate valuation of the whole, although this will depend upon the purpose for which the valuation is required.<br><br>If the identification of individual properties and their values is consigned to a schedule(s) appended to the report, a summary of values must be included within the body of the report. If there has been a material change in market conditions, or in the circumstances of a property or portfolio, between the *valuation date* (where this is earlier than the *date of the report*) and the date of report, the valuer should draw attention to this. It may also be prudent for the valuer to draw the client's attention to the fact that values change over time and a valuation given on a particular date may not be valid on an earlier or later date.<br><br>'Negative values' must be stated separately and not set off against the positive values of assets (see VS 6.8).<br><br>Where it is appropriate to refer to valuation uncertainty the guidance in GN 1 and the RICS user guide, *Reflecting uncertainty in valuations for investment purposes* (2011), may relevant. |
| (t) Signature and *date of the report* | The report must be signed by the person who accepts responsibility for it (see VS 1.5).<br><br>A valuation is the responsibility of an individual valuer. RICS does not allow a valuation to be prepared by a 'firm' as stated in IVS 103(a). However, the use of 'for and on behalf of' is an acceptable substitution. |

# Appendix 7 Examples of published references to valuation reports



## 1 Introduction

**1.1** The following are examples of the typical degree of detail required for valuation reports and are intended to be illustrative only. The valuer must have due regard to the requirements of VS 6.12 on publication statements and Appendix 6.1(n), and produce a statement that reflects the scope and nature of the property valued.

## 2 Valuations by an external valuer

### *Valuation under IFRS*

**2.1** The company's freehold and leasehold properties were valued on 31 December 2011 by an *external valuer*, Joe Smith, FRICS of Alpha Chartered Surveyors. The valuations were in accordance with the requirements of the *RICS Valuation Standards*, 7th edition (or the current edition at the *valuation date*), and the *International Valuation Standards*. The valuation of each property was on the basis of *market value*, subject to the following *assumptions* (include as appropriate):

- **for owner-occupied property**: the property would be sold as part of the continuing business;
- **for *investment property***: the property would be sold subject to any existing leases; or
- **for surplus property and property held for development**: the property would be sold with vacant possession in its existing condition.

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

- comparable recent market transactions on arm's length terms;
- the *depreciated replacement cost* approach, because the specialised nature of the asset means that there are no market transactions of this type of asset except as part of the business or entity; or
- using an estimate of the future potential net income generated by use of the property, because its specialised nature means that there is no market based evidence available.

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

**2.4** A statement regarding disclosures should be made in accordance with VS 1.9.

## 3 Valuations by an internal valuer



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

> The company's freehold and leasehold properties were valued by an internal valuer, Joe Smith FRICS, the company's chief estates surveyor, as at 31 December 2011.
>
> The company's freehold and leasehold properties were valued as at 31 December 2011, by the directors, in conjunction with the company's own professionally qualified staff.

**3.2** Where appropriate, the following additional statement may be required:

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

# Appendix 8
# European Mortgage Federation paper on mortgage lending value



## 1 Introduction

**1.1** This appendix, which is the text of an explanatory note prepared by the European Mortgage Federation, is provided for information only. RICS has no responsibility for the contents, and the paper is neither mandatory nor approved guidance.

**Mortgage Lending Value**

1. Mortgage Lending Value may be used by the financial services industry in the activity of lending secured by real estate. The Mortgage Lending Value provides a long-term sustainable value limit, which guides internal banking decisions in the credit decision process (e.g. loan-to-value, amortisation structure, loan duration) or in risk management.
2. Mortgage Lending Value facilitates the assessment of whether a mortgaged property provides sufficient collateral to secure a loan over a long period. Given that Mortgage Lending Value is intended to estimate property value for a long period of time, it cannot be grouped together with other valuation approaches used to estimate Market Value on a fixed date.
3. Additionally, Mortgage Lending Value can be used as a risk management instrument in a number of ways in the context of:
   - capital requirements for credit institutions as detailed in Basel I and II;
   - funding of mortgage loans through covered bonds secured by real estate as the cover assets;
   - the development of capital market products converting real estate and real estate collateral into tradable assets (e.g. mortgage backed securities).
4. The concept of Mortgage Lending Value is defined in detail by legislation, Directives and additional country specific regulations.
5. Mortgage Lending Value shall mean the value of the property as determined by a valuer making a prudent assessment of the future marketability of the property by taking into account the long-term sustainable aspects of the property, the normal and local market conditions, as well as the current use and alternative possible uses of the property. Speculative elements should not be taken into account in the assessment of Mortgage Lending Value. Mortgage Lending Value should be documented in a clear and transparent way.

6. All internationally recognised valuation methods also apply to the Mortgage Lending Value, subject to the type of property and the market specificities (historic, legal, etc.) where the property is located. These are:
   - comparison method;
   - income method;
   - depreciated replacement cost method.
7. Regarding the technical transposition of the definition mentioned above, the long-term validity of Mortgage Lending Value requires compliance with a certain number of steps aimed at eliminating short-term market volatility or temporary market trends. The valuer must address the following key issues when determining the Mortgage Lending Value of a property:
   - The future marketability and saleability of the property has to be assessed carefully and prudently. The underlying time perspective goes beyond the short-term market and covers a long-term period.
   - As a principle, the long-term sustainable aspects of the property such as the quality of the location, construction and allocation of areas must be taken into account.
   - As far as the sustainable yield to be applied is concerned, the rental income must be calculated based on past and current long-term market trends. Any uncertain elements of possible future yield increases should not be taken into account.
   - The application of capitalisation rates is also based on long-term market trends and excludes all short-term expectations regarding the return on investment.
   - The valuer must apply minimum depreciation rates for administration costs and capitalisation of rents.
   - If the Mortgage Lending Value is derived using comparison values or depreciated replacement costs, the sustainability of the comparative values needs to be taken into account through the application of appropriate discounts where necessary.
   - The Mortgage Lending Value is generally based on the current use of the property. The Mortgage Lending Value shall only be calculated on the basis of a better alternative use, under certain circumstances, i.e. if there is a proven intention to renovate or change the use of the property.
   - Further requirements, for example with respect to compliance with national standards, transparency, content and comprehensibility of the valuation complement the legal framework for the calculation of Mortgage Lending Value.
8. There are important differences between Market Value and Mortgage Lending Value: Market Value is internationally recognised for the assessment of the value of a property at a given moment in time. It estimates the price that could be obtained for a property at the date of valuation, notwithstanding that this value could alter very rapidly and no

longer be up-to-date. In contrast, the purpose of Mortgage Lending Value is to provide a long-term sustainable value, which evaluates the suitability of a property as a security for a mortgage loan independently from future market fluctuations and on a more stable basis. It provides a figure, usually below Market Value and therefore, able to absorb short-term market fluctuations whilst at the same time accurately reflecting the underlying long-term trend in the market.

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# Appendix 9 Comparison between RICS Valuation – Professional Standards and the IVS

## 1 Introduction

**1.1** The IVS issued as at 1 January 2012 is included in both hard copies and in the electronic versions of *RICS Valuation – Professional Standards*.

**1.2** IVS comprises:

- IVS Definitions
- IVS Framework
- General Standards
  - IVS 101 Scope of Work
  - IVS 102 Implementation
  - IVS 103 Reporting
- Asset Standards
  - IVS 200 Businesses and Business Interests
  - IVS 210 Intangible Assets
  - IVS 220 Plant and Equipment
  - IVS 230 Real Property Interests
  - IVS 233 Investment Property under Construction
  - IVS 250 Financial Instruments

**1.3** This table is a detailed comparison between the IVS and this edition of the RICS standards.

| The IVS | Red Book equivalent and comment |
|---|---|
| **IVS Definitions** | Where the Glossary includes terms that are defined in the IVS, the IVS wording has been adopted. |
| **The IVS Framework** | There is no direct equivalent of the IVS Framework in these standards, as most of the terms described are incorporated into various locations. See the comment in VS 1.2.2 for further details. |

| **The IVS Framework** Valuation and Judgement | There is no specific reference, but the principles are reflected in VS 1 generally. |
|---|---|
| Independence and Objectivity | VS 1.7 to VS 1.9 cover these terms in more detail. |
| Competence | VS 1.5 and VS 1.6 cover this term in more detail. |
| Price Cost and Value | No specific reference is given. |
| The Market | No specific reference is given. |
| Market Activity | No specific reference is given. |
| Market Participants | No specific reference is given. |
| Entity Specific Factors | No specific reference but the principle is reflected in various commentaries and appendices. |
| Aggregation | The principles are reflected in a revision to Appendix 2.2.1(c). |
| Basis of Value | VS 3.1 incorporates paragraphs 26–28 of the framework. |
| Market Value | VS 3.2 incorporates paragraphs 30–35 of the framework. |
| Transaction Costs | VS 3.2 covers this term in more detail. |
| Investment Value | VS 3.4 covers this term in more detail. |
| Fair Value | VS 3.5 covers this term in more detail. |
| Special Value | VS 3.2 incorporates paragraphs 44–47 of the framework. |
| Synergistic Value | VS 3.2 incorporates paragraph 48 of the framework. |
| Assumptions | Appendix 3, VS 2.2 and Appendix 4 covers this term in more detail. |
| Forced Sales | VS 2.3 and Appendix 4, paragraphs 2.2 to 2.4, cover this term in more detail. |
| Valuation Approaches | No specific reference is given. |
| Market Approach | The definition is included in the Glossary. |
| Income Approach | The definition is included in the Glossary. |
| Cost Approach | The definition is included in the Glossary. |
| Methods of Application | No specific reference is given. |
| Valuation Inputs | No specific reference is given. |

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| **General Standards** | There is no direct equivalent of this general heading. |
| **IVS 101 Scope of Work** | VS 2 and Appendix 2 include all the material within this standard. To ensure consistency between the IVS and RICS standards, any changes made to the RICS standards are noted in this part of the table. |
| (a) Identification and status of the valuer | (i) VS 2.1(i) covers this in more detail and has been revised to make reference to the identity of the valuer.<br>(ii) VS 2.1(h) and VS 1.7 cover this in more detail.<br>(iii) VS 1.7 to VS 1.9 cover this in more detail.<br>(iv) VS 1.6 and VS 2.1(q) cover this in more detail. It should be noted that RICS does not allow a valuer to be 'an individual firm' as indicated in paragraph 2(a)–(i) of IVS 101. |
| (b) Identification of the client and any other intended users | VS 2.1(a) covers this in more detail. |
| (c) Purpose of the valuation | VS 2.1(b) covers this in more detail. |
| (d) Identification of the asset or liability to be valued | VS 2.1(c)–(d) and Appendix 2 cover this in more detail. Minor changes have been made so that the commentary in the appendix refers to 'asset' rather than 'property', where appropriate |
| (e) Basis of value | VS 2.1(f) covers this in more detail. |
| (f) Valuation date | VS 2.1(g) covers this in more detail. |
| (g) Extent of investigation | VS 2.1(l), VS 5.1 and VS 5.2 cover this in more detail. |
| (h) Nature and source of information to be relied upon | VS 2.1(m) and VS 2.4 cover this in more detail. |
| (i) Assumptions and special assumptions | VS 2.1 (k), Appendix 3 and Appendix 4 cover these in more detail. |
| (j) Restrictions on use, distribution or publication | VS 2.1(n)–(o) cover this in more detail. |
| (k) Confirmation that the valuation will be undertaken in accordance with the IVS | VS 2.1(p) covers this in more detail. Where the valuation must comply with the IVS, a statement should be made indicating that compliance with the RICS standards also complies with IVS. |
| (l) Description of report | VS 6.1.2 and VS 6.2 cover this in more detail. |
| **IVS 102 Implementation** | There is no direct equivalent of this general heading. |
| Investigations | VS 5 covers this in more detail. |

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| Valuation approaches | This principle for these is reflected in Appendix 6.1.1(q). |
| Valuation record | VS 5.1.8 covers this in more detail. |
| **IVS 103 Reporting** | VS 6 and Appendix 6, reporting, includes all the material within this standard. To ensure consistency between the standards any changes made to the RICS standards are noted in this part of the table. |
| (a) Identification and status of the valuer | VS 6.1(h), (i), (p) and (r) cover this in more detail. |
| (b) Identification of the client and any other intended users | VS 6.1(a) covers this in more detail. |
| (c) Purpose of the valuation | VS 6.1(b) covers this in more detail. |
| (d) Identification of the asset or liability to be valued | VS 6.1(c)–(e) cover this in more detail. |
| (e) Basis of value | VS 6.1(f) and VS 6.3 cover this in more detail. |
| (f) Valuation date | VS 6.1(g) covers this in more detail. |
| (g) Extent of investigation | VS 6.1(l) covers this in more detail. |
| (h) Nature and source of information to be relied upon | VS 6.1(m) covers this in more detail. |
| (i) Assumptions and special assumptions | VS 6.1(k) and VS 6.4 cover this in more detail. |
| (j) Restrictions on use, distribution or publication | VS 6.1(n)–(o) cover this in more detail. |
| (k) Confirmation that the valuation will be undertaken in accordance with the IVS | VS 6.1(p) covers this in more detail. |
| (l) Valuation approach and reasoning | VS 6.1(q) covers this in more detail. |
| (m) Amount of the valuation or valuations | VS 6.1(s) covers this in more detail. |
| (n) Date of the valuation report | VS 6.1(t) covers this in more detail. |
| Post valuation date events | Appendix 6, section 1(s), covers this in more detail. |
| **Asset Standards** | There is no direct equivalent of this general heading. |
| **IVS 200 Businesses and Business Interests** | This is not referenced in these standards. |
| **IVS 210 Intangible Assets** | This is not referenced in these standards. |

| | |
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| **IVS 220 Plant and Equipment** | GN 5 covers this in more detail. |
| **IVS 230 Real Property Interests** | This is not referenced in these standards. |
| **IVS 233 Investment Property under Construction** | This is not referenced in these standards. |
| **IVS 250 Financial Instruments** | This is not referenced in these standards. |
| **Valuation applications** | There is no direct equivalent of this general heading. |
| **IVS 300 Valuations for Financial Reporting; and Annexe – Valuations of Property, Plant and Equipment in the Public Sector** | VS 4.1 and VS 4.3 cover these in further detail. |
| **IVS 310 Valuations of Property Interests for Secured Lending** | VS 4.2 and Appendix 5 cover this in further detail. |

# Guidance notes

# GN 1 Valuation certainty

## 1 Introduction

**1.1** The purpose of this *guidance note* is to encourage best practice in the reporting of valuations, with specific reference to the degree of certainty and risk attached to them.

**1.2** All valuations are professional opinions on a stated basis, coupled with any appropriate *assumptions* or *special assumptions* (see VS 3.1). A valuation is not a fact, it is an estimate. The degree of subjectivity involved will inevitably vary from case to case, as will the degree of certainty, or probability, that the valuer's opinion of *market value* would exactly coincide with the price achieved were there an actual sale at the *valuation date*. Ensuring user understanding and confidence in valuations requires transparency in the valuation approach and adequate explanation of all factors that materially impact the valuation.

**1.3** For some purposes it is often helpful, if not essential, to the understanding of the valuation to include supporting evidence, an explanation of the approach and the market context. It is recognised that such commentary, context and explanation may not be required in all cases. However, valuers should view the provision of such supporting advice as a means to increase the user's confidence in the valuation.

**1.4** Valuers should not treat a statement expressing less confidence than usual in a valuation as an admission of weakness. Indeed, if a failure to draw attention to material uncertainty gives a client the impression that greater weight could be attached to the opinion than is warranted, the report would be misleading and in breach of VS 6.1.

## 2 Matters that may affect valuation certainty

**2.1** The following list, which is not exhaustive, provides some examples of issues that may have a material effect on the degree of certainty and confidence that can be applied to a valuation opinion:

(a) status of the valuer;
(b) inherent uncertainty;
(c) restrictions on enquiries or information provided;
(d) liquidity and market activity; and
(e) market instability.

### (a) Status of the valuer

**2.2** The accuracy and relevance of the judgments required for a valuation depends on the skill and experience of the individual making them. The confidence in those judgments is also reliant on the independence of the valuer. VS 1.5 to VS 1.9 set out the criteria relating to the qualification and independence of the valuer. VS 2.1 and VS 6.1 require a statement to be made that the valuer has sufficient experience and no conflict of interest.

### (b) Inherent uncertainty

**2.3** The property itself may have particular characteristics that make it difficult for the valuer to form an opinion of the likely value. For example, it may be an unusual, or even unique, type of property. Similarly the quantification of significant hope value, either related to potential planning permission or the existence of a *special purchaser*, will be highly dependent on the *assumptions* made.

### (c) Restrictions on enquiries or information provided



**2.4** Where the information available to the valuer is limited or restricted, either by the client or the circumstances of the valuation, less certainty can be attached to the valuation than would otherwise be the case. VS 6.1(m) requires that the sources of information are stated and attention drawn to any limitations.

### (d) Liquidity and market activity

**2.5** In markets that are inactive with low levels of liquidity there is a reduced amount of data to provide empirical support for valuations. In such cases the valuer should be as explicit and transparent as possible to demonstrate the degree to which the conclusion is based on subjectivity. Similarly, in liquid and functioning markets the valuer should state that there is an abundance of empirical data to support the conclusions drawn.

### (e) Market instability

**2.6** Disruption of markets can arise due to unforeseen financial, macro-economic, legal, political or even natural events. If the *valuation date* coincides with, or is in the immediate aftermath of, such an event there may be a reduced level of certainty that can be attached to a valuation, due to inconsistent or absent empirical data, or the valuer being faced with an unprecedented set of circumstances on which to base a judgment. In such situations, demands placed on the valuer can be unusually testing. Although the valuer should still be able to make a judgment, it is important that the context of that judgment is clearly expressed.

## 3 Reporting

**3.1** VS 6.1 requires that the valuation report must not be misleading or create a false impression. The valuer should draw attention to, and comment on, any issues affecting the certainty of the valuation. The extent of that commentary will vary, depending on the purpose of the valuation and the format of the report agreed with the client.

**3.2** Where appropriate, the valuer also should consider including the use of *special assumptions* and sensitivity analysis, and give a full and clear account as to why they are being included:

- **Use of *special assumptions***: Where the valuer can reasonably foresee that different values may arise under different circumstances, the valuer should discuss with the client the provision of alternative valuations using *special assumptions*. However, it is important to note the requirements of VS 2.2, which stipulates that *special assumptions* may only be used if they can be regarded as realistic, relevant and valid in connection with the circumstances of the valuation.
- **Sensitivity analysis**: Where issues are identified that could have a material impact on the certainty attached to the valuation, it may be prudent to provide a sensitivity analysis to illustrate the effect that any changes to these variables could have on the reported valuation.

**3.3** It would not normally be acceptable for a valuation report to have a standard caveat to deal with valuation certainty. The degree to which an opinion is uncertain will be unique to the specific valuation, and the use of standard clauses can devalue or bring into question the authority of the advice given. The task is to produce authoritative and considered professional advice within the report. Issues that affect the degree of certainty should be reported in this context.

**3.4** Unless specifically requested, the expression of values within a stated range is not good practice. In most cases the valuer has to provide a single figure. The use of qualifying words such as 'in the region of' would not normally be appropriate or adequate to convey material uncertainty without further explicit comment. Where different values may arise under different circumstances, it is preferable to provide them as stated *special assumptions*.

**3.5** If a mathematical measure of uncertainty is included in any report, it is essential that the method or model used is adequately explained, with any limitations appropriately highlighted.

# GN 2 Valuation of individual trade related properties

## 1 Introduction

**1.1** Certain properties are valued using the profits method (also known as the *income approach*) of valuation. This *guidance note* sets out the principles of this method of valuation. However, it does not concern itself with the detailed approach to a valuation that may vary according to the property to be valued.

**1.2** This *guidance note* is of global application.

**1.3** This *guidance note* relates only to the valuation of an individual property that is valued on the basis of trading potential. Valuations of businesses will be covered by separate guidance.

**1.4** Certain properties are normally bought and sold on the basis of their trading potential. Examples include hotels, pubs and bars, restaurants, nightclubs, casinos, cinemas and theatres, and various other forms of leisure property. The essential characteristic of this type of property is that it has been designed or adapted for a specific use, and the resulting lack of flexibility usually means that the value of the property interest is intrinsically linked to the returns that an owner can generate from that use. The value therefore reflects the trading potential of the property. It can be contrasted with generic property that can be occupied by a range of different business types, such as standard office, industrial or retail property.

**1.5** Valuers who prepare valuations of *trade related property* usually specialise in this particular market, as knowledge of the operational aspects of the property valuation, and of the industry as a whole, is fundamental to the understanding of market transactions and the analysis required.

**1.6** The use of comparable information may be derived from a wide variety of sources, not just transactional evidence. Also, information may be drawn from different operational entities with regard to the component parts of the profits valuation.

**1.7** The valuer should emphasise within the report that the valuation is assessed having regard to trading potential and should refer to the actual profits achieved. If the trading potential and/or the actual profits vary, there could be a change in the reported value (see GN 1, Valuation certainty).

**1.8** This guidance assumes that the current trade related use of the property will continue. However, where it is clear that the property may have an alternative use that may have a higher value, an appropriate comment should be made in the report. Where such an alternative use value is provided, it should be accompanied

by a statement that the valuation takes no account of the costs of business closure, disruption or any other costs associated with realising this value.

## 2 Terms used in this guidance note

**2.1** The terms used in this *guidance note* may have different meanings when used by other professional disciplines.

### *Adjusted net profit*

**2.2** The valuer's assessment of the actual net profit of a currently trading operational entity. It is the net profit that is shown from the accounts once adjustments for abnormal and non-recurring expenditure, finance costs and depreciation relating to the property itself, as well as rent where appropriate, have been made. It relates to the existing operational entity and gives the valuer guidance when assessing the fair maintainable operating profit (FMOP).

### *Earnings before interest, taxes, depreciation and amortisation (EBITDA)*

**2.3** A term that relates to the actual operating entity and may be different from the valuer's estimated FMOP.

### *Fair maintainable operating profit (FMOP)*

**2.4** The level of profit, stated prior to depreciation and finance costs relating to the asset itself (and rent if leasehold), that the reasonably efficient operator (REO) would expect to derive from the fair maintainable turnover (FMT) based on an assessment of the market's perception of the potential earnings of the property. It should reflect all costs and outgoings of the REO, as well as an appropriate annual allowance for periodic expenditure, such as decoration, refurbishment and renewal of the trade inventory.

### *Fair maintainable turnover (FMT)*

**2.5** The level of trade that an REO would expect to achieve on the *assumption* that the property is properly equipped, repaired, maintained and decorated.

### *Market rent*

**2.6** The estimated amount for which a property would be leased on the *valuation date* between a willing lessor and a willing lessee on appropriate lease terms in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. Whenever *market rent* is provided the 'appropriate lease terms' which it reflects should also be stated.

### *Market value*

**2.7** The estimated amount for which an asset should exchange on the *valuation date* between a willing buyer and a willing seller in an arm's-length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

### *Operational entity*

**2.8** Usually includes:

- the legal interest in the land and buildings;
- the trade inventory, usually comprising all trade fixtures, fittings, furnishings and equipment; and
- the market's perception of the trading potential, together with an assumed ability to obtain/renew existing licences, consents, certificates and permits.

Consumables and stock in trade are normally excluded.

### *Personal goodwill (of the current operator)*

**2.9** The value of profit generated over and above market expectations that would be extinguished upon sale of the *trade related property*, together with financial factors related specifically to the current operator of the business, such as taxation, depreciation policy, borrowing costs and the capital invested in the business.

### *Reasonably efficient operator (REO)*

**2.10** A concept where the valuer assumes that the market participants are competent operators, acting in an efficient manner, of a business conducted on the premises. It involves estimating the trading potential rather than adopting the actual level of trade under the existing ownership, and it excludes personal *goodwill*.

### *Tenant's capital*

**2.11** May include, for example, all consumables, purchase of the inventory, stock and working capital.

### *Trade related property*

**2.12** Any type of *real property* designed for a specific type of business where the property value reflects the trading potential for that business.

### *Trading potential*

**2.13** The future profit, in the context of a valuation of the property, that an REO would expect to be able to realise from occupation of the property. This could be above or below the recent trading history of the property. It reflects a range of factors such as the location, design and character, level of adaptation and trading history of the property within the market conditions prevailing that are inherent to the property asset.

## 3 Profits method of valuation

**3.1** The profits method of valuation involves the following steps:

**Step 1:** An assessment is made of the FMT that could be generated at the property by an REO.

**Step 2:** Where appropriate an assessment is made of the potential gross profit, resulting from the FMT.

**Step 3:** An assessment is made of the FMOP. The costs and allowances to be shown in the assessment should reflect those to be expected of the REO – which will be the most likely purchaser or operator of the property if offered in the market.

**Step 4:**

(a) To assess the *market value* of the property the FMOP is capitalised at an appropriate rate of return reflecting the risk and rewards of the property and its trading potential. Evidence of relevant comparable market transactions should be analysed and applied.

(b) In assessing *market value* the valuer may decide that an incoming new operator would expect to improve the trading potential by undertaking alterations or improvements. This will be implicit within the valuer's estimate of FMT at step 1. In such instances, an appropriate allowance should be made from the figure resulting from step 4 to reflect the costs of completing the alterations or improvements and the delay in achieving FMT. Similarly, if the property is in need of repair and/or decoration to enable the REO to achieve the FMT, then an appropriate allowance should be made from the figure resulting from step 4(a) to reflect the cost of such repairs and decorations.

(c) To assess the *market rent* for a new letting, the rent payable on a rent review or the reasonableness of the actual rent passing (particularly when preparing an investment valuation), an allowance should be made from the FMOP to reflect a return on the tenant's capital invested in the operational entity – for example, the cost of trade inventory, stock and working capital. The resultant sum is referred to as the divisible balance. This is apportioned between the landlord and tenant having regard to the respective risks and rewards, with the landlord's proportion representing the annual rent.

**3.2** Certain extended or more detailed approaches to a profits method of valuation may be appropriate, particularly for some larger or more complex *trade related properties*. Consideration of discounted cash flow assessments and different income-streams may be adopted. Such knowledge will aid in the analysis and review of historic and current trading performance, as well as with forecasts that may show increases or decreases on actual trade. This can assist in forming an opinion of the FMT and FMOP considered achievable by a likely purchaser or REO.

**3.3** It is important that the valuer is regularly involved in the relevant market for the class of property, as practical knowledge of the factors affecting the particular market is required.

**3.4** When preparing a *trade related property* valuation it is essential that the valuer reviews the cumulative result of the different steps of the valuation process. The valuation should be considered having regard to the valuer's general experience and knowledge of the market.

## 4 Valuation special assumptions

**4.1** A *trade related property* will usually be valued to *market value* or *market rent*, but valuers are commonly asked for a valuation subject to *special assumptions*. Typical *special assumptions* are as follows:

(a) on the basis that trade has ceased and no trading records are available to prospective purchasers or tenants;
(b) on the same basis as (a) but also assuming the trade inventory has been removed;
(c) as a fully equipped operational entity that has yet to trade (also known as 'Day One' valuation); and
(d) subject to stated trade projections, assuming they are proven. This is appropriate when considering development of the property.

## 5 Valuation approach for a fully equipped operational entity

**5.1** The valuation of a *trade related property* as a fully equipped operational entity necessarily assumes that the transaction will be either the letting or the sale of the property, together with the trade inventory, licences, etc., required to continue trading.



**5.2** However, care must be taken because this *assumption* does not necessarily mean that all the trade inventory is to be included in the valuation of the property. For example, some equipment may be owned by *third parties* and therefore would not form part of the interest being valued. Any *assumption* made about the trade inventory included in the valuation should be clearly set out in the report.

**5.3** There may be tangible assets that are essential to the running of the operational entity and are either owned separately from the land and buildings, or subject to separate finance leases or charges. In such cases, an *assumption* may need to be made that the owners or beneficiaries of any charge would consent to the transfer of the assets as part of a sale of the operational entity. If it is not certain that such an *assumption* can be made, the valuer must consider carefully the potential impact on the valuation that the lack of availability of those assets would have to anyone purchasing or leasing the operational entity and comment accordingly in the report.

**5.4** When *trade related properties* are sold or let as fully equipped operational entities, the purchaser or operator normally needs to renew licences or other statutory consents and take over the benefit of existing certificates and permits. If the valuer is making any different *assumption*, it should be clearly stated as a *special assumption*.

**5.5** Where it is not possible to inspect the licences, consents, certificates and permits relating to the property, or other information cannot be verified, the *assumptions* made should be identified in the report, together with a recommendation that their existence should be verified by the client's legal advisers.

### *Assessing the trading potential*

**5.6** There is a distinction between the *market value* of a *trade related property* and the value – or its *worth* – to the particular operator. The operator will derive *worth* from the current and potential net profits from the operational entity operating in the

chosen format. While the present operator may be one potential bidder in the market, the valuer will need to understand the requirements and achievable profits of other potential bidders, along with the dynamics of the open market, to come to an opinion of value for that particular property.

**5.7** A *trade related property* is considered to be an individual trading entity and is typically valued on the *assumption* that there will be a continuation of trading.

**5.8** When assessing future trading potential, the valuer should exclude any turnover and costs that are attributable solely to the personal circumstances, or skill, expertise, reputation and/or brand name of the existing operator. However, the valuer should reflect additional trading potential that might be realised by an REO taking over the property at the *valuation date*.

**5.9** The actual trading performance should be compared with similar types of *trade related property* and styles of operation. Therefore a proper understanding of the profit potential of those property types and how they compare with one another is essential. A *trade related property* valuer should test, by reference to market transactions and similar *trade related properties*, whether the present trade represents the FMT in current market conditions. When available, the actual trading accounts of the subject property and similar properties may need adjusting to reflect the circumstances of the REO.

**5.10** For many trading entities, the vehicle for a transfer of the business will be the sale of a freehold or leasehold interest in the property. Such transactional evidence can be used as comparable evidence in the valuation of *trade related properties*, so long as the valuer is in a position to exclude the value of the component parts of the transaction that are not relevant. Examples include stock, consumables, cash, liabilities and *intangible assets* (such as brand names or contracts, to the extent they would not be available to the REO).

**5.11** Changes in competition can have a dramatic effect on profitability, and hence value. The valuer should be aware of the impact of current and expected future levels of competition. If a significant change from existing levels is anticipated, the valuer should clearly identify this in the report and comment on the general impact it might have on profitability and value.

**5.12** Outside influences, such as the construction of a new road or changes in relevant legislation, can also affect the trading potential and hence the value of the *trade related property*.

**5.13** Where it is intended to reflect purchaser's costs in the valuation (usually in the case of investment valuations), the normal *market approach* is to be adopted and an appropriate comment should be made in the report.

**5.14** Where the property is trading and the trade is expected to continue, the valuation will be reported as follows:

> Market value *[or market rent]* as a fully equipped operational entity having regard to trading potential subject to any agreed or special assumptions *[which must be clearly set out]*.

# 6 Valuation approach for a non-trading property

**6.1** The valuation process for a non-trading property is the same as outlined in paragraph 5, but where the property is empty either through cessation of trade, or because it is a new property with no established trading history, different *assumptions* are to be made. For example, an empty property may have been stripped of all or much of its trade inventory or a new property may not have the trade inventory installed, but either could still be valued having regard to its trading potential.

**6.2** The cessation of an operational entity and the removal of some or all the trade inventory are likely to have an effect on the value of the property. It would therefore be appropriate to express the value on both the basis of one or more *special assumptions*, and a basis reflecting the status quo. This is often a requirement when advising a lender on the value of *trade related property* for loan security purposes. For example, the differences could reflect the cost and time involved in purchasing and installing the trade inventory, obtaining new licences, appointing staff and achieving FMT.

**6.3** Where the property is empty, the valuation will be reported as follows:

> Market value *[or market rent]* of the empty property having regard to trading potential subject to the following special assumptions *[which must be clearly set out]*.



# 7 Apportionment

**7.1** The valuer may need, or be requested, to provide an indicative apportionment of a valuation or a transaction price for:

- analysis as a comparable;
- inclusion in *financial statements* to comply with the applicable accounting standards;
- secured lending; or
- tax purposes.

**7.2** Any such apportionment of *market value* would usually relate to:

- the land and buildings reflecting the trading potential; and
- the trade inventory.

**7.3** When considering the apportionment of a transaction price, particularly where the sale is through share transfer in a limited company, the valuer should proceed with caution as the transaction may, in addition to that listed in paragraph 7.2, reflect the following:

- the *trading stock*, consumables and cash;
- *intangible assets;* and
- liabilities, such as salaries, taxes, debts, etc.

**7.4** Apportionments for tax purposes have to be in accordance with specific legislation and are outside the scope of this *guidance note*.

## 8 Valuation for investment purposes

**8.1** The basic approach to an investment valuation of *trade related property* is the same as for any other category of property. Where the investment is a portfolio or group of properties GN 3, Valuation of portfolios and groups of properties, will be relevant.

**8.2** When valuing a *trade related property* investment, the valuer will need to carry out the assessment of the FMT and FMOP as set out in paragraph 3.1. It is also necessary to assess the *market rent* of the property so as to determine the security of the income stream and growth potential. The rent payable and the rent review will be determined by the terms of the subsisting or proposed lease.

**8.3** The capitalisation rate adopted for investment valuations differs from that for vacant possession valuations. The investment rate of return will generally be determined by market transactions of similar *trade related property* investments. Clearly, due to the differing characteristics of *trade related property* and the wide variety of lease terms, careful analysis of comparable transactions is essential.

**8.4** The valuer will include the landlord's fixtures and fittings with the land and buildings, but probably not the trade inventory, which will usually be owned by the occupational tenant. However, the valuer should highlight the importance of the trade inventory to the trading potential and value of the property.

# GN 3 Valuation of portfolios and groups of properties

## 1 Introduction

**1.1** This *guidance note* addresses matters that the valuer should consider when undertaking a valuation of several properties simultaneously for the same client.

**1.2** To avoid giving misleading or inappropriate advice, particular regard must be had to matters such as 'lotting' or grouping, the identification of different property categories and any *assumptions* or *special assumptions* relating to the circumstances under which the properties may be brought to the market.



## 2 Identification of separate property

**2.1** Where there is doubt about what constitutes a single property, the valuer should generally 'lot', or group, the properties for valuation in the manner most likely to be adopted in the case of an actual sale of the interest(s) being valued. However, the valuer should discuss the options with the client and must confirm the approach adopted in both the *terms of engagement* and the report.

**2.2** Examples of situations where specific clarification of the lotting *assumption* needs to be made include:

- physically adjoining properties that have been acquired separately by the current owner – for example, where a developer has assembled a site with a view to future redevelopment, or where an investor is building a strategic stake in the locality;
- physically separate properties that are occupied by the same entity and where there is a functional dependence between the properties – for example, a car park that is separate from, but exclusively used by, the occupier of a building;
- where ownership of a number of separate properties would be of particular advantage to a single owner or occupier because of economies that could result from either increased market share or savings in administration or distribution, as with a chain of retail outlets or hotels; and
- where each individual property is an essential component of an operation covering a large geographical area – for example, as part of a national or regional utility network, such as telecommunication masts.

**2.3** The purpose of the valuation may well dictate the approach taken. For example, there may be a requirement for the value of the assets to be reported individually. The extent of what comprises an individual property or other asset will need to be clarified with the client.

**2.4** Requests to value properties on an *assumption* that lots them in an artificial manner should normally be declined. However in certain circumstances, unusual lotting may be dealt with using a *special assumption* (see VS 2.2).

## 3 Valuation assumptions

**3.1** Once the valuer has identified the lots within a portfolio that are to be valued separately, consideration needs to be given to any particular *assumptions* or *special assumptions* that may be necessary. These need to be recorded in the *terms of engagement* (see VS 2) and in the report (see VS 6). Examples of situations where different *assumptions* can have a material effect on the valuation of a portfolio are discussed in the following paragraphs.

**3.2** If a whole portfolio, or a substantial number of properties within it, were to be placed on the market at the same time, it could effectively flood the market, leading to a reduction in values. Conversely, the opportunity to purchase a particular group of properties might produce a premium. In other words, the value of the whole could exceed the sum of the individual parts, and vice versa.

**3.3** If valuing for a purpose that assumes that the portfolio will continue to remain in the existing ownership or occupation, for example, for inclusion in *financial statements*, it would be inappropriate to make any reduction or allowance in the valuation to reflect the possible effect of flooding the market. A statement to this effect should be made in the report.

**3.4** If the same portfolio were to be valued as security for secured lending, the possible adverse effect on individual properties if the whole portfolio were placed on the market at the same time should not be ignored. In such case it would normally be appropriate to state that the *assumption* has been made that the properties would be marketed in an orderly way and they would not all be placed on the market at the same time. However, if circumstances existed that such an *assumption* would not be made by the market, for example, if it were known that the current owner was in financial difficulty, this would become a *special assumption* and its effect on the valuation should be clearly stated (see VS 2.2).

**3.5** Likewise, where the valuer ascribes a single value to a group of separate properties, any *assumptions* necessary to support that approach should be stated. If the valuer considers that the treatment of the portfolio on this basis is not one that the market would necessarily make, such an *assumption* would become a *special assumption* (see VS 2.2).

## 4 Reporting requirements

**4.1** In any case where the total value of the properties within a portfolio would differ significantly depending on whether they were disposed of individually, in groups or as a single lot, this should be stated clearly in the report. The lotting *assumptions* made should also be included in any published reference.

**4.2** Where a portfolio or group of properties has been valued on the *assumption* that

it would be sold as a single entity, the reported *market value* will relate to the whole of the group. Any breakdown of the *market value* of the individual properties should be clearly expressed as such, with a statement that this apportionment does not necessarily equate to the *market value* of the interest in any individual property.

**4.3** Conversely, if the total of the *market values* for each individual property in a portfolio as an aggregated figure is provided, care should be taken not to present this as the *market value* of the entire portfolio.

# GN 4 Personal property

## 1 Introduction and application

**1.1** In the context of this *guidance note*, the term 'personal property' refers to assets that are not permanently attached to land or buildings. This includes antiques and fine art, furnishings, collectables and appliances. It excludes plant and equipment, which is the subject of specific guidance in GN 5.

**1.2** This *guidance note* provides additional commentary on the application of the standards to the valuation of personal property. It only applies to written valuations, which are mainly, but not exclusively, required for insurance and taxation purposes. The guidance does not apply to personal property that is part of an interest in land and buildings and valued therewith, or part of an operational entity that is to be valued with regard to trading potential (see GN 2).

**1.3** This guidance does not apply where advice is tendered in the expectation, or in the course, of an instruction to dispose of, or acquire, personal property (whether by auction or other methods). It also does not apply for advice concerning the anticipated price achievable or payable, including advice on whether a particular offer should be accepted or made (see VS 1.1.5 on exceptions).

## 2 Terms of engagement

**2.1** The knowledge of clients will range from some that have a deep understanding of the personal property markets, to others that are unfamiliar with those markets, the terms used or the concepts embraced by valuers.

**2.2** It is imperative that the *terms of engagement* are understood and agreed between the valuer and the client prior to the submission of the valuation report.

**2.3** The valuer may wish to develop standard letters of engagement that can be used for any type of valuation instruction. Where the valuation has to comply with these *valuation standards* the valuer must produce *terms of engagement* that comply with the minimum terms set out in VS 2.1. The full list is reproduced below together with comments, where necessary, that clarify the acceptable variations required when dealing with personal property:

(a) identification of the client and any other intended users;
(b) the purpose of the valuation;
(c) the subject of the valuation;
(d) the interest to be valued (there may be situations where the interest in personal property to be valued is shared with others, and in such cases, it should be clearly specified);
(e) the type of asset or liability and how it is used or classified by the client (this is not normally applicable to personal property);

(f) the *basis* (or *bases*) *of value* (see paragraph 5);
(g) the *valuation date*;
(h) disclosure of any material involvement, or a statement that there has not been any previous material involvement;
(i) the identity of the valuer responsible for the valuation and, if required, a statement of the status of the valuer;
(j) where appropriate, the currency to be adopted;
(k) any *assumptions*, *special assumptions*, reservations, special instructions or *departures*;
(l) the extent of the valuer's investigations (see paragraph 4);
(m) the nature and source of information to be relied on by the valuer (see paragraph 4);
(n) any consent to, or restrictions on, publication;
(o) any limits or exclusion of liability to parties other than the client;
(p) confirmation that the valuation will be undertaken in accordance with these standards and that it also complies with the IVS, where appropriate;
(q) confirmation that the valuer has the knowledge, skills and understanding to undertake the valuation competently;
(r) the basis on which the fee will be calculated;
(s) where the *firm* is *registered for regulation by RICS*, reference to the *firm's* complaints handling procedure, with a copy available on request; and
(t) a statement that compliance with these standards may be subject to monitoring under the institution's conduct and disciplinary regulations.



## 3 Identifying the market

**3.1** The purpose of the valuation will have an impact upon the anticipated market in which it is assumed the transaction will take place. It is recognised that there may be several identifiable routes to market for personal property and that they can take a number of different forms. This may result in different observable prices and the valuer must clarify, in the *terms of engagement* and the report, the market(s) in which it is assumed that the assets will be sold.

**3.2** The main types of market are:

- auction;
- retail; and
- private treaty sale with or without a special interest.

## 4 Inspection, investigations, information and assistance received

**4.1** The *inspection* of personal property may be limited due to its location or, in the case of insurance claims, the fact that it has ceased to exist. The limits to any

*inspection* or investigation must be recorded. The valuer will need to agree with the client the extent to which an *inspection* is feasible, or the extent to which information provided by the client or other parties may be relied on (see VS 5, Investigations).

**4.2** Where the valuer has relied on information provided by the client, this should be recorded. The source of any such information is to be cited in the report and reasonably verified where possible. Where verification is not possible this is to be stated in the report.

**4.3** The instruction may require that the valuer calls for, and relies on, the services of other specialist consultants and/or other professionals. In such cases the valuer should take steps, as are reasonably necessary, to ensure that such services are competently performed and the conclusions relied on are reasonable and credible. Otherwise, the valuer should disclose the fact that no such steps were taken (see VS 6.10, Incorporation of other valuations).

## 5 Valuation approach

**5.1** The type of value approach used by the valuer will depend on the purpose of the valuation and the required *basis of value*. The main types of approach used in the valuation of personal property include:

- **comparison with the sale prices of identical, or similar, items achieved around the *valuation date*:** when considering the result of an auction, the price achieved is taken to be the finally accepted bid, often called the 'hammer price', without any adjustment for buyers or sellers premiums, commission or other charges;
- **replacement with a replica:** a replica is a copy of the original item, as near as possible to the original in terms of nature, quality and age of materials, but created by means of modern construction methods (this approach is usually only adopted for insurance purposes); and
- **replacement with a facsimile:** a facsimile is an exact copy of the original item, created with materials of a closely similar nature, quality and age using construction methods of the original period (this approach is usually only adopted for insurance purposes).

## 6 Reports

**6.1** It is the responsibility of the valuer to ensure that the valuation report is clear and unambiguous, and is prepared with high standards of integrity, clarity and objectivity (see VS 6.1).

**6.2** VS 6 on valuation reports and published references to them will apply to the reporting of personal property valuations and the valuer will need to comply with the list of minimum requirements in VS 6.1. The report must repeat all the particular variations incorporated into the *terms of engagement*, the valuation approach and investigations.

**6.3** With regard to VS 6.1(c) the description of the personal property should be appropriate for the purpose of the valuation. For example, the description of an

important object for insurance valuation purposes should be comprehensive, while a description of an item of modest value taken for taxation purposes may be less detailed. The use of photographs where appropriate is recommended.

**6.4** Specific terms are usually adopted for personal property describing antiques and fine arts, and in such cases it is recommended that the Object ID be used as the minimum descriptive standard. Further details of Object ID can be found at http://archives.icom.museum/object-id/about.html.

**6.5** With regard to VS 6.1(f), the actual *basis of value* adopted and the description of the market in which the item is being valued must be made clear. If appropriate, it should also be confirmed that the value complies with any special requirements of the client or other regulatory rules. For instance, values for taxation purposes have to comply with the relevant national legislation and may also have to adopt a specific *basis of value*.

**6.6** A suggested structure for a valuation report is:

- cover sheet;
- index;
- minimum requirements of VS 6.1, as amended in the *terms of engagement*;
- layout (by category or other order);
- summary;
- statement of value (with certification statement, if required, for the purpose – see VS 6.2);
- glossary of terms (where appropriate); and
- images (where appropriate, or these may be incorporated within the main body of text).

# GN 5 Plant and equipment

## 1 Introduction

**1.1** This *guidance note* provides additional commentary on the application of the *valuation standards* to plant and equipment.

**1.2** Plant and equipment assets have particular characteristics that distinguish them from most types of *real property*, and this fact influences the approach to, and reporting of, their value. Plant and equipment are typically capable of being moved or relocated and often will depreciate at a significantly faster rate than *real property*. Frequently, the value will differ notably depending on whether an item of plant or equipment is valued in combination with other assets within an operational unit, or as an individual item for exchange. In addition, whether plant or equipment may be considered as either *in situ* (in place) or for removal will also affect value.

**1.3** Plant and equipment may be broadly divided into the following categories:

- **Plant**: assets that are inextricably combined with others and that may include items that form part of the building, services installations, specialised buildings, machinery and equipment;
- **Machinery**: individual, or a collection of, machines that may have been installed wholly in connection with the occupiers' industrial or commercial processes (a machine is an apparatus used for a specific process in connection with the operation of the entity); or
- **Equipment**: other assets such as furniture and furnishings, tenants' fixtures and fittings, vehicles and loose tools that are used to assist the operation of the enterprise or entity.

**1.4** The boundaries between these categories are not always easy to define, and the criteria used may vary according to the purpose of the valuation and the users' accounting conventions.

**1.5** The general rule is that assets installed primarily to provide services to the buildings should be valued as part of the property interest if they would normally be included in the sale of the property. However, exceptions to this general rule may occur where the valuation is required for inclusion in a balance sheet or for tax purposes. In these cases the client may require a separate valuation for certain items of building service plant.

**1.6** In a valuation for *financial statements* the accounts of the entity will normally identify the items of plant and equipment that are separately valued. In other cases the valuer will need to clarify with the client the items that should be included in a valuation of the plant and equipment.

**1.7** When different valuers are employed to carry out property and plant valuations, careful liaison will be needed to avoid either omissions or double counting.

## 2 Plant and equipment usually included in valuations of the property interest

**2.1** This will include:

- items associated with the provision of services (gas, electricity, water, drainage, fire protection and security) to the property;
- equipment for space heating, hot water and air conditioning not integral to any process; and
- structures and fixtures that are not an integral part of process equipment, for instance, chimneys, plant housings and railway tracks.

**2.2** Occasionally, items normally valued with the land and buildings will be subject to a *third-party* interest, for example, a finance arrangement or finance lease (see paragraph 4). The valuer should be particularly cautious in such cases. The client may require that the valuation ignores any such encumbrances, in which case a *special assumption* should be made to this effect. However, this type of *special assumption* may not always be appropriate, as the valuer may need to investigate the cost of paying off the *third party* to gain outright control, or assess the impact on the value of the property interest if the item were removed.



## 3 Plant and equipment separately valued

**3.1** Plant and equipment valued separately from the property interest can be divided into broad categories of assets. 'Fixed assets' are often defined by the accounting standards applicable in the relevant state. The different categories may need to be identified and valued separately, depending on the purpose of the valuation.

**3.2** Examples of 'fixed assets' include:

- process and production plant and machinery;
- fixtures and fittings;
- office equipment, including computers;
- office furniture; and
- vehicles and mobile plant.

**3.3** Items that may fall within the definition of plant and equipment, but which may not be regarded as 'fixed assets' include:

- product-dedicated items, for example, moulds, jigs, dies and spare parts; and
- stocks, materials-in-trade and work in progress.

**3.4** Although *intangible assets* fall outside the definition of plant and equipment, the former may have an impact on their value. In such cases the valuer should establish appropriate *assumptions* with regard to the availability of any relevant *intangible assets* before reporting a valuation. Examples of *intangible assets* include:

- commercial and administration records, drawings, designs and technical data; and

- licences, operating systems, *goodwill*, patents, trademarks, brand names and other intellectual property.

## 4 Encumbered assets

**4.1** It is common for plant and equipment to be subject to financing arrangements that require the lender being paid any balance outstanding under the arrangement before it can be sold. This balance may or may not exceed the unencumbered value of the item.

**4.2** Items subject to finance leases are normally included in a valuation of an organisation's assets, but should also be identified separately.

**4.3** Items that are subject to operating leases or are the property of *third parties* should also be excluded. These items may also require separate valuation.

## 5 Material considerations

**5.1** When valuing plant and equipment on the basis of *market value*, VS 3.2 requires indication of whether the valuation assumes that the assets remain in their working place, or are valued for removal. Further *assumptions* may also be required, depending upon the purpose of the valuation. Examples include:

- how the property is to be offered for sale, for example, as a whole or as individual items;
- the assumed method of sale;
- whether the purchaser or vendor is to bear the costs of decommissioning or removal; and
- whether allowance is made for any cost of reinstatement following removal and, if so, who is to bear the cost.

**5.2** If a valuation is being undertaken with a view to disposing of plant and equipment separately from the property in which it is situated, there may be constraints on the time available for marketing and disposal – for example, if a lease on the property is due to expire. If the valuer considers that this time limit is inadequate for proper marketing, as defined in the conceptual framework for *market value*, it may be inappropriate to use this *basis of value*, other than to illustrate the adverse impact of the time constraint. The valuer can advise on the price that is likely to be obtained as a result of the constraint, but should not describe this as a 'forced sale' value (see VS 2.3).

**5.3** If no constraint exists at the *valuation date*, but a client requires advice on the impact that such a constraint on the marketing period may have, a *market value* can be provided subject to a *special assumption* in the report that clarifies the time limit assumed and the reasons for it.

**5.4** Many of the *inspection* requirements set out in VS 5 can be readily adapted to plant and equipment assets. In order to prepare a valuation, the valuer first needs to establish matters such as the type, specification, capacity and purpose of the items,

then consider matters such as age, efficiency, condition, economic and functional obsolescence, and total useful economic working life.

**5.5** As when valuing land and buildings, it will normally be impractical, if not impossible, for the valuer to establish every material fact that could have an impact on the valuation. Therefore the extent of the valuer's investigations, and any *assumptions* reflected in the valuation, will have to be agreed with the client and included in the report.

**5.6** Similarly, there will be occasions when factors affecting the land and buildings will impact the valuation of plant and equipment. Examples include where the property is held on a short lease, if there are proposals for redevelopment or if there is contamination of the land that would require plant to be decontaminated prior to removal.

## 6 Regulatory measures



**6.1** Industrial activities are frequently subject to specific legislation and regulations. Non-compliance with these legal requirements may result in the suspension of the right to use the plant and equipment in question. Many of these are specific to the plant and process being considered. Therefore the valuer must investigate the nature of the plant and activity, as well as the purpose of the valuation and its extent, in determining how far the regulatory measure can, or might, affect the valuation.

**6.2** Where there is doubt about compliance with any regulations the valuer should discuss the matter with the client and refer to the outcome in the report. This should be done either by agreeing to make *assumptions*, or referring to any certificates of compliance that may be available.

# GN 6 Depreciated replacement cost method of valuation for financial reporting

## 1 Introduction

**1.1** The purpose of this *guidance note* is to provide information on the use of the *depreciated replacement cost (DRC)* approach. The '*cost approach*' and *DRC* are regarded as synonymous terms; both are in common use around the world to describe a method of valuation of all types of assets. This *guidance note* also highlights the reporting requirements outlined in these *valuation standards* that are particularly relevant when the *DRC* method has been used.

**1.2** It is important to understand that the word 'depreciation' is used in a different context for valuation than for financial reporting. In a *DRC* valuation, 'depreciation' refers to the reduction, or writing down, of the cost of a modern equivalent asset to reflect the obsolescence and relative disabilities affecting the actual asset. In financial reporting, 'depreciation' accounting refers to a charge made against an entity's income to reflect the consumption of an asset over a particular accounting period. These are distinct usages of the word, and there is no direct correlation between the methods used to assess depreciation in each case.

**1.3** The intention of this guidance is to provide guidelines that better ensure:

- client involvement and understanding;
- valuations are appropriate to the needs of both public and private sector clients;
- transparency; and
- year-on-year consistency in asset valuation approach, including where there is a change of valuer.

**1.4** The appendix contains a list that will assist the valuer in checking that all the matters to be considered within this guidance have been addressed.

**1.5** Where *DRC* is used for valuations in the public sector, there may be specific requirements within the rules governing those valuations that amend specific parts of this guidance, for instance, the date at which the building is assumed to be available. Such specific requirements take precedence over this *guidance note*.

## 2 Definition of depreciated replacement cost

**2.1** There are three principal valuation approaches that are generally recognised internationally:

- direct market comparison;
- *income approach*; and
- *cost approach*.

These approaches may all be used to assess different *bases of value*, including *market value*.

**2.2** This *guidance note* focuses on the use of *DRC* to derive *market value*. When used to assess *market value* the objective is to establish the price that would be paid between a willing buyer and willing seller acting at arm's length. Therefore when considering comparative costs and depreciation adjustments, the valuer must have regard to the evidence of the market (in so far as is practicable), not only the circumstances of the current owner.

**2.3** *DRC* is a form of *cost approach* that is defined by RICS as:

> the current cost of replacing an asset with its modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation.



**2.4** The *DRC* approach is based on the economic theory of substitution. Like the other valuation approaches listed in paragraph 2.1, it involves comparing the asset being valued with another. However, *DRC* is normally used in situations where there is no directly comparable alternative. The comparison therefore has to be made with a hypothetical substitute, also described as the modern equivalent asset. The underlying theory is that the potential buyer (described in the *market value* definition) in the exchange would not pay any more to acquire the asset being valued than the cost of acquiring an equivalent new one. The technique involves assessing all the costs of providing a modern equivalent asset using pricing at the *valuation date*.

**2.5** In order to assess the price that the buyer would bid for the actual asset, depreciation adjustments have to be made to the gross replacement cost to reflect the differences between it and the modern equivalent. These differences can reflect factors such as the comparative age or remaining economic life, the comparative running costs and the comparative efficiency and functionality of the actual asset.

**2.6** This *guidance note* discusses factors that may need to be taken into account in assessing both the cost of a modern equivalent asset and the depreciation adjustments applied to the actual asset.

## 3 When depreciated replacement cost is used

**3.1** *DRC* is used where there is no active market for the asset being valued – that is, where there is no useful or relevant evidence of recent sales transactions due to the specialised nature of the asset.

**3.2** Although the *DRC* method may be used for the valuation of different types of specialised asset, particular complications arise when applying the *DRC* method to *specialised property*, which is defined in the Glossary as:

> a property that is rarely, if ever, sold in the market, except by way of a sale of the business or entity of which it is part, due to the uniqueness arising from its specialised nature and design, its configuration, size, location or otherwise.

This definition is broad and can apply to properties or assets that may be of conventional construction, but become specialised by virtue of being of a size or in a location where is no relevant or reliable evidence of sales involving similar property.

**3.3** However, *DRC* is often referred to as a method of last resort and is only to be relied on if it is impractical to produce a reliable valuation using other methods. The classification of an asset as specialised should not automatically lead to the conclusion that a *DRC* valuation must be adopted. If sufficient direct market evidence exists, it still may be possible to undertake a valuation of the *specialised property* using the sales comparison and/or the income capitalisation approach.

**3.4** For certain types of specialised asset that are associated with an identifiable and dedicated cash flow, the income (or 'profits test') approach may be more appropriate. The use of *DRC* may not be preferred but may be used as a cross-check to establish whether the return on capital is realistic.

**3.5** The market for assets will change over time. Assets that might previously have been classified as having no market may have an active market that has recently emerged. For example, within the healthcare and leisure sectors, evidence of market transactions is growing. Therefore, before adopting the *DRC* method the valuer will need to be satisfied that there are no transactions involving similar buildings in similar use that could provide sufficient evidence to use a sales comparison approach.

**3.6** The value of a *specialised property* (or a specialised plant and equipment asset) is intrinsically linked to its use. If there is no demand in the market for the use for which the property is designed, then the specialised features will either be of no value or have a detrimental effect on value as they represent an encumbrance. It is therefore important to establish the entity's intentions when valuing for inclusion in a *financial statement*. If the *specialised property* is not to be retained for the delivery of a product or service because there is no longer demand for it, it follows that the use of *DRC* would be inappropriate. No hypothetical buyer would consider procuring a modern equivalent asset if this would immediately be redundant. Such surplus property is valued having regard to its potential for alternative use, with due allowance for any costs associated in achieving that alternative use.

**3.7** Some buildings (or specialised plant and equipment assets) have a conventional basic design that is superficially similar to other buildings that are regularly bought and sold in the market, but on closer *inspection* have specialised features or extensive adaptations designed to meet the requirements of the actual occupier. Typical examples, which may be purpose built or adapted, include an office building with enhanced security features such as thickened walls, toughened glazing and extra stand-off land, or an industrial building with structural alterations to accommodate a particular production process.

**3.8** Where the entity has significantly adapted an existing asset to its requirements, it may elect to treat the cost of specialised adaptations as a separate item in its *financial statements*. In such case, the valuer would need to value the interest in the asset on the *special assumption* that the adaptations do not exist. If detrimental to

value it may also be appropriate to state that no account has been taken of the costs associated with their removal and reinstatement.

**3.9** If the entity does not treat the costs of specialised adaptations separately, the latter will then be valued as part of the property interest. The valuer will have to decide whether the adaptations are sufficiently extensive for the property to meet the definition of a *specialised property*. The valuer will also have to decide whether there is no other reliable method of assessing the *market value* plus adaptation, before using the *DRC* method. In respect of *real property* this decision will reflect the market in the locality. In one location there may be sales evidence of other similarly adapted buildings, thus using the *DRC* method would be inappropriate. However, the same building in another location may properly be valued using the *DRC* method because there is no remotely comparable property bought and sold in that location.

**3.10** *DRC* method is not suitable for use in valuations of *real property* for loan security. This is due to the specialised nature of assets that are normally valued using *DRC*, and because the method assumes that there is a continuing demand for the use of the asset. Exceptionally, in rare cases, it may be used to support a valuation for loan security arrived at using a different approach.



## 4 Valuer qualifications

**4.1** It is fundamental that *DRC* is recognised as a valuation to which the *valuation standards* apply, and not a cost estimation exercise. Each valuation to which the standards apply must be prepared by, or under the supervision of, an appropriately qualified valuer.

**4.2** The valuer's task includes consideration of the key elements of a market transaction involving the specialised asset. The specialised knowledge required in order to properly undertake a *DRC* valuation includes:

- an understanding of the asset, its function and its environment;
- knowledge of the specification that would be required for an equivalent asset in the current market, and the cost of acquiring or procuring that asset;
- sufficient knowledge of the asset and its marketplace to determine the remaining physical and economic life of the asset; and
- sufficient knowledge of the sector in question to assess functional, technical or economic obsolescence.

**4.3** Although a single valuer may not have all the knowledge or skills required, the *valuation standards* accept that these can be met in aggregate by more than one valuer. VS 1.6 requires that if the valuer proposes to employ another *firm* to provide valuation advice, as opposed to providing information to assist the valuer in preparing his or her own valuation, the client's approval must be obtained.

## 5 Settling the terms of engagement

**5.1** The discussion of the *terms of engagement* provides an essential link between the valuer and the client that will help to establish whether the use of the *DRC* method is appropriate.

**5.2** VS 2.1(a) to (t) stipulates certain matters that must be addressed by the *terms of engagement*. The following particular points may need more detailed attention:

- (c) the subject of the valuation;
- (d) the interest to be valued;
- (e) the type of property and how it is used, or classified, by the client
- (l) the extent of the valuer's investigations; and
- (m) the nature and source of information to be relied upon by the valuer.

### *(c) the subject of the valuation; and (d) the interest to be valued*

**5.3** If the asset is specialised it may be necessary to define what is to be included in the valuation. The identification of assets that are classified as part of the property interest and those that are classified as plant and equipment is often unclear in a *specialised property*. Many specialised assets comprise separately identifiable components, and the valuer will need to discuss with the client whether it is appropriate to value these as separate items, or to what degree would be appropriate to regard them as aggregated into a single asset, and valued accordingly. The entity's accounting policies may influence this decision.

### *(e) the type of property and how it is used, or classified, by the client*

**5.4** The valuer will need to establish how the entity uses the asset and confirm that there is an intention to continue that use. For a *specialised property* it may be necessary to establish the extent of the land occupied by the specialised improvements and distinguish this from land that is properly classified as either surplus or in conventional use.

### *(l) the extent of the valuer's investigations; and (m) the nature and source of information to be relied upon by the valuer*

**5.5** With specialised assets the valuer may have to place greater reliance on information provided by the client, or its other advisers, than would be the case with more conventional assets. This information can include information of the cost, design features and performance of the asset. Since the asset is specialised it follows that detailed knowledge of these matters may be outside the knowledge and expertise that could normally be expected of a valuer in that sector. It may be important to discuss and agree the extent to which the valuer may rely on such information provided by the client or, if further specialist input is to be obtained by the valuer, the source and cost of that further advice.

**5.6** Where the valuer has not provided an earlier valuation it is recommended that the client be asked to provide a copy of any previous report. The information in that report will enable the valuer to establish the approach taken and assist the client in reconciling any significant valuation differences that may arise.

**5.7** It is essential that the valuer maintains accurate and comprehensive records of discussions with the client and the reasons for the conclusions reached.

## 6 Assessing replacement cost

**6.1** The general principle is that the costs reflect those of a modern equivalent asset. Although the actual or estimated cost of reproducing the actual asset may be relevant in this assessment, there will be many cases, especially with old or obsolete assets, where this information is irrelevant.

**6.2** The principle can be illustrated by considering the value of an item of machinery that is a few years old. If technological advances mean that the same output can now be achieved with a smaller and more efficient machine, the actual machine would not be replaced. The modern equivalent is defined by its comparative performance and output, not its physical characteristics.

**6.3** In assessing the cost of the replacement asset, due account has to be taken of all the costs that would be incurred by a potential buyer on the *valuation date*. These could include the costs of delivery, transportation, installation, commissioning and any unrecoverable duties or taxes. Quite often a specialised asset will have to be especially commissioned, so design and other fees may also be incurred.



**6.4** When considering *specialised property*, the current gross replacement cost of the asset is assessed. This comprises the cost of replacing the land plus the cost of replacing the improvements to the land. For the latter, the approach is to assess the cost of their replacement with a modern equivalent and then make depreciation adjustments to reflect the differences between it and the actual asset when compared with a modern equivalent. Costs that may be expected to be incurred in replacing the asset include:

- setting up costs, where appropriate, such as planning fees and site preparation works;
- professional fees related to the project;
- a contingency allowance, if appropriate; and
- finance costs, taking into account the likely pattern of payment.

Once the gross replacement cost has been derived, the depreciation factors are applied as a further and separate calculation.

**6.5** The asset being valued may take a considerable period, often years, to replace. In assessing the replacement cost of the modern equivalent asset, based upon current prices the prospect for cost fluctuation and related issues that may occur over such a prolonged period may be taken into account.

## 7 The site value of a specialised property

**7.1** Although the ultimate objective of the *DRC* method is to produce a valuation of the actual property in its actual location, the initial stage of estimating the gross replacement cost has to reflect the cost of a site suitable for a modern equivalent facility. Often this will be a site of a similar size and in a similar location to the actual site. However, if the actual site is clearly one that a prudent buyer would no longer consider appropriate because it would be commercially wasteful or would be an

inappropriate use of resources, the modern equivalent site is assumed to have the appropriate characteristics. The fundamental principle is that the hypothetical buyer for a modern equivalent asset would purchase the least expensive site that would be suitable and appropriate for its proposed operations.

**7.2** The property being valued may be located in a situation that would now be considered unnecessarily expensive. This may be due to changes in the way in which the service provided is delivered, or to changes in the market for the product it produces. An example could be a hospital that was originally constructed in the centre of a city that might now be better situated in the suburbs because of changes in the transport infrastructure or the migration of the population it served. Another example could be where a specialised industrial facility was originally located close to a source of raw materials that are now imported, thus rendering the original location irrelevant.

**7.3** Other factors need to be considered in addition to establishing the location of the modern equivalent site. The modern equivalent asset may not require a site as extensive as the actual site. In this respect land is no different to any other asset. If 2 hectares are now sufficient to provide the same service, the modern equivalent site will be 2 hectares, even if the actual site is 4 hectares.

**7.4** There may also be geographical limitations on where the modern equivalent site might be located, imposed by physical or practical considerations. For example, a specialist industrial operation may require a site located next or close to a dock if material has to be imported by sea. A local authority may have an obligation to provide a service within a particular geographical locality, even though cheaper sites may be available elsewhere.

**7.5** Sites of *specialised properties* often include areas of vacant land. This may be held for possible future expansion, as a safety or security cordon, or may simply be surplus. The valuer will need to enquire as to the purpose of any vacant land at the actual property in order to assess whether this would be a necessary feature of the notional replacement site. If not then it is not reflected in the *DRC* calculation, although its value will need to be considered separately. Surplus land will normally be reported as a separate asset as it needs to be identified and treated separately in the *financial statements*.

**7.6** Once the extent and location of the site that would be necessary to create the modern equivalent asset has been identified, the next step is to estimate what it would cost to acquire that site in the market at the *valuation date*. Because many *specialised properties* will be *sui generis* uses under planning legislation, there can be practical difficulties in determining from what planning use it is appropriate to draw the sales comparison. In the case of a specialised industrial property, it would usually be appropriate to assume that land with an industrial planning consent (or where such permission could be anticipated) would provide the best comparable evidence. Likewise for the site of a specialised administration building in a town centre, sites for office use would provide the most appropriate comparables.

**7.7** The actual use of the property may be so specialised that it may be impossible to categorise it in general market terms. In such cases the valuer has to determine what other uses the property can offer to a buyer of an alternative site for the

specialised use to make it competitive in the market. This may be a range of uses that prevail in the locality of the actual site, but for the reasons discussed earlier, this may not be appropriate if the modern equivalent site would be located elsewhere. In that case, it is the range of uses in that locality that would be considered.

**7.8** In the public sector, particular issues can arise with *specialised property* that provides a service to a defined local community, such as schools, libraries and health centres. One characteristic of such property is that the service requirement may be attached to a tightly defined geographical area, which limits the availability of alternative sites.

**7.9** The valuer may need to decide and agree with the entity on the possible locations for the current defined service requirement. This might mean competing against other users, but where land could be made available by using statutory powers, this might indicate the appropriate approach to the valuation. The overriding objective is for the valuer to establish the lowest amount that a prudent purchaser would pay to acquire a site for an equivalent development in a relevant location at the *valuation date*.



**7.10** A particular problem that arises with schools, within either the public or private sector, is when they have playing fields within the curtilage. This land will be considered separately from the land upon which the buildings are constructed, as no prudent purchaser would buy land with consent for residential or commercial development for use as a playing field. The potential on the existing site is not relevant in the *DRC* calculation, as the purchaser of the equivalent asset would acquire land for which playing field use would be the only permitted form of development. There are many examples of schools, universities and private businesses that have their main facilities within a town, but have their associated playing fields in an out-of-town location that is outside the permitted development boundary.

**7.11** In some circumstances the actual site may be leasehold. The consideration of the land value will therefore reflect the terms of the existing lease.

**7.12** Incidental costs, such as fees and carrying costs, are restricted to those costs associated with the normal acquisition and development of land.

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

**8.1** When valuing a *specialised property* it is often difficult to distinguish between what may be classified as a building or structure and what may be classified as plant. In the specialised industrial sector, many structures effectively only provide support and weather protection for process plant – if the plant was removed then the ‘building’ would not exist. In such cases there has to be discussion with the entity as to whether a distinction needs to be made between buildings and plant and, if so, what items fall under each heading.

**8.2** Because of the diverse nature of the buildings, structures and plant that may form part of a *specialised property*, the term ‘site improvement’ refers to all

additions to the land. These are buildings, structures or some modifications to land of a permanent nature, involving expenditures of labour and capital, and they are intended to enhance the value or utility of the property. Improvements have differing patterns of use and economic lives.

**8.3** Site improvements will include all site works associated with the development, including services, fencing, paving and any other items of a permanent nature that support the specialised use. The following paragraphs provide guidance on calculating the cost of buildings and site improvements. Although they refer specifically to buildings, the same principles apply to all improvements.

**8.4** In order to assess the cost of a modern equivalent building, the valuer needs first to establish the size and specification that the hypothetical buyer would ideally require at the *valuation date* in order to provide the same level of productive output or an equivalent service. If the actual building is old, it will usually be the case that a new building could be smaller but still provide the same level of service. For example, a modern building will often be able to offer more efficient space, as it can provide open plan or clear span areas that have a greater capacity than an older building with fragmented accommodation and a poor net to gross floor area.

**8.5** Having established the size of the notional building to be costed, the valuer may need to determine an appropriate specification for the building. It cannot be assumed that this would be the same as the actual building, especially if it is not new. The design and construction of a modern equivalent may differ from the existing building because features of the latter are now unsuitable or just irrelevant for the needs of the entity. In other cases, the existing materials may still be suitable but are simply unavailable, or only available at a cost that would be uneconomic. Care has to be taken to consider the service that is being provided within the building, and to price for a specification that would be compatible with the service potential of the subject building.

**8.6** For example, the specification that would be appropriate for a high security government department (for example, a defence weapons establishment) will be different from that appropriate for a specialised, but not security-sensitive, use. Similarly the specification required for a general care, private sector hospital will be different from that for a specialised, high-dependency unit within public sector provision.

## *Historic buildings*

**8.7** Historic buildings can present particular valuation difficulties. The principle that the cost is based on a modern equivalent asset still applies, but there may be situations where the only way that a replacement asset could provide equivalent service potential would be if it reproduced the actual building. However, reproduction will be very rare. In most cases the fact that the entity currently occupies a historic building is incidental to the service provided and would be totally irrelevant when specifying a modern equivalent.

**8.8** Only where the historic nature of the building itself creates an intrinsic part of the benefit or service potential of the asset would it be correct to reflect the cost of reproducing the actual asset in the cost of the modern equivalent. An example

could be an art gallery housed in a building that itself is as important as the exhibits it contains in attracting visitors. Another example provided in International Public Sector Accounting Standard 17 (IPSAS 17, *Property Plant and Equipment*, paragraph 47), published by the International Federation of Accountants (IFAC, www.ifac.org), is of a parliament building that may be reproduced rather than replaced with an alternative because of its significance to the community. In cases where it would not be possible to reproduce the actual building, it may be appropriate to assess the cost of constructing a building with a similarly distinctive design and high specification.

**8.9** Some historic or heritage assets may be impossible to replace because a modern reproduction could never recreate the historic significance of the asset. The decision of whether or not a historic asset is to be capitalised is a matter for the entity, although the valuer may be asked to comment upon the practicability or otherwise of valuing the asset.



## *Sources of cost information*

**8.10** Having determined the nature, size and specification of the modern equivalent building and all other necessary improvements, the cost of providing these may be assessed by reference to published building cost data. However, published construction price data may be of limited assistance where the replacement building or structure is highly specialised. Instead, the valuer may have to rely on actual costs involved in the creation of the current asset, or discuss with the entity the need to commission specialist cost advice.

**8.11** If the valuer has access to the actual costs incurred in constructing the asset, those costs may need adjustment to reflect differences between these costs and those that would be incurred in constructing the modern equivalent.

**8.12** The most obvious of these differences is the date on which the price is fixed. The cost of the modern equivalent will reflect the cost that would be incurred if the works were commissioned on the *valuation date*. Various cost indices are published for construction and engineering work that show typical historic price fluctuations, and they can be used to adjust historic cost data to the *valuation date*.

**8.13** Other factors that may result in the cost of creating the actual asset to differ from that of a notional replacement include the following:

- **Site preparation:** work may have been undertaken to prepare the actual site for development that would not be necessary for the assumed equivalent site. For example, costs actually incurred in levelling a site or providing services to the site boundary may already be reflected in the cost of acquiring an equivalent site in the market if the available evidence was for level, serviced land.
- **Phasing of work:** a large site may have been developed in phases, whereas the cost of the modern equivalent reflects the cost that would be incurred in replacing the whole asset at the *valuation date* let as a single contract. This could create economies of scale and reduce contract overheads, for example, on preliminaries work.
- **Optimal working conditions:** if the cost of the equivalent site is based on a site that is assumed to be free of any difficulties or constraints on

development, then any additional costs incurred because of abnormal conditions on the actual site are ignored.

- **Contract variations:** any additional costs incurred in constructing the actual building caused by design or specification changes during the progress of the contract are ignored.
- **Planning changes:** when the actual asset was constructed it may have had deemed planning consent. As the planning legislation has changed, the cost of obtaining consent for a modern equivalent may need to be taken into account.

Two other related factors are the additional cost of footings for heavy machinery (where specialised plant and equipment is required) and additional costs arising from extending an existing property.

**8.14** Incidental costs, such as fees and carrying costs, are to be restricted to those costs associated with the assumed procurement of the building. Allowance for VAT is made only where this is an irrecoverable cost. Although it would not normally be appropriate to make an addition to the cost to reflect developer's profit (because the purchaser is deemed to be procuring the building for owner occupation), it may be appropriate to add for management time if this were a significant cost that would be incurred in constructing a modern equivalent.

**8.15** The entity may require the valuer to provide an estimate of the cost of components within the actual building for depreciation accounting as part of the valuation instruction (see paragraph 1.4). These costs are not to be confused with the cost of creating an equivalent component in the modern equivalent building, but are intended to reflect a realistic allocation of the end value attributed to the building in exactly the same way as if the asset had been valued using a sales comparison or *income approach*.

## 9 Assessing depreciation

**9.1** Having established the replacement cost of a modern equivalent asset, it is then necessary to adjust or depreciate it to reflect differences between this modern equivalent and the actual asset being valued. The underlying principle is that the hypothetical buyer has the option of procuring either the modern equivalent or the actual asset. If the modern equivalent provides the ideal facility for the buyer, the price paid for the actual asset is expected to reflect all the disadvantages that it suffers in comparison.

**9.2** Applying depreciation is primarily a process of replicating how the market would view the asset. Depreciation rates and estimates of the future economic life of an asset are influenced by market trends and/or the entity's intentions. The valuer is recommended to identify these trends and intentions, and to be capable of using them to support the depreciation rates applied. The application of *DRC* should replicate the deductive process of a potential buyer with a limited market for reference.

**9.3** Three principal types of depreciation allowance, or obsolescence, may be identified as:

- physical deterioration;
- functional obsolescence; and
- external obsolescence.

### *Physical deterioration*

**9.4** This is the result of wear and tear over the years, which may be combined with a lack of maintenance. The valuer compares the decline in value of an asset of a similar age with the value of new assets in the same market.

**9.5** The asset is valued in its existing condition, with the valuer fully taking into account any physical deterioration arising from a lack of maintenance or other causes, and the recognition that a lack of adequate maintenance can accelerate the rate of depreciation. Thus, depreciation caused by inadequate maintenance is to be reflected in the allowance made, just as a deduction for disrepair would be made from a valuation based on sales comparison. Physical deterioration is frequently measured by reference to the anticipated physical life of the asset.



**9.6** The physical deterioration of the asset is to be viewed not in absolute terms, but within context. In some markets and for some types of asset, a degree of physical deterioration will not adversely affect the value, while in other cases it will. It would be inappropriate to determine the effect of physical deterioration on value depreciation only in purely mechanistic terms.

### *Functional obsolescence*

**9.7** Functional obsolescence arises where the design or specification of the asset no longer fulfils the function for which it was originally designed. An example would be a building that was designed with specific features to accommodate a process that is no longer carried out. In some cases functional obsolescence is absolute, i.e. the asset is no longer fit for purpose. In other cases the asset will still be capable of use, but at a lower level of efficiency than the modern equivalent or may be capable of modification to bring it up to a current specification. The depreciation adjustment will reflect either the cost of upgrading or, if this is not possible, the financial consequences of the reduced efficiency compared with the modern equivalent.

**9.8** Functional obsolescence may also arise because of advances in technology. A machine may be capable of replacement with a smaller, cheaper equivalent that provides a similar output, or a modern building may be more efficient because of superior insulation and modern services.

**9.9** The modern equivalent asset may be cheaper to recreate than the current asset, and so the replacement cost already reflects that of an 'optimised' asset, thus making further adjustment under this heading unnecessary. An example would be where the modern equivalent reflects a smaller building because there is no need for it to reflect historic or redundant features that exist in the actual building. Further depreciation to account for these features would be double counting.

**9.10** There will be situations where the asset being valued is too small, as technological advances now make it possible to achieve economies of scale. An

example would be an aircraft terminal, designed to cater for a maximum number of passengers per plane, which is now too small to handle larger modern planes.

**9.11** Another cause of functional obsolescence is legislative change. In the industrial sector an existing plant may be incapable of meeting current environmental regulations, or in some cases the product it was built to produce is now illegal. In the service sector, the need for occupiers to comply with current regulations on health and safety or disabled access may also give rise to differing degrees of functional obsolescence.

### *Economic obsolescence*

**9.12** This arises from the impact of changing economic conditions on the demand for goods or services produced by the asset. However, care has to be taken to distinguish these factors that are due to economic conditions, from factors that are specific to the entity. Any writing down of a valuation derived solely from the *DRC* approach to reflect the profitability of the business is a matter for the occupier.

**9.13** A common example of economic obsolescence is where over-capacity in a particular market reduces the demand and therefore value for the actual asset, regardless of how modern or efficient it may be. In the industrial sector, falling commodity prices have seen periods when excess market capacity has made the production of commodities such as oil or steel uneconomic. During such periods, this would have had a significant impact on the demand and therefore on the value of specialised facilities used to produce these products. In these particular examples, the cyclical nature of the markets might mean that a purchaser might be willing to buy and hold the facility in anticipation of a return to profitability, but the price would need to reflect the risks involved.

### *Measuring obsolescence*

**9.14** The three principal categories of obsolescence identified are not the only reasons why it may be necessary to adjust the cost of the modern equivalent asset in order to establish the value of the actual asset. Depreciation rates may be all encompassing or analysed separately. The three main headings simply illustrate common reasons for the actual asset being *worth* less than the modern equivalent. Frequently it will be not be possible to identify a separate adjustment under each category; in other cases, the distinction between the categories may be blurred. It is important to ensure that separate consideration of depreciation under each heading does not result in double counting.

**9.15** There will be cases where obsolescence is total. Examples include:

- **Physical obsolescence:** if the cost of repairing, reconditioning or refurbishing the actual asset to render it useable has exceeded the cost of a modern equivalent, the asset would have no value.
- **Functional obsolescence:** the introduction of new technology may render obsolete a relatively new asset with an otherwise long anticipated life, with the result that there would be no demand for it other than any value for salvage or an alternative use.
- **Economic obsolescence:** if demand for the product or service provided by

the asset has collapsed and is not expected to recover, there would be no demand for the asset other than for any salvage value or alternative use.

**9.16** Total obsolescence is often clear from the outset of the instruction, and the asset in question is classified accordingly as surplus or redundant by the entity. However, if the valuer concludes that an asset is completely obsolete during the course of the valuation exercise, this matter should be discussed with the entity before proceeding, as reclassification as surplus will indicate that a different valuation approach is required.

**9.17** It follows that the *DRC* method is normally used where obsolescence is only partial. Although the actual asset may not be in the same condition, as efficient or as technically advanced as a modern equivalent, it may still have a useful remaining life and will therefore have a value for that use. Assessing the remaining life of the asset is therefore an important aspect of the *DRC* method.



## *Asset life*

**9.18** The depreciation that will affect an asset when compared with its modern equivalent will depend on its anticipated remaining life. An asset that is expected to have a remaining life of 20 years will be *worth* a higher percentage of a new replacement than one with an expected life of five years. The remaining life can depend on physical or economic factors, or a combination of both. The physical life is how long the asset could be used for any purpose, ignoring any potential for refurbishment or reconstruction. The economic life is how long a succession of owners could use the asset for its designed purpose. The remaining life for valuation purposes will be the lower of the physical life and economic life where these do not coincide.

**9.19** The life of the asset (and its pattern of depreciation) determined as part of the *DRC* valuation is not necessarily based on the same criteria as the estimate of the 'useful life' or 'future useful economic life', or in the public sector 'service delivery lifespan' and attendant depreciation, which has to be determined by the entity for depreciation accounting (the latter two tasks are not to be confused).

**9.20** In assessing the remaining life, it may be assumed that routine servicing and repairs are undertaken, but the possibility of materially extending the life of the asset by significant refurbishment or the replacement of components is disregarded.

**9.21** For some classes of asset a regular pattern of depreciation can be determined over the whole life of an asset, although the value will reflect the remaining life available at the *valuation date*. Where this is the case, the percentage of the current replacement cost remaining at the *valuation date* may be estimated using a 'straight-line', 'reducing balance' or an 'S-curve' method. These are described in the following paragraphs.

**9.22** It will be helpful to discuss with the client how the entity deals with depreciation in its *financial statements* and how the valuer's approach may differ.

## *Straight-line*

**9.23** The straight-line basis tends to be the most commonly adopted method for calculating depreciation of buildings because of its simplicity and relative ease of

application. Straight-line depreciation assumes the same amount is allocated for depreciation for each year of the estimated life.

**9.24** The weakness of this method is the very simplistic assumption of the uniform erosion of the asset's value over its total life, compared with the equivalent replacement asset. The assumption is clearly correct at two points in the life – the beginning and the end – but it would be entirely fortuitous if it were correct at any intermediate point, which is when a valuation is most likely to take place. However, this effect may be mitigated by frequent valuations.

### *Reducing balance*

**9.25** The reducing balance method of depreciation assumes a constant percentage rate of depreciation from the reducing base. The reduction of the balance at the end of each period by a fixed proportion of itself creates a sagging depreciating value curve over the life of the asset. This method effectively 'compounds' the total depreciation. This may match reasonable expectations of declining value over time better than the straight-line method.

### *S-curve*

**9.26** The S-curve is recommended where sufficient data is available for the valuer to be confident that the curve represents the likely reality. In some cases it presents the most realistic representation of an asset's depreciation by assuming that depreciation is at a low rate in the early years, then accelerates in the middle years and reduces again in the final years. However, some assets, such as plant, may have a different depreciation pattern (high at first rather than low).

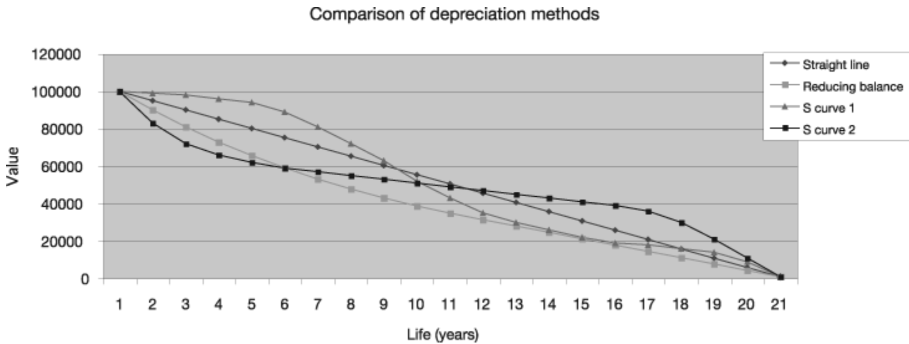
**9.27** Although it is normally accepted that the S-curve realistically represents the pattern of depreciation over the life of most assets, the percentage for any given year will depend on decisions made as to the rates of depreciation at different times and when these change. In the absence of empirical evidence in support of these inputs, the exact pattern of the curve may be dependent on subjective inputs and may be no more relevant than the other methods discussed.

**9.28** The chart in Figure 1 (next page) compares the patterns of each of the methods where it is assumed an asset has an original cost of £100,000, which reduces to a value of £1,000 over 20 years. Two types of S-curve are shown to illustrate the possible range of differences, as it is recognised that the pattern of depreciation will differ between, for example, buildings and plant and equipment.

**9.29** The three methods outlined are all in common use. Of these, the straight-line approach has the advantage of simplicity. However, it does not represent the way in which asset values are normally reflected in the marketplace. The reducing balance method may also be open to similar criticism that it does not reflect market perceptions. The S-curve attempts a surrogate for market behaviour and is appropriate where there is empirical evidence available.

**9.30** Other forms of depreciation curves are available, and where they are used by a particular market the valuer is expected to reflect them. In making adjustments for depreciation and obsolescence the valuer is advised to rely on professional knowledge, judgment and market experience, as well as take due account of the nature of the asset and the type of use to which it is put.

**Figure 1**




## 10 Other considerations

**10.1** It is not normally appropriate to make any deduction for depreciation from the cost of acquiring a modern equivalent site in the market, because freehold land rarely depreciates. When valuing *specialised property* the normal practice is to assess the cost of the improvements separately, assess the appropriate depreciation and then add this to the cost of replacing the land in order to arrive at the final valuation.

**10.2** Where a *specialised property* has many buildings or structures, some may have a longer anticipated life than others. Although it may be appropriate to adopt different rates of depreciation for different structures in making the valuation, care has to be taken not to lose sight of the objective of the exercise, which is to establish the value of the whole of the defined *specialised property*. It would therefore be inappropriate to assign a substantially longer life to an individual building or component than the anticipated life of the whole of the defined property.

**10.3** If individual buildings are identified as having potential for an alternative use beyond the anticipated life of the overall *specialised property*, this may be separately reported and based on a different valuation method, but should not be reflected in the *DRC* calculations. The objective of the *DRC* approach is to establish how valuable the *specialised property* is in comparison with a modern equivalent. The modern equivalent cannot be assumed to be exactly alike with the same alternative potential; it is purely the utility of the asset for the current use that is being assessed as part of the *DRC* calculation.

**10.4** There will be situations where the valuer can readily identify that the site of a *specialised property* could be redeveloped for an alternative, and more valuable, use if the current use was to be discontinued. In assessing the cost of the equivalent replacement site as part of the *DRC* calculation, this potential has to be disregarded for the simple reason that the hypothetical buyer would not buy a site to construct the specialised facilities if it had to compete with more valuable uses. In most cases, the potential of the actual site will have been identified using a sales comparison, not a *DRC* approach. However, the fact that this potential is irrelevant to the *DRC* process does not mean that it is irrelevant to the entity. In these circumstances VS 6.7 requires the valuer to report the value based on the alternative use. Further discussion on this can be found in section 9.

## 11 Final reconciliation

**11.1** The *DRC* calculation usually involves the consideration of many separate elements, and an essential final step is for the valuer to ensure that the resulting mathematical conclusion is consistent with the underlying valuation objective – that is, to establish the price that would be paid in an exchange between a willing seller and willing buyer in an arm's-length transaction.

**11.2** The valuer is advised to 'stand back and look' at the overall conclusion, taking particular care to check that the process of adjusting for depreciation has not resulted in any factor being either double counted or ignored. An attribute of the actual asset may be identified that has not been reflected in the process of depreciating by comparison with the hypothetical modern equivalent. In the case of a *specialised property* this could include an adjustment for any additional value in the land in its current location, which could lead to a buyer of the specialised facility for its continued use to bid more for this property than it would for a modern equivalent with no such potential.

## 12 Reporting

**12.1** The report must comply with VS 6, Valuation reports. The matters that have to be covered in all valuation reports are listed in VS 6.1, and VS 6.5 and VS 6.6 impose additional requirements when the *DRC* approach is used. A summary is given in the following paragraphs.

**12.2** A statement that the *DRC* method has been used is necessary (see VS 6.1(q)). If the valuation is being undertaken for inclusion in accounts prepared under *International Financial Reporting Standards* (*IFRS*), the value is reported as being on the basis of *market value*. However, in order to comply with VS 6.1 (q), a statement is required explaining that because of the specialised nature of property, the value is estimated using a *DRC* method and is not based on the evidence of sales of similar assets in the market. This statement matches a requirement in International Accounting Standards (IAS) 16 for the entity to include a similar statement in the published accounts.

**12.3** For assets held in the private sector, to comply with VS 6.5 a statement that the valuation is subject to the adequate profitability of the business paying due regard to the total assets employed must be included.

**12.4** For assets held in the public sector, to comply with VS 6.6 a statement that the valuation is subject to the prospect and viability of the continued occupation and use must be included. If the valuer was readily able to identify that the asset has a higher value for an alternative use, this must be reported in accordance with VS 6.7(a) as the *market value*, together with a statement that the value for alternative use takes no account of matters such as business closure or disruption and any associated costs that would be incurred. This is most likely to arise in connection with a *specialised property*, where the land may have a higher value for redevelopment than the *DRC* value.

**12.5** If the valuer considers that the value of the asset would be materially lower if the business ceased, the report must also contain a statement to this effect (see VS 6.7(b)). The *valuation standards* do not require the valuer to provide an actual figure for this purpose. If the entity wishes to establish the impact of possible closure of a specialised facility on the value of the assets employed, it may commission valuations to reflect the 'break-up', salvage or alternative use value of the asset. This would be a separate exercise and not part of the *DRC* valuation for inclusion in the *financial statements*. Any valuations provided would need to be on the *special assumption* that the entity had ceased operations (see VS 2.2).

# Appendix to GN 6: Checklist

This checklist is intended to provide the valuer with a simple way of confirming that all the matters discussed in this *guidance note* have been considered.

Where large numbers of properties are to be valued it may be helpful for a separate list and a schedule to be prepared for groups of properties. The schedule could indicate against each entry the matters that have been discussed and agreed.

It may be helpful to attach such a schedule to the report so that any reader will be fully aware of the approach taken. This will also help ensure that consistency is achieved when a revaluation is undertaken.

| Item for consideration | Ref. in GN | Comments |
|---|---|---|
| 1 Appropriate to use *DRC* | 3.1–3.9 | |
| 2 Qualification of the valuer | 4.1–4.2 | |
| (a) Specialist assistance | 4.3 | |
| 3 *Terms of engagement* settled | 5.1–5.2 | |
| 4 Assessing replacement cost | 6.1–6.5 | |
| (a) Site value | 7.1–7.12 | |
| (b) Actual | | |
| (c) Modern equivalent | | |
| 5 Building and site improvements | 8.1–8.6 | |
| (a) Plant identified | | |
| (b) Infrastructure works | | |
| (c) Size of modern equivalent | | |
| (d) Specification of modern equivalent | | |
| 6 Consideration of historic buildings | 8.7–8.8 | |
| 7 Sources of cost information | 8.9–8.14 | |
| 8 Assessment of depreciation | 9.1–9.2 | |
| (a) Physical deterioration | 9.4–9.6 | |
| (b) Functional or technical obsolescence | 9.7–9.11 | |
| (c) Economic obsolescence | 9.12–9.13 | |
| (d) Asset life | 9.18–9.22 | |

Guidance notes

| Item for consideration | Ref. in GN | Comments |
|---|---|---|
| 9 Depreciation method<br>(a) Straight line<br>(b) Reducing balance<br>(c) S-curve | 9.23–9.30<br>9.23–9.24<br>9.25<br>9.26–9.27 | |
| 10 Other considerations | 10.1–10.4 | |
| 11 Final reconciliation | 11.1–11.2 | |
| 12 Reporting<br>(a) All items under VS 6.1<br>(b) Statement that *DRC* used<br>(c) VS 6.5 (private sector)<br>(d) VS 6.6 (public sector)<br>(e) VS 6.7 (alternative values)<br>(f) Alternative value statements | 12.1 | |

Ensure file contains all relevant information on the decisions taken during the *DRC* process.

# Other RICS publications

Other RICS publications that may have a relevance to valuation may be obtained from the website at www.rics.org/guidance. They include the following mandatory practice standard, *guidance notes* and valuation information papers which have been prepared and approved by the RICS Valuation Standards Board.

## Practice standard (mandatory)

Surveyors acting as expert witnesses, 3rd edition (2008)

## Guidance notes

*Asbestos and its implications for surveyors and their clients*, 3rd edition (2011)

*Boundaries*, 2nd edition (2009)

*The capital and rental valuation of public houses, bars, restaurants and nightclubs in England and Wales*, 1st edition (2010)

*Contamination, the environment and sustainability: implications for chartered surveyors and their clients*, 3rd edition (2010)

*Discounted cash flow for commercial property investments*, 1st edition (2010)

*Leasehold reform in England and Wales*, 2nd edition (2011)

*Mineral-bearing land and waste management sites*, 1st edition (2011)

*Surveying safely*, 1st edition (2011)

*Valuation of data centres*, 1st edition (2011)

*Valuation of financial statements under UK GAAP* (2011)

*Valuation of individual new-build homes*, 1st edition (2009)

*Valuation of land for affordable housing*, 1st edition (2010)

*Valuation of medical centre and surgery premises*, 2nd edition (2010)

*Valuation of rural property*, 2nd edition (2011)

*Valuation of trees for amenity and related non-timber uses*, 1st edition (2010)

*Valuation of woodlands*, 1st edition (2010)

## Valuation information papers (all currently under review)

VIP 3: *The Capital and Rental Valuation of Petrol Filling Stations in England, Wales and Scotland* (2003)

VIP 6: *The Capital and Rental Valuation of Hotels in the UK* (2004)

VIP 11: *The Valuation and Appraisal of Private Care Home Properties in England Wales and Scotland* (2007)

VIP 12: *Valuation of development land* (2008)

VIP 13: *Sustainability and commercial property valuation* (2009)

# International Valuation Standards

## 2011

International Valuation Standards Council

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ISBN: 978-0-9569313-0-6

The International Valuation Standards Council, the authors and the publishers do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

Typeset and printed by Page Bros, Norwich

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# Introduction

Valuations are widely used and relied upon in financial and other markets, whether for inclusion in financial statements, for regulatory compliance or to support secured lending and transactional activity. The International Valuation Standards Council (IVSC) is an independent, not-for-profit, private sector organisation that has a remit to serve the public interest. The IVSC's objective is to build confidence and public trust in the valuation process by creating a framework for the delivery of credible valuation opinions by suitably trained valuation professionals acting in an ethical manner.

The IVSC achieves this objective by:

- creating and maintaining the International Valuation Standards (IVS),
- issuing technical guidance for professional valuers, and
- promoting the development of the valuation profession and ethical practices globally.

The overriding objective of the IVS is to increase the confidence of users of valuation services in valuations on which they rely. In pursuit of this the IVS:

(a) promote consistency and aid the understanding of all types of valuation by identifying or developing globally accepted principles and definitions,

(b) identify and promulgate common principles for the undertaking of valuation assignments and the reporting of valuations,

(c) identify specific matters that require consideration and methods commonly used when valuing different types of assets or liabilities,

(d) identify the appropriate valuation processes and reporting disclosures for the major purposes for which valuations are required,

(e) reduce diversity of practice by enabling the convergence of different valuation standards used in specific sectors and states.

While the standards are designed to be applied by valuation professionals, they are intended to be of benefit to users of valuation services and to the operation and regulation of markets generally. The standards identify valuation methods that are commonly used but do not explain their application in detail. Some explanatory commentary is provided to assist understanding of the requirements of each standard in context but technical guidance on valuation techniques is not included. Valuation methodology and other technical guidance are separately published by IVSC but do not form part of these standards.

The International Valuation Standards Board (IVSB) is the standard-setting body of the IVSC. The IVSB members are appointed by the IVSC Trustees having regard to criteria set out in the bylaws of the organisation and the IVSB has autonomy in the development and approval of the IVS.

In developing the IVS, the IVSB:

(a) follows due process in the development of any new standard that involves consultation with providers and users of valuation services and public exposure of all new standards and material alterations to existing standards,

(b) liaises with other bodies that have a standard-setting function for valuation within a defined geographic area or for a defined sector,

(c) conducts outreach activities including round table discussions with invited constituents and targeted discussions with specific users or user groups.

The IVSB is subject to oversight by the Board of Trustees of the IVSC to ensure that it acts in accordance with the Council's remit and adopts suitable processes for determination of the standards.

## Structure

The IVS consist of the following:

### IVS Definitions

This contains those words or phrases that have a specific meaning in the context of the standards and that appear in more than one standard. Definitions that are only used in a single standard are only defined in that standard.

### IVS Framework

The IVS Framework contains generally accepted valuation concepts and principles upon which the IVS are based and that are to be considered and applied when following the standards.

### General Standards

The three General Standards have general application for all asset types and valuation purposes, subject only to variations or additional requirements specified in the Asset Standards or the Valuation Applications. The General Standards are IVS 101 *Scope of Work*, IVS 102 *Implementation* and IVS 103 *Reporting*.

### Asset Standards

The Asset Standards consist of a standard and a commentary. The standard sets out requirements that either modify or augment the General Standards and include illustrations of how the principles in the General Standards are generally applied to the particular asset class. The commentary provides additional background information on the characteristics of each asset type that influence value and identifies the common valuation approaches and methods used.

### Valuation Applications

Valuation Applications are produced for common purposes for which valuations are required. Each application contains a standard and guidance. The standard includes any additions to or modifications of the requirements in the General Standards and illustrations of how the principles in the General Standards and Asset Standards apply when undertaking valuations for that purpose. The guidance section provides information on:

(a) the valuation requirements of internationally applicable regulations or standards issued by other bodies that may be applicable, eg International Financial Reporting Standards,

(b) other commonly accepted requirements for valuations for that purpose,

(c) appropriate valuation procedures to meet these requirements.

## Application of these Standards

Where a statement is made that a valuation will be or has been undertaken in accordance with IVS, it is implicit that all relevant individual standards are complied with. Where a departure is necessary to comply with any legislative or regulatory requirements, this should be clearly explained.

## Assets and Liabilities

The standards apply to the valuation of both assets and liabilities. To assist the legibility of these standards, the words asset or assets are deemed to include liability or liabilities, except where it is expressly stated otherwise, or is clear from the context that liabilities are excluded.

## Effective Dates

This publication includes those standards approved by the IVSB as of 1 June 2011. The effective date for each standard is shown in the standard. Although for convenience, printed and bound copies of the standards approved as of a given date are published at regular intervals, changes may be made to existing standards or additional standards introduced at any time, subject to the IVSB following the due process. Any amended or new standards will be available on the IVSC website at www.ivsc.org.

## 2007 Standards

The standards, applications and guidance notes in the eighth edition published in 2007 are no longer applicable after 31 December 2011.

# Principal Changes



### Critical Review Recommendations

IVSC is the successor body to the International Valuation Standards Committee, which from the early 1980s until 2007 developed and published the IVS. In 2006, the former Committee established a Critical Review Group with a remit of considering how the standards could be improved to meet the requirements of the evolving market for valuation. The report of the Critical Review Group was published in 2007 and comments invited on its recommendations. In developing these new standards the IVSB has had regard to most of the major recommendations made in this review and also to the feedback received during the consultation process.

As a result there are major changes in the style and presentation of the revised standards compared with earlier versions. Because of this it is impractical to list every change that has been made. Among the more significant changes are:

### Eliminating Repetition

To make the standards more accessible there was a need to reduce their length and apparent complexity. Merging material that previously appeared in different parts of IVS 2007 revealed significant repetition of the same concepts and topics.

### Eliminating Methodology

Two Guidance Notes in IVS 2007 on the Cost Approach (GN8) and Discounted Cash Flow (GN9) are discussions on the use and application of specific valuation techniques that fall outside the criteria for inclusion in the standards. In the new standards approaches and methods are defined and explained at high level but no detail is provided on their application. In future the IVSC Professional Board will publish Technical Information Papers (TIPS) on methodology separately from the standards. The former GN8 and GN9 are being reviewed by the IVSC Professional Board and exposure drafts were published on these topics in 2011 and further TIPs are planned. Details of the IVSC's current work plan can be found at www.ivsc.org.

### Eliminating the Code of Ethics

The IVSC is a valuation standards setter. Ethical behaviour is a vital component of valuation practice but accrediting and regulating individual valuers is a matter for those adopting the standards. Valuer regulation also takes many forms in different sectors and states. Including a Code of Ethics in standards that are intended to be capable of mandatory application created an obstacle to their adoption because the code inevitably differed in detail from those used by others. The Code of Ethics that appeared in earlier editions has therefore been removed, although the IVSC Professional Board has a project to develop a model Code of Ethics to act as a benchmark for other codes and to assist the development of the profession in emerging economies.

### Glossary

The 2007 edition of the IVS included a very substantial glossary. This included many terms that are not used in the standards and superfluous definitions where the definition provided was no different to the common dictionary meaning of the word or words. The revised standards do not include a glossary, only a short list of definitions used in the standards themselves to assist in their interpretation. This is limited to words and terms that are used with a particular meaning that is not necessarily clear from their everyday or common usage. A comprehensive glossary of common valuation terms is under development by the IVSC Professional Board but will not form part of the standards.

### Greater Focus on Principles

In the previous standards there had been a tendency to make prescriptive requirements that were too detailed for practical application across a wide range of global valuation practice. The new standards focus on the required principles, illustrated as necessary with examples, in order to enable them to be applied as widely as possible.

### Changes by Section

Although detailed text changes cannot be individually referenced, the more significant changes from IVS 2007 on a section-by-section basis are summarised below:

| **IVS 2007** | **Revised Standards** |
|---|---|
| Concepts Fundamental to Generally Accepted Valuation Principles (GAVP) | The generic valuation principles have been carried forward into the IVS *Framework*. Other material discussing *market value* and land and property has been merged into IVS 230 *Real Property Interests.* |
| Code of Conduct | Removed – see comment above. |

| IVS 2007 | Revised Standards |
|---|---|
| Property Types | Not directly replicated. Some elements included in individual asset standards. |
| Introduction to IVS 1,2,3 | Not directly replicated. Elements included in IVS *Framework* and IVS 103 *Reporting*. |
| IVS 1 *Market Value* and IVS 2 *Other Bases of Value* | Merged into IVS *Framework*. |
| IVS 3 *Valuation Reporting* | Principles carried forward into IVS 103 *Reporting.* |
| IVA 1 *Valuations for Financial Reporting* | Now included in IVS 300 *Valuations for Financial Reporting*. The material has been updated and a clear distinction is now made between the valuation standard and guidance on the valuations needed to meet specific accounting requirements. |
| IVA 2 *Valuations for Secured Lending* | Made specific to real property and carried forward to IVS 310 *Valuations of Property Interests for Secured Lending.* The distinction between the valuation standard and guidance has been made clear and there have been other minor changes. |
| IVA 3 *Valuation of Public Sector Assets for Financial Reporting* | Now forms annexe to IVS 300 *Valuations for Financial Reporting.* |
| GN1 *Real Property Valuation* and GN2 *Lease Interests* | Elements carried forward and merged to IVS 230 *Real Property Interests.* |
| GN3 *Valuation of Plant and Equipment* | Updated and carried forward to IVS 220 *Plant and Equipment*. |
| GN4 *Valuation of Intangible Assets* | This was replaced by a revised and extended GN4 published in February 2010. This contained comprehensive guidance on *intangible assets*. The new standard IVS 210 *Intangible Assets* is based on the revised GN4, but the more detailed guidance has been omitted. This is being incorporated into a separate Technical Information Paper. |

| IVS 2007 | Revised Standards |
|---|---|
| GN5 *Valuation of Personal Property* | No equivalent in new standards. The definition of personal property in the previous standards was very broad and covered many asset classes that are now the subject of more specific standards. The previous GN was withdrawn by the IVSB in February 2010. |
| GN6 *Business Valuation* | Updated standards for business valuation are in IVS 200 *Businesses and Business Interests.* |
| GN7 *Consideration of Hazardous and Toxic Materials* | This topic is just one of many that potentially affect an asset's value. No other topics have been highlighted in previous IVS. Not carried forward. |
| GN8 *Cost Approach* and GN9 *Discounted Cash Flow* | These are discussions on valuation methods and do not meet the criteria for inclusion in the standards. The IVSC is producing revised Technical Information Papers on these and other valuation methods. |
| GN10 *Valuation of Agricultural Property* | Not being carried forward as the previous standard contained no requirements that differed from those for other *real property* types. |
| GN11 *Reviewing Valuations* | The scope of and the limitations on any valuation assignment are now covered generically in IVS 101 *Scope of Work.* Not carried forward. The IVSC currently has a project on developing guidance on audit reviews that may lead to future changes to the existing standards or to a new standard. |
| GN12 *Valuation of Trade Related Property* | A revised standard appeared in the Exposure Draft but has not been approved by the Board pending further consultation on the relationship with IVS 200 *Businesses and Business Interests* and IVS 230 *Real Property Interests*. |
| GN13 *Mass Appraisal for Property Taxation* | Not being carried forward as it contains no valuation procedures that differ from the General Standards. |

| **IVS 2007** | **Revised Standards** |
|---|---|
| GN14 *Valuations of Properties in Extractive Industries* | A comprehensive project on valuations in the Extractive Industries is about to commence and will probably lead to a new standard and Technical Guidance. The current GN has not been carried forward and was withdrawn by the IVSB in February 2010. |
| GN15 *Valuation of Historic Property* | Carried forward as annexe to IVS 230 *Real Property Interests.* |
| GN17 *Valuation of Investment Property under Construction* (published February 2010) | Carried forward as IVS 233 *Investment Property under Construction.* |

# IVS Definitions

The definitions below are of words or phrases used in the IVS *Framework*, the General Standards or in more than one Asset Standard or Valuation Application that have a specific or limited meaning. These terms are italicised in the text of each standard.

**Basis of value** – a statement of the fundamental measurement assumptions of a valuation.

**Cost approach** – provides an indication of value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction.

**Fair value** – the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.[1]

**Goodwill** – any future economic benefit arising from a business, an interest in a business or from the use of a group of assets which is not separable.

**Income approach** – provides an indication of value by converting future cash flows to a single current capital value.

**Intangible asset** – a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and economic benefits to its owner.

**Investment property** – property that is land or a building, or part of a building, or both, held by the owner to earn rentals or for capital appreciation, or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes, or

(b) sale in the ordinary course of business.

[1] This does not apply to valuations for financial reporting – see IVS 300.

**Investment value** – the value of an asset to the owner or a prospective owner for individual investment or operational objectives.

**Market approach** – provides an indication of value by comparing the subject asset with identical or similar assets for which price information is available.

**Market rent** – the estimated amount for which a property would be leased on the *valuation date* between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

**Market value** – the estimated amount for which an asset or liability should exchange on the *valuation date* between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

**Real estate** – land and all things that are a natural part of the land, eg trees, minerals and things that have been attached to the land, eg buildings and site improvements and all permanent building attachments, eg mechanical and electrical plant providing services to a building, that are both below and above the ground.

**Real property** – all rights, interests and benefits related to the ownership of *real estate*.

**Special assumption** – an assumption that either assumes facts that differ from the actual facts existing at the *valuation date* or that would not be made by a typical market participant in a transaction on the *valuation date*.

**Special purchaser** – a particular buyer for whom a particular asset has *special value* because of advantages arising from its ownership that would not be available to other buyers in a market.

**Special value** – an amount that reflects particular attributes of an asset that are only of value to a *special purchaser*.

**Synergistic value** – an additional element of value created by the combination of two or more assets or interests where the combined value is more than the sum of the separate values.

**Trade related property** – any type of *real property* designed for a specific type of business where the property value reflects the trading potential for that business.

**Valuation date** – the date on which the opinion of value applies.

# IVS Framework

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**The IVS Framework includes generally accepted valuation concepts, principles and definitions upon which the International Valuation Standards are based. This framework should be considered and applied when following the individual standards and valuation applications.**

**Valuation and Judgement**

1. Applying the principles in these standards to specific situations will require the exercise of judgement. That judgement must be applied objectively and should not be used to overstate or understate the valuation result. Judgement shall be exercised having regard to the purpose of the valuation, the *basis of value* and any other assumptions applicable to the valuation.

**Independence and Objectivity**

2. The process of valuation requires the valuer to make impartial judgements as to the reliance to be given to different factual data or assumptions in arriving at a conclusion. For a valuation to be credible, it is important that those judgements can be seen to have been made in an environment that promotes transparency and minimises the influence of any subjective factors on the process.

3. Many states have laws or regulations that only allow certain persons to value particular classes of assets for various purposes. Additionally, many professional bodies and valuation providers have ethical codes that require the identification and disclosure of potential conflicts of interest. The purpose of these standards is to set internationally recognised principles and definitions for the preparation and reporting of valuations. They do not include regulations on the relationship between those commissioning valuations and those undertaking them, as matters relating to the conduct and ethical behaviour of valuers is for professional bodies or other bodies that have a regulatory role over valuers.

4. While specific conduct rules for valuers are outside the scope of these standards, it is nevertheless a fundamental expectation that appropriate controls and procedures are in place to ensure the necessary degree of independence and objectivity in the valuation process so that the results can be seen to be free from bias. Where the purpose of the valuation requires the valuer to have a specific status or disclosures confirming the valuer’s status to be made, the requirements are set out in the appropriate standard.

**Competence**

5. Because valuation requires the exercise of skill and judgement, it is a fundamental expectation that valuations are prepared by an individual or firm having the appropriate technical skills, experience

and knowledge of the subject of the valuation, the market in which it trades and the purpose of the valuation.

6. For complex or large multi-asset valuations, it is acceptable for the valuer to seek assistance from specialists in certain aspects of the overall assignment, providing this is disclosed in the scope of work (see IVS 101 *Scope of Work*).

**Price, Cost and Value**

7. Price is the amount asked, offered or paid for an asset. Because of the financial capabilities, motivations or special interests of a given buyer or seller, the price paid may be different from the value which might be ascribed to the asset by others.

8. Cost is the amount required to acquire or create the asset. When that asset has been acquired or created, its cost is a fact. Price is related to cost because the price paid for an asset becomes its cost to the buyer.

9. Value is not a fact but an opinion of either:

   (a) the most probable price to be paid for an asset in an exchange, or

   (b) the economic benefits of owning an asset.

   A value in exchange is a hypothetical price and the hypothesis on which the value is estimated is determined by the purpose of the valuation. A value to the owner is an estimate of the benefits that would accrue to a particular party from ownership.

10. The word "valuation" can be used to refer to the estimated value (the valuation conclusion) or to refer to the preparation of the estimated value (the act of valuing). In these standards it should generally be clear from the context which meaning is intended. Where there is potential for confusion or a need to make a clear distinction between the alternative meanings, additional words are used.

**The Market**

11. A market is the environment in which goods and services trade between buyers and sellers through a price mechanism. The concept of a market implies that goods or services may be traded among buyers and sellers without undue restriction on their activities. Each party will respond to supply-demand relationships and other price-setting factors as well as to their own understanding of the relative utility of the goods or services and individual needs and desires.

12. In order to estimate the most probable price that would be paid for an asset, it is of fundamental importance to understand the extent of the market in which that asset would trade. This is because the price that can be obtained will depend upon the number of buyers and sellers in the particular market on the *valuation date*. To have an effect on price, buyers and sellers must have access to that market. A market can be defined by various criteria. These include:

    (a) the goods or services that are traded, eg the market for motor vehicles is distinct from the market for gold,

    (b) scale or distribution restraints, eg a manufacturer of goods may not have the distribution or marketing infrastructure to sell to end users and the end users may not require the goods in the volume at which they are produced by the manufacturer,

    (c) geography, eg the market for similar goods or services may be local, regional, national or international.

13. However, although at any point in time a market may be self-contained and be little influenced by activity in other markets, over a period of time markets will influence each other. For example, on any given date the price of a asset in one state may be higher than could be obtained for an identical asset in another. If any possible distorting effects caused by government trading restrictions or fiscal policies are ignored, suppliers would, over time, increase the supply of the asset to the state where it could obtain the higher price and reduce the supply to the state where the price was lower, thus bringing about a convergence of prices.

14. Unless otherwise clear from the context, references in IVS to the market mean the market in which the asset or liability being valued is normally exchanged on the *valuation date* and to which most participants in that market, including the current owner, normally have access.

15. Markets rarely operate perfectly with constant equilibrium between supply and demand and an even level of activity, due to various imperfections. Common market imperfections include disruptions of supply, sudden increases or decreases in demand or asymmetry of knowledge between market participants. Because market participants react to these imperfections, at a given time a market is likely to be adjusting to any change that has caused disequilibrium. A valuation that has the objective of estimating the most probable price in the market has to reflect the conditions in the relevant market on the *valuation date*, not an adjusted or smoothed price based on a supposed restoration of equilibrium.

**Market Activity**

16. The degree of activity in any market will fluctuate. Although it may be possible to identify a normal level of activity over an extended period, in most markets there will be periods when activity is significantly higher or lower than this norm. Activity levels can only be expressed in relative terms, eg the market is more or less active than it was on a previous date. There is no clearly defined line between a market that is active or inactive.

17. When demand is high in relation to supply, prices would be expected to rise which tends to attract more sellers to enter the market and therefore increased activity. The converse is the case when demand is low and prices are falling. However, different levels of activity may be a response to price movements rather than the cause of them. Transactions can and do take place in markets that are currently less active than normal and, just as importantly, prospective buyers are likely to have in mind a price at which they would be prepared to enter the market.

18. Price information from an inactive market may still be evidence of *market value*. A period of falling prices is likely to see both decreased levels of activity and an increase in sales that can be termed “forced” (see paras 53 to 55 below). However, there are sellers in falling markets that are not acting under duress and to dismiss the evidence of prices realised by such sellers would be to ignore the realities of the market.

**Market Participants**

19. References in IVS to market participants are to the whole body of individuals, companies or other entities that are involved in actual transactions or who are contemplating entering into a transaction for a particular type of asset. The willingness to trade and any views attributed to market participants are typical of those of buyers and sellers, or prospective buyers and sellers, active in a market on the *valuation date*, not to those of any particular individual or entity.

20. In undertaking a market-based valuation, matters that are specific to the current owner or to one particular potential buyer are not relevant because both the willing seller and the willing buyer are hypothetical individuals or entities with the attributes of a typical market participant. These attributes are discussed in the conceptual framework for *market value* (see paras 31(d) and 31(e)). The conceptual framework also requires the exclusion of any element of *special value* or any element of value that would not be available to market participants generally (see paras 31(a) and 31(f)).

### Entity Specific Factors

21. The factors that are specific to a particular buyer or seller and not available to market participants generally are excluded from the inputs used in a market-based valuation. Examples of entity specific factors that may not be available to market participants include the following:

    (a) additional value derived from the creation of a portfolio of similar assets,

    (b) unique synergies between the asset and other assets owned by the entity,

    (c) legal rights or restrictions,

    (d) tax benefits or tax burdens,

    (e) an ability to exploit an asset that is unique to that entity.

22. Whether such factors are specific to the entity or would be available to others in the market generally is determined on a case-by-case basis. For example, an asset may not normally be transacted as a stand-alone item but as part of a group. Any synergies with related assets would transfer to market participants along with the transfer of the group and therefore are not entity specific.

23. If the objective of the valuation is to determine the value to a specific owner, entity specific factors are reflected in the valuation of the asset. Situations in which the value to a specific owner may be required include the following examples:

    (a) supporting investment decisions,

    (b) reviewing the performance of an asset.

### Aggregation

24. The value of an individual asset is often dependent upon its association with other related assets. Examples include:

    (a) offsetting assets and liabilities in a portfolio of financial instruments,

    (b) a portfolio of properties that complement each other by providing a prospective buyer with either a critical mass or a presence in strategic locations,

    (c) a group of machines in a production line, or the software required to operate a machine or machines,

    (d) recipes and patents that support a brand,

    (e) interdependent land, buildings, plant and other equipment employed in a business enterprise.

25. Where a valuation is required of assets that are held in conjunction with other complementary or related assets, it is important to clearly define whether it is the group or portfolio of assets that is to be valued or each of the assets individually. If the latter, it is also important to establish whether each asset is assumed to be valued:

    (a) as an individual item but assuming that the other assets are available to a buyer, or

    (b) as an individual item but assuming that the other assets are not available to a buyer.

**Basis of Value**

26. A *basis of value* is a statement of the fundamental measurement assumptions of a valuation.

27. It describes the fundamental assumptions on which the reported value will be based, eg the nature of the hypothetical transaction, the relationship and motivation of the parties and the extent to which the asset is exposed to the market. The appropriate basis will vary depending on the purpose of the valuation. A *basis of value* should be clearly distinguished from:

    (a) the approach or method used to provide an indication of value,

    (b) the type of asset being valued,

    (c) the actual or assumed state of an asset at the point of valuation,

    (d) any additional assumptions or *special assumptions* that modify the fundamental assumptions in specific circumstances.

28. A *basis of valuatio*n can fall into one of three principal categories:

    (a) The first is to indicate the most probable price that would be achieved in a hypothetical exchange in a free and open market. *Market value* as defined in these standards falls into this category.

    (b) The second is to indicate the benefits that a person or an entity enjoys from ownership of an asset. The value is specific to that person or entity, and may have no relevance to market participants in general. *Investment value* and *special value* as defined in these standards fall into this category.

    (c) The third is to indicate the price that would be reasonably agreed between two specific parties for the exchange of an asset. Although the parties may be unconnected and negotiating at arm’s length, the asset is not necessarily exposed in the market and the price agreed may be one that reflects the specific advantages or disadvantages of ownership to the parties involved rather than the market at large. *Fair value* as defined in these standards falls into this category.

29. Valuations may require the use of different *bases of value* that are defined by statute, regulation, private contract or other document. Although such bases may appear similar to the *bases of value* defined in these standards, unless unequivocal reference is made to IVS in the relevant document, their application may require a different approach from that described in IVS. Such bases have to be interpreted and applied in accordance with the provisions of the source document. Examples of *bases of value* that are defined in other regulations are the various valuation measurement bases found in International Financial Reporting Standards (IFRS) and other accounting standards.

**Market Value**

30. *Market value* is the estimated amount for which an asset should exchange on the *valuation date* between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

31. The definition of *market value* shall be applied in accordance with the following conceptual framework:

(a) "the estimated amount" refers to a price expressed in terms of money payable for the asset in an arm's length market transaction. *Market value* is the most probable price reasonably obtainable in the market on the *valuation date* in keeping with the *market value* definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of *special value*;

(b) "an asset should exchange" refers to the fact that the value of an asset is an estimated amount rather than a predetermined amount or actual sale price. It is the price in a transaction that meets all the elements of the market value definition at the *valuation date*;

(c) "on the *valuation date*" requires that the value is time-specific as of a given date. Because markets and market conditions may change, the estimated value may be incorrect or inappropriate at another time. The valuation amount will reflect the actual market state and circumstances as of the effective *valuation date*, not as of either a past or future date. The definition also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might otherwise be made;

(d) "between a willing buyer" refers to one who is motivated, but not compelled to buy. This buyer is neither over eager nor determined to buy at any price. This buyer is also one who purchases in accordance with the realities of the current market and with current market expectations, rather than in relation to an imaginary or hypothetical market that cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than the market requires. The present owner is included among those who constitute "the market";

(e) "and a willing seller" is neither an over eager nor a forced seller prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in the current market. The willing seller is motivated to sell the asset at market terms for the best price attainable in the open market after proper marketing, whatever that price may be. The factual circumstances of the actual owner are not a part of this consideration because the willing seller is a hypothetical owner;

(f) "in an arm's length transaction" is one between parties who do not have a particular or special relationship, eg parent and subsidiary companies or landlord and tenant, that may make the price level uncharacteristic of the market or inflated because of an element of s*pecial value*. The *market value* transaction is presumed to be between unrelated parties, each acting independently;

(g) "after proper marketing" means that the asset would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable in accordance with the *market value* definition. The method of sale is deemed to be that most appropriate to obtain the best price in the market to which the seller has access. The length of exposure time is not a fixed period but will vary according to the type of asset and market conditions. The only criterion is that there must have been sufficient time to allow the asset to be brought to the attention of an adequate number of market participants. The exposure period occurs prior to the *valuation date*;

(h) "where the parties had each acted knowledgeably, prudently" presumes that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the asset, its actual and potential uses and the state of the market as of the *valuation date*. Each is further presumed to use that knowledge prudently to seek the price that is most favourable for their respective positions in the transaction. Prudence is assessed by referring to the state of the market at the *valuation date*, not with benefit of hindsight at some later date. For example, it is not necessarily imprudent for a seller to sell assets in a market with falling prices at a price that is lower than

previous market levels. In such cases, as is true for other exchanges in markets with changing prices, the prudent buyer or seller will act in accordance with the best market information available at the time;

(i) "and without compulsion" establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.

32. The concept of *market value* presumes a price negotiated in an open and competitive market where the participants are acting freely. The market for an asset could be an international market or a local market. The market could consist of numerous buyers and sellers, or could be one characterised by a limited number of market participants. The market in which the asset is exposed for sale is the one in which the asset being exchanged is normally exchanged (see paras 16 to 20 above).

33. The *market value* of an asset will reflect its highest and best use. The highest and best use is the use of an asset that maximises its productivity and that is possible, legally permissible and financially feasible. The highest and best use may be for continuation of an asset's existing use or for some alternative use. This is determined by the use that a market participant would have in mind for the asset when formulating the price that it would be willing to bid.

34. The highest and best use of an asset valued on a stand-alone basis may be different from its *highest and best use* as part of a group, when its contribution to the overall value of the group must be considered.

35. The determination of the highest and best use involves consideration of the following:

(a) to establish whether a use is possible, regard will be had to what would be considered reasonable by market participants,

(b) to reflect the requirement to be legally permissible, any legal restrictions on the use of the asset, eg zoning designations, need to be taken into account,

(e) the requirement that the use be financially feasible takes into account whether an alternative use that is physically possible and legally permissible will generate sufficient return to a typical market participant, after taking into account the costs of conversion to that use, over and above the return on the existing use.

**Transaction Costs**

36. *Market value* is the estimated exchange price of an asset without regard to the seller's costs of sale or the buyer's costs of purchase and without adjustment for any taxes payable by either party as a direct result of the transaction.

**Investment Value**

37. *Investment value* is the value of an asset to the owner or a prospective owner for individual investment or operational objectives.

38. This is an entity-specific *basis of value*. Although the value of an asset to the owner may be the same as the amount that could be realised from its sale to another party, this *basis of value* reflects the benefits received by an entity from holding the asset and, therefore, does not necessarily involve a hypothetical exchange. *Investment value* reflects the circumstances and financial objectives of the entity for which the valuation is being produced. It is often used for measuring investment performance. Differences between the *investment value* of an asset and its *market value* provide the motivation for buyers or sellers to enter the marketplace.

**Fair Value**

39. *Fair value* is the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.

40. The definition of fair value in IFRS is different from the above. The IVSB considers that the definitions of fair value in IFRS are generally consistent with *market value*. The definition and application of fair value under IFRS are discussed in IVS 300 *Valuations for Financial Reporting.*

41. For purposes other than use in financial statements, *fair value* can be distinguished from *market value*. *Fair value* requires the assessment of the price that is fair between two identified parties taking into account the respective advantages or disadvantages that each will gain from the transaction. It is commonly applied in judicial contexts. In contrast, *market value* requires any advantages that would not be available to market participants generally to be disregarded.

42. *Fair value* is a broader concept than *market value.* Although in many cases the price that is fair between two parties will equate to that obtainable in the market, there will be cases where the assessment of *fair value* will involve taking into account matters that have to be disregarded in the assessment of *market value*, such as any

element of *special value* arising because of the combination of the interests.

43. Examples of the use of *fair value* include:

(a) determination of a price that is fair for a shareholding in a non-quoted business, where the holdings of two specific parties may mean that the price that is fair between them is different from the price that might be obtainable in the market,

(b) determination of a price that would be fair between a lessor and a lessee for either the permanent transfer of the leased asset or the cancellation of the lease liability.

**Special Value**

44. *Special value* is an amount that reflects particular attributes of an asset that are only of value to a *special purchaser*.

45. A *special purchaser* is a particular buyer for whom a particular asset has *special value* because of advantages arising from its ownership that would not be available to other buyers in the market.

46. *Special value* can arise where an asset has attributes that make it more attractive to a particular buyer than to any other buyers in a market. These attributes can include the physical, geographic, economic or legal characteristics of an asset. *Market value* requires the disregard of any element of *special value* because at any given date it is only assumed that there is a willing buyer, not a particular willing buyer.

47. When *special value* is identified, it should be reported and clearly distinguished from *market value*.

**Synergistic Value**

48. *Synergistic value* is an additional element of value created by the combination of two or more assets or interests where the combined value is more than the sum of the separate values. If the synergies are only available to one specific buyer then it is an example of *special value*.

**Assumptions**

49. In addition to stating the *basis of value*, it is often necessary to make an assumption or multiple assumptions to clarify either the state of the asset in the hypothetical exchange or the circumstances under which the asset is assumed to be exchanged. Such assumptions can have a significant impact on value.

50. Examples of additional assumptions in common use include, without limitation:

    - an assumption that a business is transferred as a complete operational entity,
    - an assumption that assets employed in a business are transferred without the business, either individually or as a group,
    - an assumption that an individually valued asset is transferred together with other complementary assets (see paras 24 and 25 above),
    - an assumption that a holding of shares is transferred either as a block or individually,
    - an assumption that a property that is owner-occupied is vacant in the hypothetical transfer.

51. Where an assumption is made that assumes facts that differ from those existing at the *date of valuation*, it becomes a *special assumption* (see IVS 101 *Scope of Work*). *Special assumptions* are often used to illustrate the effect of possible changes on the value of an asset. They are designated as “special” so as to highlight to a valuation user that the valuation conclusion is contingent upon a change in the current circumstances or that it reflects a view that would not be taken by market participants generally on the *valuation date*.

52. Assumptions and *special assumptions* must be reasonable and relevant having regard to the purpose for which the valuation is required.

**Forced Sales**

53. The term “forced sale” is often used in circumstances where a seller is under compulsion to sell and that, as consequence, a proper marketing period is not possible. The price that could be obtained in these circumstances will depend upon the nature of the pressure on the seller and the reasons why proper marketing cannot be undertaken. It may also reflect the consequences for the seller of failing to sell within the period available. Unless the nature of and the reason for the constraints on the seller are known, the price obtainable in a forced sale cannot be realistically estimated. The price that a seller will accept in a forced sale will reflect its particular circumstances rather than those of the hypothetical willing seller in the *market value* definition. The price obtainable in a forced sale has only a coincidental relationship to *market value* or any of the other bases defined in this standard. A “forced sale” is a description of the situation under which the exchange takes place, not a distinct *basis of value*.

54. If an indication of the price obtainable under forced sale circumstances is required, it will be necessary to clearly identify the reasons for the constraint on the seller including the consequences of failing to sell in the specified period by setting out appropriate assumptions. If these circumstances do not exist at the *valuation date*, these must be clearly identified as *special assumptions*.

55. Sales in an inactive or falling market are not automatically "forced sales" simply because a seller might hope for a better price if conditions improved. Unless the seller is compelled to sell by a deadline that prevents proper marketing, the seller will be a willing seller within the definition of *market value* (see paras 18 and 31(e)) above).

**Valuation Approaches**

56. One or more valuation approaches may be used in order to arrive at the valuation defined by the appropriate *basis of value* (see paras 26 to 29 above). The three approaches described and defined in this Framework are the main approaches used in valuation. They all are based on the economic principles of price equilibrium, anticipation of benefits or substitution.

**Market Approach**

57. The *market approach* provides an indication of value by comparing the subject asset with identical or similar assets for which price information is available.

58. Under this approach the first step is to consider the prices for transactions of identical or similar assets that have occurred recently in the market. If few recent transactions have occurred, it may also be appropriate to consider the prices of identical or similar assets that are listed or offered for sale provided the relevance of this information is clearly established and critically analysed. It may be necessary to adjust the price information from other transactions to reflect any differences in the terms of the actual transaction and the *basis of value* and any assumptions to be adopted in the valuation being undertaken. There may also be differences in the legal, economic or physical characteristics of the assets in other transactions and the asset being valued.

**Income Approach**

59. The *income approach* provides an indication of value by converting future cash flows to a single current capital value.

60. This approach considers the income that an asset will generate over its useful life and indicates value through a capitalisation process. Capitalisation involves the conversion of income into a

capital sum through the application of an appropriate discount rate. The income stream may be derived under a contract or contracts, or be non-contractual, eg the anticipated profit generated from either the use of or holding of the asset.

61. Methods that fall under the *income approach* include:

- income capitalisation, where an all-risks or overall capitalisation rate is applied to a representative single period income,
- discounted cash flow where a discount rate is applied to a series of cash flows for future periods to discount them to a present value,
- various option pricing models.

62. The *income approach* can be applied to liabilities by considering the cash flows required to service a liability until it is discharged.

**Cost Approach**

63. The *cost approach* provides an indication of value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction.

64. This approach is based on the principle that the price that a buyer in the market would pay for the asset being valued would, unless undue time, inconvenience, risk or other factors are involved, be not more than the cost to purchase or construct an equivalent asset. Often the asset being valued will be less attractive than the alternative that could be purchased or constructed because of age or obsolescence. Where this is the case, adjustments may need to be made to the cost of the alternative asset depending on the required *basis of value*.

**Methods of Application**

65. Each of these principal valuation approaches includes different detailed methods of application. Various methods that are commonly used for different asset classes are discussed in the Asset Standards.

**Valuation Inputs**

66. Valuation inputs refer to the data and other information that are used in any of the valuation approaches described in this standard. These inputs may be actual or assumed.

67. Examples of actual inputs include:

- prices achieved for identical or similar assets,
- actual cash flows generated by the asset,
- the actual cost of identical or similar assets.

68. Examples of assumed inputs include:

- estimated or projected cash flows,
- the estimated cost of a hypothetical asset,
- market participants' perceived attitude to risk.

69. Greater reliance will normally be placed on actual inputs; however, where these are less relevant, eg where the evidence of actual transactions is dated, historic cash flows are not indicative of future cash flows or the actual cost information is historic, assumed inputs will be more relevant.

70. A valuation will normally be more certain where multiple inputs are available. Where only limited inputs are available particular caution is required in investigating and verifying the data.

71. Where the input involves evidence of a transaction, care should be taken to verify whether the terms of that transaction were in accord with those of the required *basis of value.*

72. The nature and source of the valuation inputs should reflect the *basis of value*, which in turn depends on the valuation purpose. For example, various approaches and methods may be used to indicate *market value* providing they use market derived data. The *market approach* will by definition use market derived inputs. To indicate *market value* the *income approach* should be applied using inputs and assumptions that would be adopted by market participants. To indicate *market value* using the *cost approach*, the cost of an asset of equal utility and the appropriate depreciation should be determined by analysis of market-based costs and depreciation. The data available and the circumstances relating to the market for the asset being valued will determine which valuation method or methods are most relevant and appropriate. If based on appropriately analysed market derived data each approach or method used should provide an indication of *market value*.

73. Valuation approaches and methods are generally common to many types of valuation. However, valuation of different types of assets involves different sources of data that must reflect the market in which the assets are to be valued. For example, the underlying investment of *real estate* owned by a company will be valued in the context of the relevant *real estate* market in which the *real estate* trades, whereas the shares of the company itself will be valued in the context of the market in which the shares trade.

# General Standards

## IVS 101 Scope of Work

| **Contents** | **Paragraphs** |
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### General Principle

1. There are many different types and levels of valuation advice that may be provided. IVS are designed to apply to a wide spectrum of valuation assignments. A valuation must be appropriate for its intended purpose and it is also important that the recipient understands what is to be provided and any limitations on the use of the valuation. A scope of work sets out the agreed purpose of the valuation, the extent of investigation, procedures that will be adopted, assumptions that will be made and the limitations that will apply. The scope of work may be prepared at the outset or during the progress of the valuation assignment but before the valuation and report are finalised.

### Requirements

2. A scope of work shall be prepared and confirmed in writing that addresses the matters set out below. For certain asset classes or applications there may be variations from this standard or additional matters to be included or considered in preparing the scope of work. These are found in the relevant Asset Standard or Valuation Application.

**(a) Identification and status of the valuer**

A statement confirming:

(i) the identity of the valuer. The valuer may be an individual or firm;

(ii) that the valuer is in a position to provide an objective and unbiased valuation;

(iii) whether the valuer has any material connection or involvement with the subject of the valuation or the party commissioning the valuation;

(iv) that the valuer is competent to undertake the valuation. If the valuer needs to seek material assistance from others in relation to any aspect of the assignment, the nature of such assistance and the extent of reliance shall be agreed and recorded.

**(b) Identification of the client and any other intended users**

Confirmation of those for whom the valuation is being produced is important when determining the form and content of the valuation report to ensure that it contains information relevant to their needs.

Any restriction on those who may rely upon the valuation shall be agreed and recorded.

**(c) Purpose of the valuation**

The purpose for which the valuation is being prepared shall be clearly stated, eg the valuation is required for loan security, to support a share transfer or to support an issue of shares. The purpose of the valuation will determine the *basis of value*.

It is important that valuations are not used out of context or for purposes for which they are not intended.

**(d) Identification of the asset or liability to be valued**

Clarification may be needed to distinguish between an asset and an interest in or right of use of that asset.

If the valuation is of an asset that is utilised in conjunction with other assets, it will be necessary to clarify whether those assets are included in the valuation, excluded but assumed to be available or excluded and assumed not to be available (see IVS *Framework* paras 24 and 25).

**(e) Basis of value**

The valuation basis must be appropriate for the purpose. The source of the definition of any *basis of value* used shall be cited or the basis explained. The valuation bases recognised by IVS are defined and discussed in the IVS *Framework*, but other bases may be used. It may also be necessary to clarify the currency in which the valuation will be reported.

**(f) Valuation date**

The *valuation date* is defined in IVS as the date on which the opinion of value applies. This may be different from the date on which the valuation report is to be issued or the date on which investigations are to be undertaken or completed.

**(g) Extent of investigation**

Any limitations or restrictions on the inspection, inquiry and analysis for the purpose of the valuation shall be set out in the scope of work.

If relevant information is not available because the conditions of the assignment restrict the investigation, if the assignment is accepted, then these restrictions and any necessary assumptions or *special assumptions* shall be recorded in the scope of work.

**(h) Nature and source of the information to be relied upon**

The nature and source of any relevant information that is to be relied upon without specific verification during the valuation process shall be agreed and recorded.

**(i) Assumptions and special assumptions**

All assumptions and any *special assumptions* that are to be made in the conduct and reporting of the valuation shall be recorded.

Assumptions are matters that are reasonable to accept as fact in the context of the valuation assignment without specific investigation or verification. They are matters that, once stated, are to be accepted in understanding the valuation.

A *special assumption* is an assumption that either assumes facts that differ from the actual facts existing at the *valuation date* or that would not be made by a typical market participant in a transaction on the *valuation date*.

*Special assumptions* are often used to illustrate the effect of changed circumstances on value. Examples of *special assumptions* include:

- that a proposed building had actually been completed on the *valuation date*,

- that a specific contract was in existence on the *valuation date* which had not actually been completed,
- that a financial instrument is valued using a yield curve that is different from that which would be used by a market participant.

Only assumptions and *special assumptions* that are reasonable and relevant having regard to the purpose for which the valuation is required shall be made.

**(j) Restrictions on use, distribution or publication**

Where it is necessary or desirable to restrict the use of the valuation or those relying upon it, this shall be recorded. If matters are identified that are likely to cause the valuation to be qualified, this shall also be recorded.

**(k) Confirmation that the valuation will be undertaken in accordance with the IVS**

While confirmation of conformity with IVS is required, there may be occasions where the purpose of the valuation requires a departure from IVS. Any such departure shall be identified together with justification for that departure. A departure would not be justified if it results in a valuation that is misleading.

**(l) Description of report**

Confirmation of the format of the report to be provided shall be agreed and recorded. Reference shall be made to any of the report contents specified in IVS 103 *Reporting* that are to be excluded.

**Changes to Scope of Work**

3. Some of the above matters may not be capable of determination until the assignment is in progress, or changes to the scope may become necessary during the course of the assignment, eg additional information may become available or a matter emerge that requires further investigation. The scope of work requirements can be contained in a single document issued at the outset or in a series of documents prepared throughout the course of the assignment providing all matters are recorded before the assignment is completed and the valuation report is issued.

**Effective Date**

4. The effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

# IVS 102 Implementation

**Contents** | **Paragraphs**


| Contents | Paragraphs |
|---|---|
| General Principle | 1 |
| Investigations | 2–4 |
| Valuation Approaches | 5–7 |
| Valuation Record | 8 |
| Effective Date | 9 |


## General Principle

1. Valuation assignments shall be conducted in accordance with the principles set out in this standard and the terms and conditions set out in the scope of work.

## Investigations

2. Investigations made during the course of a valuation assignment must be adequate having regard to the purpose for which the valuation is required and the *basis of value* to be reported.

3. Sufficient evidence shall be assembled by means such as inspection, inquiry, computation and analysis to ensure that the valuation is properly supported. When determining the extent of evidence necessary, professional judgement is required to ensure the information to be obtained is adequate having regard to the purpose of the valuation. As a matter of practical expediency, it is normal for limits to be agreed on the extent of the valuer's investigations. Any such limits shall be recorded in the scope of work.

4. The purpose of the valuation, the *basis of value*, the extent and limits on the investigations and any sources of information that may be relied upon are recorded in the scope of work, see IVS 101 *Scope of Work*. If during the course of an assignment it becomes clear that the investigations included in the scope of work will not result in a credible valuation or information to be provided by third parties is either unavailable or inadequate, an appropriate revision to the scope of work shall be made.

## Valuation Approaches

5. Consideration shall be given as to the relevant and appropriate valuation approaches. The principal valuation approaches are described in the IVS *Framework* and methods that are commonly used to apply these approaches to different asset types are discussed in the commentaries to the Asset Standards.

6. The most appropriate valuation approach or method will depend upon consideration of the following:

- the adopted *basis of value*, determined by the purpose of the valuation,
- the availability of valuation inputs and data,
- the approaches or methods used by participants in the relevant market.

7. More than one valuation approach or method may be used to arrive at an indication of value, especially where there are insufficient factual or observable inputs for a single method to produce a reliable conclusion. Where more than one approach and method is used, the resulting indications of value should be analysed and reconciled to reach a valuation conclusion.

**Valuation Record**

8. A record shall be kept of the work done during the valuation process for a reasonable period having regard to any relevant legal or regulatory requirements. Subject to any such requirements this record shall include the key inputs, all calculations, investigations and analyses relevant to the final conclusion, and a copy of any draft or final report provided to the client.

**Effective Date**

9. The effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

# IVS 103 Reporting

| **Contents** | **Paragraphs** |
|---|---|
| General Principle | 1–3 |
| Report Contents | 4–5 |
| Effective Date | 6 |

## General Principle

1. The final step in the valuation process is communicating the value to the commissioning party and any other intended users. It is essential that the valuation report communicates the information necessary for proper understanding of the valuation. A valuation report shall not be ambiguous or misleading and shall provide the intended reader with a clear understanding of the valuation provided.

2. To provide comparability, relevance and credibility, the valuation report shall set out a clear and accurate description of the scope of the assignment, its purpose and intended use, confirmation of the *basis of value* used and disclosure of any assumptions, *special assumptions,* material uncertainty or limiting conditions that directly affect the valuation.

3. This standard applies to all valuation reports whether printed on paper or transmitted electronically. For certain asset classes or applications there may be variations from this standard or additional requirements to be reported upon. These are found in the relevant Asset or Valuation Application.

## Report Contents

4. The purpose of the valuation, the complexity of the asset being valued and the users' requirements will determine the level of detail appropriate to the valuation report. The format of the report and any exclusion from the content requirements of this standard should have been agreed and recorded in the scope of work.

5. All valuation reports shall include reference to the matters listed below. Items (a) to (k) in this list relate to matters that should be recorded in the scope of work (see IVS 101*Scope of Work*). It is recommended that the scope of work be referred to in the report.

   **(a) Identification and status of the valuer**

   The valuer can be an individual or a firm. A statement confirming that the valuer is in a position to provide an objective

and unbiased valuation and is competent to undertake the valuation shall be included.

The report shall include the signature of the individual or firm responsible for the valuation.

If the valuer has obtained material assistance from others in relation to any aspect of the assignment, the nature of such assistance and the extent of reliance shall be referenced in the report.

**(b) Identification of the client and any other intended users**

The party commissioning the valuation shall be identified together with any other parties whom it is intended may rely on the valuation (see also (j) below).

**(c) Purpose of the valuation**

The purpose of the valuation shall be clearly stated.

**(d) Identification of the asset or liability to be valued**

Clarification may be needed to distinguish between an asset and an interest in or right of use of that asset.

If the valuation is of an asset that is utilised in conjunction with other assets, it will be necessary to clarify whether those assets are included in the valuation, excluded but assumed to be available or excluded and assumed not to be available (see IVS *Framework* paras 24 and 25).

**(e) Basis of value**

This shall be appropriate for the purpose. The source of the definition of any *basis of value* used shall be cited or the basis explained. Some common valuation bases are defined and discussed in the IVS *Framework*.

**(f) Valuation date**

The *valuation date* is defined in IVS as the date on which the opinion of value applies. This may be different from the date on which the valuation report is issued or the date on which investigations are to be undertaken or completed. Where relevant, these dates shall be clearly distinguished in the report.

**(g) Extent of investigation**

The extent of the investigations undertaken, including the limitations on those investigations set out in the scope of work, shall be disclosed in the report.

**(h) Nature and source of the information relied upon**

The nature and source of any relevant information relied upon in the valuation process without specific verification by the valuer shall be disclosed.

**(i) Assumptions and special assumptions**

All assumptions and any *special assumptions* made shall be clearly stated.

**(j) Restrictions on use, distribution or publication**

Where it is necessary or desirable to restrict the use of the valuation or those relying upon it, this shall be stated.

**(k) Confirmation that the valuation has been undertaken in accordance with the IVS**

While confirmation of conformity with IVS is required, there may be occasions where the purpose of the valuation requires a departure from the IVS. Any such departure shall be identified, together with justification for that departure. A departure would not be justified if it results in a valuation that is misleading.

**(l) Valuation approach and reasoning**

To understand the valuation figure in context, the report shall make reference to the approach or approaches adopted, the key inputs used and the principal reasons for the conclusions reached.

This requirement does not apply if it has been specifically agreed and recorded in the scope of work that a valuation report shall be provided without reasons or other supporting information.

**(m) Amount of the valuation or valuations**

This shall be expressed in the applicable currency.

**(n) Date of the valuation report**

The date on which the report is issued shall be included. This may be different from the *valuation date* (see (f) above).

**Effective Date**

6. The effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

# Asset Standards



## IVS 200 Businesses and Business Interests


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**STANDARD**

1. The principles contained in the General Standards apply to valuations of businesses and business interests. This standard only includes modifications, additional requirements or specific examples of how the General Standards apply for valuations to which this standard applies.

**Scope of Work (IVS 101)**

2. To comply with the requirement to identify the asset or liability to be valued in IVS 101 para 2(d), the specific interest in the business to

be valued shall be recorded. This will include items such as specifying the legal structure of the business, whether it is a whole or partial interest, whether it is confined to or excludes certain assets or liabilities and the class or classes of shares involved.

3. Typical assumptions or *special assumptions* that may need to be stated to comply with IVS 101 para 2(i) when valuing a business or business interest include:

- in the case of a partial interest, an assumption clarifying whether the owner or owners of the remaining interest(s) are either intending to sell or retain their holdings,
- whether certain assets or liabilities owned by the business are to be disregarded.

**Implementation (IVS 102)**

4. If the valuation is of an interest that has the ability to liquidate the assets of the business, consideration shall be given as to whether the total value of the assets sold individually following liquidation would exceed their combined value as a going concern.

**Reporting (IVS 103)**

5. There are no additional requirements for businesses and business interests other than inclusion of appropriate references to matters addressed in the scope of work in accordance with paras 2 and 3 above.

**Effective Date**

6. The effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

## COMMENTARY

### Definitions

C1. In the context of this Commentary, the following definitions apply.

(a) Enterprise value – the total value of the equity in a business plus the value of its debt or debt-related liabilities, minus any cash or cash equivalents available to meet those liabilities.

(b) Equity value – the value of a business to all of its shareholders.

### Businesses

C2. A business is a commercial, industrial, service or investment activity. A valuation of a business may either comprise the whole of the activity of an entity or a part of the activity. It is important to distinguish between the value of a business entity and the value of the individual assets or liabilities of that entity. If the purpose of the valuation requires individual assets or liabilities to be valued and those assets are separable from the business and capable of being transferred independently, those assets or liabilities should be valued in isolation and not by apportionment of the value of the entire business. Before undertaking a valuation of a business, it is important to establish whether the valuation is of the entire entity, shares or a shareholding in the entity, a specific business activity of the entity or of specific assets or liabilities.

C3. Valuations of businesses are required for different purposes including acquisitions, mergers and sales of businesses, taxation, litigation, insolvency proceedings and financial reporting.

C4. The following matters may require consideration depending on the context and purpose of the valuation and the nature of the business or the business interest being valued.

### Ownership Rights

C5. The rights, privileges or conditions that attach to the ownership interest, whether held in proprietorship, corporate or partnership form, require consideration in the valuation process. Ownership rights are usually defined within a jurisdiction by legal documents such as articles of association, clauses in the memorandum of the business, articles of incorporation, bylaws, partnership agreements and shareholder agreements. Ownership interests may be of part, or share, of a business or of the entire business. In some situations it may also be necessary to distinguish between legal and beneficial ownership. Care should be taken to distinguish between rights and obligations inherent to the interest and those that may be contained in an agreement between current shareholders.

C6. The documents may contain restrictions on the transfer of the interest and may contain provisions governing the *basis of valuation* that has to be adopted in the event of transfer of the interest. For example, the documents may stipulate that the interest should be valued as a pro rata fraction of the entire issued share capital regardless of whether it is a controlling or minority interest. In each case, the rights of the interest being valued and the rights attaching to any other class of interest needs to be considered at the outset.

C7. A non-controlling interest may have a lower value than a controlling interest. A majority interest is not necessarily a controlling interest. The voting and other rights attaching to the interest will be determined by the legal framework under which the entity is established. There are often different classes of equity in business, each having different rights. Where this is the case it is therefore possible that a minority interest may still have control or an effective veto over certain actions.

**Business Information**

C8. The valuation of a business entity or interest frequently requires reliance upon information received from management, representatives of the management or other experts. Significant care should be taken to specify what information can be relied upon and which has to be verified, and the extent of verification required, during the valuation process when settling the scope of work, see IVS 101 *Scope of Work* para 2(g).

C9. Although the value on a given date reflects the anticipated benefits of future ownership, the history of a business is useful in that it may give guidance as to the expectations for the future.

C10. Awareness of relevant economic developments and specific industry trends is essential for business valuation. Matters such as political outlook, government policy, exchange rates, inflation, interest rates and market activity may affect businesses that operate in different sectors of the economy quite differently.

C11. The valuation of an ownership interest in a business is only relevant in the context of the financial position of the business at a point in time. It is important to understand the nature of assets and liabilities of the business and to determine which items are required for use in the income-producing process and which ones are redundant to the business at the *valuation date*.

C12. Businesses may have unrecorded assets or liabilities that are not reflected on the balance sheet. Such assets could include patents, trademarks, copyrights, brands, know-how and proprietary

databases. *Goodwill* is a residual value after all tangible and identifiable intangible assets have been taken into account. The valuation of intangible assets is addressed in IVS 210 *Intangible Assets*.

**Valuation Approaches**

C13. The market and the income approaches described in the IVS *Framework* can be applied to the valuation of a business or business interest. The *cost approach* cannot normally be applied except in the case of early stage or start-up businesses where profits and/or cash flow cannot be reliably determined and adequate market information is available on the entity's assets.

C14. The value of certain types of businesses, eg an investment or holding business, can be derived from a summation of the assets and liabilities. This is sometimes called the "net asset approach" or "asset approach". This is not a valuation approach in its own right as the values of the individual assets and liabilities are derived using one or more of the principal valuation approaches described in the IVS *Framework* before being aggregated.

**Market Approach**

C15. The *market approach* compares the subject business to similar businesses, business ownership interests and securities that have been exchanged in the market and any relevant transactions of shares in the same business. Prior transactions or offers for any component of the business may be also indicative of value.

C16. The three most common sources of data used in the *market approach* are public stock markets in which ownership interests of similar businesses are traded, the acquisition market in which entire businesses are bought and sold, and prior transactions in shares or offers for the ownership of the subject business.

C17. There needs to be a reasonable basis for comparison with and reliance upon similar businesses in the *market approach*. These similar businesses should be in the same industry as the subject business or in an industry that responds to the same economic variables. Factors to be considered in whether a reasonable basis for comparison exists include the following:

- similarity to the subject business in terms of qualitative and quantitative business characteristics,
- amount and verifiability of data on the similar business,
- whether the price of the similar business represents an arm's length transaction.

C18. A comparative analysis of qualitative and quantitative similarities and differences between similar businesses and the subject business should be made.

C19. Through analysis of the publicly traded businesses or actual transactions, valuation ratios, usually price divided by some measure of income or net assets, are calculated. In calculating and selecting these ratios, consideration is given to the following matters:

(a) the ratio should provide meaningful information about the value of the business,

(b) adjustments may need to be made to render the ratio appropriate for the subject business. Examples include adjustments for differences in risk and expectations of the similar businesses and the subject business,

(c) adjustments may be required for differences in the subject ownership interest and interests in the similar businesses with regard to the degree of control, marketability, or the size of the holding.

C20. Anecdotal valuation benchmarks are frequently used by market commentators as a short-cut *market approach*. However, value indications derived from the use of such rules should not be given substantial weight, ie importance, unless it can be shown that buyers and sellers place significant reliance on them. Even where this is the case, a cross check should be undertaken using at least one other method.

C21. The market prices of publicly traded stocks or partnership interests, acquisition prices for business interests or businesses engaged in the same or similar lines of business are also used as a reasonableness check on the business valuation conclusion derived under another approach.

**Income Approach**

C22. Various methods are used to indicate value under the *income approach*. Those methods include the capitalised cash flow or earnings method and the discounted cash flow method.

C23. Income and cash flow can be measured under a variety of definitions. The income or cash flow measured can be pre-tax or post-tax, although the latter is more usual. The capitalisation or discount rate applied must be consistent with the definition of income or cash flow used.

C24. The *income approach* requires the estimation of a capitalisation rate when capitalising income or cash flow and a discount rate when discounting cash flow. In estimating the appropriate rate, factors such as the level of interest rates, rates of return expected by market participants for similar investments and the risk inherent in the anticipated benefit stream are considered.

C25. In methods that employ discounting, expected growth may be explicitly considered in the forecasted income or cash flow. In capitalisation methods that do not employ discounting, expected growth is normally reflected in the capitalisation rate. When the forecasted income or cash flow is expressed in nominal terms, ie current prices, nominal rates which include an inflation component should be used. When the forecasted income or cash flow is expressed in real terms, real rates which do not include an inflation component should be used.

C26. Enterprise value is typically derived through the capitalisation of profits or cash flows through the application of a capitalisation rate or discount rate before debt servicing costs. The capitalisation or discount rate applied is the weighted average cost of capital of an appropriate mix of debt and equity. The *market value* of the interest bearing debt is deducted from the enterprise value to determine the overall equity value. Alternatively, the equity value may be determined by measuring the equity cash flow directly. Redundant, ie non-operating, assets need to be considered when calculating enterprise or equity value.

C27. Under the *income approach*, the historical financial statements of a business entity are often used as guide to estimate the future income or cash flow of the business. Determining the historical trends over time through ratio analysis may help provide the necessary information to assess the risks inherent in the business operations in the context of the industry and the prospects for future performance.

C28. Adjustments may be appropriate to reflect differences between the actual historic cash flows and those that would be experienced by a buyer of the business interest on the *valuation date*. Examples include:

(a) to adjust revenues and expenses to levels that are reasonably representative of expected continuing operations,

(b) to present financial data of the subject business and comparison businesses on a consistent basis,

(c) to adjust non-arm's length transactions to commercial rates,

(d) to adjust the cost of labour or of items leased or otherwise contracted from related parties to reflect market prices or rates,

(e) to reflect the impact of non-recurring events from historic revenue and expense items. Examples of non-recurring events include losses caused by strikes, new plant start-up and weather phenomena. However, the forecast cash flows should reflect any non-recurring revenues or expenses that can be reasonably anticipated and past occurrences may be indicative of similar events in the future,

(f) to adjust the reported depreciation and tax basis to an estimate that compares to depreciation used in similar businesses,

(g) to adjust the inventory accounting to compare to similar businesses, whose accounts may be kept on a different basis from the subject business, or to more accurately reflect economic reality.

Inventory adjustments may be different when considering the income statement and when considering the balance sheet. For example, a first-in-first-out method of costing inventory may most accurately represent the value of the inventory when constructing a *market value* balance sheet. When examining the income statement, a last-in-first-out method of costing inventory may more accurately represent the income level in times of inflation or deflation.

C29. When using an *income approach* it may also be necessary to make adjustments to the valuation to reflect matters that are not captured in either the cash flow forecasts or the discount rate adopted. Examples may include adjustments for the marketability of the interest being valued or whether the interest being valued is a controlling or non-controlling interest in the business.

C30. Small and medium-sized businesses are often transferred as an asset sale rather than by transfer of the equity interest. In such cases it is common for items such as debtors, creditors and working capital to be excluded and for the value of the assets to be determined by applying an appropriate valuation multiple to the earnings before interest, tax and depreciation. Care should be taken to ensure that the multiple used is based on analysis of other similar asset sales.

# IVS 210 Intangible Assets


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## STANDARD

1. The principles contained in the General Standards apply to valuations of *intangible assets*. This standard only includes modifications, additional requirements or specific examples of how the General Standards apply for valuations to which this standard applies.

### Scope of Work (IVS 101)

2. To comply with the requirement in IVS 101 para 2(d) to identify the asset or liability to be valued, the *intangible asset* shall be clearly defined by reference to its type and the legal right or interest in that asset. The main types of *intangible asset* and their typical characteristics are discussed in paras C1 to C13 of the Commentary to this standard.

3. The scope of work should identify any contributory assets and confirm whether or not these are to be included in the valuation. A contributory asset is one that is used in conjunction with the subject asset to generate the cash flows associated with the subject asset. If contributory assets are to be excluded, it will be necessary to clarify whether the subject *intangible asset* is to be valued on the assumption that the contributory assets are available to a buyer or on the assumption that they are not, ie the subject asset is valued on a stand-alone basis.

4. Common examples of assumptions or *special assumptions* that arise when valuing *intangible assets* and that are required to be referred to by IVS 101 para 2(i) include that a patent has been granted when none exists at the *valuation date* or that a competing product had entered or had left the market.

**Implementation (IVS 102)**

5. There are no additional requirements for *intangible assets*.

**Reporting (IVS 103)**

6. There are no additional requirements for *intangible assets* other than inclusion of appropriate references to matters addressed in the scope of work in accordance with paras 2 to 4 above.

**Effective Date**

7. The effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

## COMMENTARY

### Principal Types of Intangible Assets

C1. An *intangible asset* is a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and economic benefits to its owner.

C2. Valuations *of intangible assets* are required for many different purposes including acquisitions, mergers and sales of businesses or parts of businesses, purchases and sales *of intangible assets*, reporting to tax authorities, litigation and insolvency proceedings, and financial reporting.

C3. An *intangible asset* can be either identifiable or unidentifiable. An *intangible asset* is identifiable if it either:

(a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so, or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

C4. Any unidentifiable *intangible asset* associated with a business or group of assets is generally termed *goodwill*.

C5. The principal classes of identifiable *intangible assets* are as follows:

- marketing related,
- customer or supplier related,
- technology related,
- artistic related.

C6. Within each class, assets may be either contractual or non-contractual.

C7. Marketing related *intangible assets* are used primarily in the marketing or promotion of products or services. Examples include trademarks, trade names, unique trade design, internet domain names and non-compete agreements.

C8. Customer or supplier related *intangible assets* arise from relationships with or knowledge of customers or suppliers. Examples include service or supply agreements, licensing or royalty agreements, order books, employment agreements and customer relationships.

C9. Technology related *intangible assets* arise from contractual or non-contractual rights to use patented technology, unpatented technology, databases, formulae, designs, software, processes or recipes.

C10. Artistic related *intangible assets* arise from the right to benefits such as royalties from artistic works such as plays, books, films and music and from non-contractual copyright protection.

**Goodwill**

C11. *Goodwill* is any future economic benefit arising from a business, an interest in a business or from the use of a group of assets which is not separable. It should be noted that different definitions of *goodwill* apply under specific financial reporting or tax regimes; these may need to be reflected where valuations are being undertaken for these purposes.

C12. Examples of benefits that are reflected in *goodwill* include:

- company specific synergies following a business combination, eg a reduction in operating costs or economies of scale not reflected in the value of other assets,
- growth opportunities, eg expansion into different markets,
- organisational capital, eg the benefits accruing from an assembled network.

C13. In general terms, the value of *goodwill* is the residual amount remaining after the values of all identifiable tangible, intangible and monetary assets, adjusted for actual or potential liabilities, have been deducted from the value of a business.

**Characteristics of Intangible Assets**

C14. Specific *intangible assets* are defined and described by characteristics such as their ownership, function, market position and image. These characteristics differentiate *intangible assets* from one another. The differentiating characteristics are illustrated in the following examples:

- confectionery brands may be differentiated through differing taste, source of ingredients and quality,
- computer software products will typically be differentiated by reference to their functional specifications.

C15. Although similar *intangible assets* within the same class will share some characteristics with one another, they will also have differentiating characteristics that will vary according to the type of *intangible asset*.

### Valuation Approaches

C16. The three principal valuation approaches described in IVS *Framework* can all be applied to the valuation of *intangible assets*.

C17. All methods of valuing *intangible ass*ets require an estimate of the remaining useful life. For some assets, this may be a finite period limited by either contract or typical life cycles in the sector. Other assets may effectively have an indefinite life. Estimating the remaining useful life will include consideration of legal, technological, functional and economic factors. As an example, an asset comprising a drug patent may have a remaining legal life of five years before expiry of the patent, but a competitor drug with expected improved efficacy may be expected to reach the market in three years. This might cause the remaining useful life of the first product to be assessed as only three years.

### Market Approach

C18. Under the *market approach*, the value of an *intangible asset* is determined by reference to market activity, eg transaction bids or offers involving identical or similar assets.

C19. The heterogeneous nature of *intangible assets* means that it is rarely possible to find market evidence of transactions involving identical assets. If there is market evidence at all it is usually in respect of assets that are similar, but not identical. As an alternative, or in addition to, comparison with the prices in any relevant transactions involving identical or similar assets through analysis of sale transactions may provide evidence of valuation multiples, eg it may be possible to determine a typical price to earnings ratio or rate of return for a class of similar *intangible assets*.

C20. Where evidence of either prices or valuation multiples is available, it will often be necessary to make adjustments to these to reflect differences between the subject asset and those involved in the transactions.

C21. These adjustments are necessary to reflect the differentiating characteristics of the subject *intangible asset* and the assets involved in the transactions. Such adjustments may only be determinable at a qualitative, rather than quantitative, level. Situations giving rise to qualitative adjustments include the following examples:

- the brand being valued may be considered to command a more dominant position in the market than those involved in the transactions,

- a drug patent being valued may have greater efficacy and fewer side effects than those involved in the transactions.

**Income Approach**

C22. Under the *income approach*, the value of an *intangible asset* is determined by reference to the present value of income, cash flows or cost savings generated by the *intangible asset*. The principal valuation methods under the *income approach* used in the valuation of *intangible assets* are:

- relief-from-royalty method, sometimes referred to as royalty savings method,
- premium profits method, sometimes referred to as incremental income method,
- excess earnings method.

C23. Each of these methods involve the converting of forecast cash flows to an indication of value using either discounted cash flow techniques or, in simple cases, the application of a capitalisation multiple to a representative single period cash flow.

**Relief-from-Royalty Method**

C24. Under the relief-from-royalty method, the value of an *intangible asset* is determined by reference to the value of the hypothetical royalty payments that would be saved through owning the asset, as compared with licensing the *intangible asset* from a third party. The hypothetical royalty payments over the life of the *intangible asset* are adjusted for tax and discounted to present value at the *valuation date*. In some cases, royalty payments may include an initial payment in addition to periodic amounts based on a percentage of the revenues or some other financial parameter.

C25. Two methods can be used to derive a hypothetical royalty rate. The first is based on market royalty rates for comparable or similar transactions. A prerequisite for this method is the existence of comparable intangible assets that are licensed at arm's length on a regular basis. The second method is based on a split of profits that would hypothetically be paid in an arm's length transaction by a willing licensee to a willing licensor for the rights to use the subject *intangible asset*.

C26. Some or all of the following valuation inputs are considered in the relief-from-royalty method:

- projections for the financial parameter, eg revenues that the royalty rate would be applied to over the life of the *intangible asset* together with an estimate of the life of the *intangible asset*,

- rate at which tax relief would be obtainable on hypothetical royalty payments;
- the cost of marketing and any other costs that would be borne by a licensee in utilising the asset;
- an appropriate discount rate or capitalisation rate to convert the asset's hypothetical royalty payments to a present value.

Where it is possible to use both methods it is common to apply both as a cross-check to each other.

C27. Royalty rates can often vary significantly in the market for apparently similar assets. It is therefore prudent to benchmark the assumed royalty input by reference to the operating margin that a typical operator would require from sales generated from use of the asset.

**Premium Profits Method**

C28. The premium profits method involves comparing the forecasted profits or cash flows that would be earned by a business using the *intangible asset* with those that would be earned by a business that does not use the *intangible asset*. It is often used when market-based royalty rates are not available or are unreliable.

C29. Having established the difference in the profits that will be generated, an appropriate discount rate is applied to convert forecasted incremental periodic profits or cash flows to a present value or a capitalisation multiple to capitalise constant incremental profits or cash flows.

C30. The premium profits method can be used to value both *intangible assets* whose use will save costs and those whose use will generate additional profits or cash flows.

**Excess Earnings Method**

C31. The excess earnings method determines the value of an *intangible asset* as the present value of the cash flows attributable to the subject *intangible asset* after excluding the proportion of the cash flows that are attributable to contributory assets. The excess earnings method is typically used in the valuation of customer contracts, customer relationships and in-process research and development projects.

C32. The excess earnings method can either be applied using a single period of forecast cash flows, referred to as the "single period excess earnings method", or using several periods of forecast cash flows, referred to as the "multi period excess earnings method". The multi period excess earnings method is more commonly used as

*intangible assets* normally bring monetary benefits over an extended period.

C33. The excess earnings method involves allocating the expected cash flows to the smallest business or group of assets of the entity that includes all the income derivable from the subject asset.

C34. From this forecast of cash flows, a deduction is made in respect of the share of the cash flows attributable to contributory tangible, intangible and financial assets. This is done by calculating an appropriate charge or economic rent for the contributory assets and deducting this from the cash flows. To arrive at a reliable valuation of the subject asset, it may also be appropriate to make an additional deduction to reflect any additional value attributable to the fact that all the assets are utilised together as a going concern. This typically reflects the benefit of the cash flows attributable to the asset of an assembled workforce which would not be available to a buyer of the individual asset.

**Tax Amortisation Benefit**

C35. In many tax regimes, the amortisation of an *intangible as*set can be treated as an expense in calculating taxable income. This "tax amortisation benefit" can have a positive impact on the value of the asset. When an *income approach* is used, it will be necessary to consider the impact of any available tax benefit to buyers and make an appropriate adjustment to the cash flows.

**Cost Approach**

C36. The *cost approach* is mainly used for internally generated *intangible assets* that have no identifiable income streams. Under the *cost approach*, the replacement cost of either a similar asset or one providing similar service potential or utility is estimated.

C37. Examples of *intangible assets* for which the *cost approach* may be used include the following:

- self-developed software, as the price of software with the same or similar service capacity can sometimes be obtained in the market,
- websites, as it may be possible to estimate the cost of constructing the website,
- an assembled workforce through determining the cost of building up the workforce.

C38. The inputs that are considered when applying the *cost approach* include the following:

- the cost of developing or purchasing an identical asset,
- the cost of developing or purchasing an asset offering the same utility or service potential,
- any adjustments required to the cost of developing or purchasing to reflect the specific characteristics of the subject asset, such as economic or functional obsolescence,
- any opportunity cost incurred by the developer of the asset.

**Multiple Approaches**

C39. Because of the heterogeneous nature of many *intangible assets* there is often a greater need to consider the use of multiple methods and approaches to derive value than for other asset classes.

# IVS 220 Plant and Equipment

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## STANDARD

1. The principles contained in the General Standards apply to valuations of plant and equipment. This standard only includes modifications, additional requirements or specific examples of how the General Standards apply for valuations to which this standard applies.

### Scope of Work (IVS 101)

2. To comply with the requirement to identify the asset or liability to be valued in IVS 101 para 2(d), consideration shall be given to the degree to which the item of plant and equipment is attached to or integrated with other assets. For example:

   - assets may be permanently attached to the land and could not be removed without substantial demolition of either the asset or any surrounding structure or building,
   - an individual machine may be part of an integrated production line where its functionality is dependent upon other assets.

   In such cases it will be necessary to clearly define what is to be included or excluded from the valuation. Any necessary assumptions or *special assumptions* relating to the availability of any complementary assets shall also be stated, see also para 4 below.

3. Plant and equipment connected with the supply or provision of services to a building are often integrated within the building and once installed are not separable from it. These items will normally form part of the *real property* interest. Examples include plant with

the primary function of supplying electricity, gas, heating, cooling or ventilation to a building and equipment such as elevators. If the purpose of the valuation requires these items to be valued separately the scope of work shall include a statement to the effect that the value of these items would normally be included in the *real property* interest and may not be separately realisable. When different valuation assignments are undertaken to carry out valuations of the *real property* interest and plant and equipment assets at the same location, care is necessary to avoid either omissions or double counting.

4. Because of the diverse nature and transportability of many items of plant and equipment, additional assumptions will normally be required to describe the state and circumstances in which the assets are valued. In order to comply with IVS 101 para 2(i) these must be considered and included in the scope of work. Examples of assumptions that may be appropriate in different circumstances include:

- that the plant and equipment assets are valued as a whole, in place and as part of the business, considered as a going concern,
- that the plant and equipment assets are valued as a whole, in place but on the assumption that the business is closed,
- that the plant and equipment assets are valued as individual items for removal from their current location.

In some circumstances, it may be appropriate to report on more than one set of assumptions, eg in order to illustrate the effect of business closure or cessation of operations on the value of plant and equipment.

**Implementation (IVS 102)**

5. There are no additional requirements for plant and equipment.

**Reporting (IVS 103)**

6. In addition to the minimum requirements in IVS 103 *Reporting*, a valuation report on plant and equipment shall include appropriate references to matters addressed in the scope of work in accordance with paras 2 to 4 above. The report shall also include comment on the effect on the reported value of any associated tangible or *intangible assets* excluded from the valuation, eg operating software for a machine or a continued right to occupy the land on which the item is situated.

**Effective Date**

7. This standard is effective from 1 January 2012, although earlier adoption is encouraged.

## COMMENTARY

### Plant and Equipment

C1. Items of plant and equipment are tangible assets that are held by an entity for use in the production or supply of goods or services, for rental by others or for administrative purposes and that are expected to be used over a period of time. The following assets are not classed as plant and equipment

- *real property*,
- mineral or natural resources,
- raw materials and consumables,
- stock and inventory,
- consumables,
- agricultural assets (eg plants, livestock, etc),
- personal property such as artwork, jewellery and collectibles.

C2. A valuation of plant and equipment will normally require consideration of a range of factors relating to the asset itself, its environment and its economic potential. Examples of factors that may need to be considered under each of these headings include the following:

Asset related:

- the asset's technical specification,
- the remaining physical life,
- the asset's condition, including maintenance history,
- if the asset is not valued in its current location, the costs of decommissioning and removal,
- any potential loss of a complementary asset, eg the operational life of a machine may be curtailed by the length of lease on the building in which it is located.

Environment related:

- the location in relation to source of raw material and market for product. The suitability of a location may also have a limited life, eg where raw materials are finite or where demand is transitory,
- the impact of any environmental or other legislation that either restricts utilisation or imposes additional operating or decommissioning costs.

Economic related:

- the actual or potential profitability of the asset based on comparison of running costs with earnings or potential earnings,

- the demand for the product from the plant and equipment with regard to both macro and micro economic factors that could impact on demand,
- the potential for the asset to be put to a more valuable use than the current use.

**Intangible Assets**

C3. *Intangible assets* fall outside the classification of plant and equipment assets. However, an *intangible asset* may have an impact on the value of plant and equipment assets. For example, the value of patterns and dies is often inextricably linked to associated intellectual property rights. Operating software, technical data, production records and patents are further examples of *intangible asset*s that can have an impact on the value of plant and equipment assets, depending on whether or not they are included in the valuation. In such cases, the valuation process will involve consideration of the inclusion of *intangible assets* and their impact on the valuation of the plant and equipment assets.

**Financing Arrangements**

C4. An item of plant and equipment may be subject to a financing arrangement. Accordingly, the asset cannot be sold without the lender or lessor being paid any balance outstanding under the financing arrangement. This payment may or may not exceed the unencumbered value of the item. Depending upon the purpose of the valuation it may be appropriate to identify any encumbered assets and to report their values separately from the unencumbered assets.

C5. Items of plant and equipment that are subject to operating leases are the property of third parties and therefore not included in a valuation of the assets of the lessee. However, such assets may need to be recorded as their presence may impact on the value of owned assets used in association.

**Forced Sale**

C6. Plant and equipment assets can be particularly susceptible to forced sale conditions, see the IVS *Framework* paras 53 to 55. A common example is where the assets have to be removed from a property in a timeframe that precludes proper marketing because a lease of the property is being terminated.

C7. The impact of such circumstances on value needs careful consideration. In order to advise on the value likely to be realised it will be necessary to consider any alternatives to a sale from the current location, such as the practicality and cost of removing the items to another location for disposal within the available time limit.

### Valuation Approaches

C8. The three principal valuation approaches described in the IVS *Framework* can all be applied to the valuation of plant and equipment assets.

C9. For classes of plant and equipment that are homogenous, eg motor vehicles and certain types of office equipment or industrial machinery, the *market approach* is commonly used as there is sufficient data of recent sales of similar assets. However, many types of plant and equipment are specialised and direct sales evidence for such items will not be available, necessitating the use of either the *income approach* or the *cost approach*.

C10. The *income approach* to the valuation of plant and equipment can be used where specific cash flows can be identified for the asset or a group of complementary assets, eg where a group of assets forming a process plant is operating to produce a marketable product.[2] However some of the cash flows may be attributable to *intangible assets* and difficult to separate from the cash flow contribution of the plant and equipment. Use of the *income approach* is not normally practical for many individual items of plant or equipment.

C11. The *cost approach* is commonly adopted for plant and equipment particularly in the case of individual assets that are specialised. This is done by calculating the depreciated replacement cost[3] of the asset. The cost to a market participant of replacing the subject asset is estimated. The replacement cost is the cost of obtaining an alternative asset of equivalent utility; this can either be a modern equivalent providing the same functionality or the cost of reproducing an exact replica of the subject asset. The latter is only appropriate where the cost of a replica would be less than the cost of a modern equivalent or where the utility offered by the subject asset could only be provided by a replica rather than a modern equivalent.

C12. Having established the replacement cost, deductions are then made to reflect the physical, functional and economic obsolescence of the subject asset when compared to the alternative asset that could be acquired at the replacement cost.

[2] More detailed guidance is contained in the Exposure Draft TIP 1 *Discounted Cash Flow (DCF) Method – Real Property and Business Valuations* published January 2011.

[3] More detailed guidance is contained in the Exposure Draft TIP 2 *Depreciated Replacement Cost* published February 2011.

# IVS 230 Real Property Interests

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## STANDARD

1. The principles contained in the General Standards apply to valuations of *real property* interests. This standard only includes modifications, additional requirements or specific examples of how the General Standards apply for valuations to which this standard applies.

### Scope of Work (IVS 101)

2. To comply with the requirement to identify the asset to be valued in IVS 101 para 2(d) the following matters shall be included:
    - a description of the *real property* interest to be valued,
    - identification of any superior or subordinate interests that affect the interest to be valued.

3. To comply with the requirements to state the extent of the investigation and the nature and source of the information to be relied upon in IVS 101 para 2(g) and (h) respectively the following matters shall be considered:

- the evidence required to verify the *real property* interest and any relevant related interests,
- the extent of any inspection,
- responsibility for information on the site area and any building floor areas,
- responsibility for confirming the specification and condition of any building,
- the extent of investigation into the nature, specification and adequacy of services,
- the existence of any information on ground and foundation conditions,
- responsibility for the identification of actual or potential environmental risks.

4. Typical examples of *special assumptions* that may need to be agreed and confirmed in order to comply with IVS 101 para 2(i) include:
    - that a defined physical change had occurred, eg a proposed building is valued as if complete at the *valuation date*,
    - that there had been a change in the status of the property, eg a vacant building had been leased or a leased building had become vacant at the *valuation date*.

**Implementation (IVS 102)**

5. There are no additional requirements for *real property* interests.

**Reporting (IVS 103)**

6. There are no additional requirements for *real property* interests other than inclusion of appropriate references to matters addressed in the scope of work in accordance with paras 2 to 4 above.

**Effective Date**

7. The effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

## COMMENTARY

### Types of Real Property Interest

C1. A *real property* interest is a right of ownership, control, use or occupation of land and buildings. There are three basic types of interest:

(a) the superior interest in any defined area of land. The owner of this interest has an absolute right of possession and control of the land and any buildings upon it in perpetuity subject only to any subordinate interests and any statutory constraints;

(b) a subordinate interest that gives the holder rights of exclusive possession and control of a defined area of land or buildings for a defined period, eg under the terms of a lease contract;

(c) a right to use land or buildings but without a right of exclusive possession or control, eg a right to pass over land or to use it only for a specified activity.

C2. Interests in *real property* may be held jointly, where a number of parties have the right to the share the whole interest, or severally, where each party has a defined proportion of the whole interest.

C3. Although different words and terms are used to describe these types of *real property* interest in different states, the concepts of an unlimited absolute right of ownership, an exclusive interest for a limited period or a non-exclusive right for a specified purpose are common to most jurisdictions. The immovability of land and buildings means that it is the right that a party holds that is transferred in an exchange, not the physical land and buildings. The value, therefore, attaches to the property interest rather than to the physical land and buildings.

### The Hierarchy of Interests

C4. The different types of *real property* interest are not mutually exclusive. A superior interest may be subject to one or more subordinate interests. The owner of the absolute interest may grant a lease interest in respect of part or all of his interest. Lease interests granted directly by the owner of the absolute interest are "head lease" interests. Unless prohibited by the terms of the lease contract, the holder of a head lease interest can grant a lease of part or all of that interest to a third party, which is known as a sub-lease interest. A sub-lease interest will always be shorter than the head lease out of which it is created, even if only by one day.

C5. These property interests will have their own characteristics, as illustrated in the following examples:

- Although an absolute interest provides outright ownership in perpetuity, it may be subject to the effect of subordinate interests. These subordinate interests could include leases, restrictions imposed by a previous owner or restriction imposed by statute.
- A lease interest will be for a defined period, at the end of which the property reverts to the holder of the superior interest out of which it was created. The lease contract will normally impose obligations on the lessee, eg the payment of rent and other expenses. It may also impose conditions or restrictions, such as in the way the property may be used or on any transfer of the interest to a third party.
- A right of use may be held in perpetuity or may be for a defined period. The right may be dependent on the holder making payments or complying with certain other conditions.

C6. When valuing a *real property* interest it is therefore necessary to identify the nature of the rights accruing to the holder of that interest and reflect any constraints or encumbrances imposed by the existence of other interests in the same property. The sum of the individual values of various different interests in the same property will frequently differ from the value of the unencumbered superior interest.

C7. Property interests are normally defined by state law and often regulated by national or local legislation. Before undertaking a valuation of a *real property* interest, an understanding of the relevant legal framework that affects the interest being valued is essential.

**Rent**

C8. When valuing either a superior interest that is subject to a lease or an interest created by a lease, it is necessary to consider the contract rent and, in cases where it is different, the *market rent*.

C9. *Market rent* is the estimated amount for which a property would be leased on the *valuation date* between a willing lessor and a willing lessee on appropriate lease terms in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

C10. The commentary given for the similar definition of *market value* in the IVS *Framework* can be applied to assist in the interpretation of *market rent*. In particular, the estimated amount excludes a rent

inflated or deflated by special terms, considerations or concessions. The "appropriate lease terms" are terms that would typically be agreed in the market for the type of property on the *valuation date* between market participants. A valuation of *market rent* should only be provided in conjunction with an indication of the principal lease terms that have been assumed.

C11. The contract rent is the rent payable under the terms of an actual lease. It may be fixed for the duration of the lease or variable. The frequency and basis of calculating variations in the rent will be set out in the lease and must be identified and understood in order to establish the total benefits accruing to the lessor and the liability of the lessee.

**Valuation Approaches**

C12. The three principal valuation approaches described in the IVS *Framework* can all be applicable for the valuation of a *real property* interest.

**Market Approach**

C13. Property interests are not homogeneous. Even if the land and buildings to which the interest being valued relates have identical physical characteristics to others being exchanged in the market, the location will be different. Notwithstanding these dissimilarities, the *market approach* is commonly applied for the valuation of *real property* interests.

C14. In order to compare the subject of the valuation with the price of other *real property* interests that have been recently exchanged or that may be currently available in the market, it is usual to adopt a suitable unit of comparison. Units of comparison that are commonly used include analysing sale prices by calculating the price per square metre of a building or per hectare for land. Other units used for price comparison where there is sufficient homogeneity between the physical characteristics include a price per room or a price per unit of output, eg crop yields. A unit of comparison is only useful when it is consistently selected and applied to the subject property and the comparable properties in each analysis. To the extent possible any unit of comparison used should be one commonly used by participants in the relevant market.

C15. The reliance that can be applied to any comparable price data in the valuation process is determined by comparing various characteristics of the property and transaction from which the data was derived with the property being valued. Differences between the following should be considered:

- the interest providing the price evidence and the interest being valued,
- the respective locations,
- the respective quality of the land or the age and specification of the buildings,
- the permitted use or zoning at each property,
- the circumstances under which the price was determined and the *basis of value* required,
- the effective date of the price evidence and the required *valuation date*.

**Income Approach**

C16. Various methods are used to indicate value under the general heading of the *income approach*, all of which share the common characteristic that the value is based upon an actual or estimated income that either is or could be generated by an owner of the interest. In the case of an *investment property*, that income could be in the form of rent; in an owner-occupied building, it could be an assumed rent (or rent saved) based on what it would cost the owner to lease equivalent space. Where a building is suitable for only a particular type of trading activity, the income is often related to the actual or potential cash flows that would accrue to the owner of that building from the trading activity. The use of a property's trading potential to indicate its value is often referred to as the "profits method".

C17. The income stream identified is then used to indicate the value by a process of capitalisation. An income stream that is likely to remain constant can be capitalised using a single multiplier, often known as the capitalisation rate. This figure represents the return, or "yield", that an investor, or the notional return in the case of an owner-occupier, would expect to reflect the time cost of money and the risks and rewards of ownership. This method, often known as the all risks yield method, is quick and simple but cannot be reliably used where the income is expected to change in future periods to an extent greater than that generally expected in the market or where a more sophisticated analysis of risk is required.

C18. In such cases, various forms of discounted cash flow models can be used. These vary significantly in detail but share the basic characteristic that the net income for a defined future period is adjusted to a present day value using a discount rate. The sum of the present day values for the individual periods represents the capital value. As in the case of the all risks yield method, the discount rate in a discounted cash flow model will be based on the time cost of money and the risks and rewards attaching to the income stream in question.

C19. The yield or discount rate discussed above will be determined by the objective of the valuation. If this is to establish the value to a particular owner or potential owner based on their own investment criteria, the rate used may reflect their required rate of return or the weighted average cost of capital. If it is to establish the *market value*, the rate will be derived from observation of the returns implicit in the price paid for *real property* interests traded in the market between market participants.

C20. The appropriate discount rate should be determined from analysis of the rates implicit in transactions in the market. Where this is not possible, an appropriate discount rate may be built up from a typical “risk free“ return adjusted for the additional risks and opportunities specific to the particular *real property* interest.

C21. The appropriate yield or discount rate will also depend on whether the income inputs or cash flows used are based on current levels or whether projections have been made to reflect anticipated future inflation or deflation.[4]

**Cost Approach**

C22. This approach is generally applied to the valuation of *real property* interests through the depreciated replacement cost method.[5] It is normally used when there is either no evidence of transaction prices for similar property or no identifiable actual or notional income stream that would accrue to the owner of the relevant interest. It is principally used for the valuation of specialised property, which is property that is rarely if ever sold in the market, except by way of sale of the business or entity of which it is part.

C23. The first step requires a replacement cost to be calculated. This is normally the cost of replacing the property with a modern equivalent at the relevant *valuation date*. An exception is where an equivalent property would need to be a replica of the subject property in order to provide a market participant with the same utility, in which case the replacement cost would be that of reproducing or replicating the subject building rather than replacing it with a modern equivalent. The replacement cost needs to reflect all incidental costs such as the value of the land, infrastructure, design fees and finance costs that would be incurred by a market participant in creating an equivalent asset.

[4] More detailed guidance is contained in the Exposure Draft TIP1 *The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations* published in January 2011.

[5] More detailed guidance is contained in the Exposure Draft TIP 2 *Depreciated Replacement Cost* published in February 2011.

C24. The cost of the modern equivalent is then subject to adjustment for obsolescence. The objective of the adjustment for obsolescence is to estimate how much less valuable the subject property would be to a potential buyer than the modern equivalent. Obsolescence considers the physical condition, functionality and economic utility of the subject property compared to the modern equivalent.

# ANNEXE – HISTORIC PROPERTY

A1. This Annexe gives additional guidance on matters that require consideration when valuations are undertaken of interests in historic *real property*.

A2. A historic property is *real property* that is publicly recognised or officially designated by a government body as having cultural or historic importance because of its association with a historic event or period, with an architectural style or with a nation's heritage. The characteristics common to historic property include the following:

- its historic, architectural and/or cultural importance,
- the statutory or legal protection to which it may be subject,
- restraints and limitations placed upon its use, alteration and disposal,
- a frequent obligation in some jurisdictions that it be accessible to the public.

A3. Historic property is a broad term, encompassing many property types. Some historic property is restored to its original condition, some is partially restored, eg the building facade, and others are not restored. Historic property also includes properties partially adapted to current standards, eg the interior space, and properties that have been extensively modernised.

**Protection of Historic Property**

A4. Historic property may have legal or statutory protection because of its cultural and economic importance. Many governments have enacted measures to safeguard specific historic property or to protect whole areas of special architectural or historic interest.

A5. The UNESCO[6] Glossary of World Heritage Terms defines cultural heritage and cultural property as follows:

"Cultural Heritage. Three groups of assets are recognized:

(a) Monuments: architectural works, works of monumental sculpture and painting, elements or structures of an archaeological nature, inscriptions, cave dwellings and combinations of features, which are of outstanding universal value from the point of view of history, art or science;

(b) Groups of buildings: groups of separate or connected buildings which, because of their architecture, their homogeneity or their

[6] UNESCO is the United Nations Educational, Scientific and Cultural Organization.

place in the landscape, are of outstanding universal value from the point of view of history, art or science; and

(c) Sites: works of man or the combined works of nature and man, and areas including archaeological sites, which are of outstanding universal value from the historical, aesthetic, ethnological or anthropological point of view."[7]

"Cultural Property is property inscribed in the World Heritage List after having met at least one of the cultural heritage criteria and the test of authenticity."[8]

A6. Not all historic property is necessarily recorded in registers of officially designated historic properties. Many properties having cultural and historic importance also qualify as historic property.

**Features of Historic Property Affecting Valuations**

A7. The valuation of historic property requires consideration of a variety of factors that are associated with the importance of these properties, including the legal and statutory protections to which they are subject, the various restraints upon their use, alteration and disposal, and possible financial grants, tax rate or tax exemptions to the owners of such properties in some jurisdictions.

A8. When undertaking a valuation of a historic property, the following matters should be considered depending upon the nature of the historic property and the purpose of the valuation:

(a) The costs of restoration and maintenance may be considerable for historic property and these costs, in turn, affect the value of the property.

(b) Legal measures to safeguard historic property may limit or restrict the use, intensity of use or alteration of a historic property. Examples include the following:

- restrictive covenants that apply to the land regardless of the owner,
- preservation easements that prohibit certain physical changes, usually based on the condition of the property at the time the easement was acquired or immediately after proposed restoration of the property,
- conservation easements that limit the future use of a property so as to protect open space, natural features or wildlife habitat.

[7] World Heritage Convention, Article I, UNESCO, 1972.
[8] World Heritage Convention, Article II, UNESCO, 1972.

A9. The valuation of historic property involves special considerations dealing with the nature of older construction methods and materials, the current efficiency and performance of such properties in terms of modern equivalent assets, the appropriateness of methods used to repair, restore, refurbish or rehabilitate the properties, and the character and extent of legal and statutory protections affecting the properties.

A10. The land or site upon which a historic property stands may be subject to constraints upon its use. In turn, any such constraints will affect the overall value of the historic property.

A11. In some cases historic property may be incapable of reliable valuation because there is no relevant market evidence, no potential for generating income and no demand to warrant replacement. An example would be a partially ruined building with no income generating potential; although it may well have historic significance, this could not be replicated or replaced.

**Valuation Approaches**

A12. The three principal valuation approaches described in the IVS *Framework* can all be applied to the valuation of a historic property.

**Market Approach**

A13. In applying the *market approach*, the historic nature of the property may change the order of priority normally given to attributes of comparable properties. It is especially important to find comparable properties with historic features similar to those of the subject historic property. Criteria for the selection of comparable properties include architectural style, property size, specific cultural or historic associations of the subject property and similarity in location as regards zoning, permissible use, legal protection and concentration of historic properties. A variety of adjustments may have to be made to the comparable sales. These involve differences in location, costs of restoration or rehabilitation, or specific encumbrances. Adjustments are normally made in the following situations:

- when costs must be incurred to restore or rehabilitate the subject property, but not the comparable sales,
- where the specific encumbrances upon the subject property, eg restrictive covenants or preservation easements, differ from those upon the comparable properties.

**Income Approach**

A14. Historic property fully utilised for commercial purposes may be valued by means of the *income approach*. Where the distinctive

physical features of a historic property contribute to its drawing power under an income producing use, it is particularly important to reflect the cost of any work necessary to restore, adapt or maintain the features of the property. Where work is required, allowances should be made for the time and cost involved in obtaining any necessary statutory consent.

**Cost Approach**

A15. When applying the *cost approach* to the valuation of a historic property, consideration is given to whether the historic features of a building would be of intrinsic value in the market for that property. Some historic buildings will be of value simply because of their symbolic status. For example, a historic building used for a famous art gallery could be just as or more important than the function it fulfils. In this situation, the service potential of such a building is inseparable from its historic features. The modern equivalent of such properties would need to reflect either the cost of reproducing a replica, or if this is not possible because the original materials or techniques are no longer available, the cost of a new building with a similarly distinctive and high specification.

A16. In many cases, the historic features will either add no value or be viewed as an encumbrance by a purchaser, eg a hospital operating in a historic building. In such cases, the modern equivalent would reflect the cost of a new building constructed to a conventional modern specification.

A17. In all cases, the adjustments for physical deterioration and functional obsolescence will need to reflect factors such as the higher cost of maintenance associated with the historic property and the loss of flexibility for adapting the building to the changing needs of an occupier.

# IVS 233 Investment Property under Construction

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## STANDARD

1. The principles contained in the General Standards and in IVS 230 *Real Property Interests* apply to valuations of *investment property* under construction. This standard only includes modifications, additional requirements or specific examples of how the General Standards apply for valuations to which this standard applies.

### Scope of Work (IVS 101)

2. To comply with the requirements to state the extent of investigations and nature and source of the information to be relied upon in IVS 101 para 2(g) and (h) respectively the following matters shall be commented upon:

   - the source of information on the proposed building, eg identifying the plans and specification which will be used to indicate the value of the completed project,
   - the source of information on the construction and other costs required to complete the project.

3. Typical examples of assumptions or *special assumptions* that may need to be agreed and confirmed in order to comply with IVS 101 para 2(i) include:

   - that the building will be completed in accordance with the identified plans and specification,

- that any preconditions required for agreed leases of the completed building would be met or complied with.

**Implementation (IVS 102)**

4. There are no additional requirements for *investment property* under construction.

**Reporting (IVS 103)**

5. In addition to the requirements of IVS 103 *Reporting* and IVS 230 *Real Property Interests* a valuation report on *investment property* under construction shall include appropriate references to matters addressed in the scope of work in accordance with paras 2 and 3 above. The report shall also include comment on such of the following matters as is relevant to the purpose of the valuation:

- a statement that the project is under construction,
- a description of the project,
- a description of the stage of development reached, the estimated cost to complete and the source of that estimate,
- identification of and, where possible, quantification of the remaining risks associated with the project, distinguishing between the risks in respect of generating rental income and construction risks,
- a description of how the risks have been reflected in the valuation,
- the key inputs to the valuation and the assumptions made in determining those inputs,
- a summary of the status of any outstanding major contracts, if relevant.

**Effective Date**

6. The effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

## COMMENTARY

### Investment Property

C1. *Investment property* is property that is land or a building, or part of a building, or both, held by the owner to earn rentals or for capital appreciation, or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes, or

(b) sale in the ordinary course of business.

C2. The owner may hold a superior or subordinate interest in *investment property*. For the descriptions of the types of property interest and the principles to be applied in valuing them, see IVS 230 *Real Property Interests*. This standard is concerned with the situation where an *investment property* is in the course of construction on the *valuation date*.

C3. Valuations of partially completed *investment property* may be required for different purposes including:

- acquisitions, mergers and sales of businesses or parts of businesses,
- loan security,
- litigation,
- financial reporting.

### Valuation Approaches

C4. This standard provides principles that should be observed in estimating the *market value* of *investment property* under construction. *Market value* is discussed in detail in the IVS *Framework* but in summary the objective is to estimate the price that would be paid and received in a hypothetical exchange of the partially completed property in the market as of the *valuation date.*

C5. In practice, few investment properties are transferred between market participants in a partially completed state, except as either part of a transfer of the owning entity or where the seller is either insolvent or facing insolvency and therefore unable to complete the project. Even in the unlikely event of there being evidence of a transfer of another partially completed *investment property* close to the *valuation date*, the degree to which work has been completed would almost certainly differ, even if the properties were otherwise similar.

C6. In the absence of directly comparable sales evidence, the value has to be estimated using one or more market-based valuation

approaches. Such approaches may use information from a variety of sources, including:

- sales evidence of comparable properties in different locations or in a different condition with adjustments made to account for such differences,
- sales evidence of comparable properties transacted in different economic conditions with adjustments made to account for such differences,
- discounted cash flow projections or income capitalisation supported by comparable market data on construction costs, lease terms, operating costs, growth assumptions, discount and capitalisation rates and other key inputs.

C7. The *market value* of a partially completed *investment property* will reflect the expectations of market participants of the value of the property when complete, less deductions for the costs required to complete the project and appropriate adjustments for profit and risk. The valuation and all key assumptions used in the valuation should reflect market conditions at the *valuation date*.

C8. It is inappropriate to estimate the *market value* of a partially completed *investment property* solely by reference to the project plan or feasibility study produced at the commencement of the project. Once the project has commenced, this is not a reliable tool for measuring value as the inputs will be historic. An approach based on estimating the percentage of the project that has been completed prior to the *valuation date* is therefore unlikely to be relevant in determining the current *market value*.

C9. If the time required from the *valuation date* to complete construction of a new *investment property* is such that the anticipated cash flows will occur over a period of time, and if the time cost of money is likely to be a significant factor, it would be appropriate to use a discounted cash flow method that reflects the probable timing of those cash flows.

C10. A valuation of *investment property* under construction may be undertaken using either a growth-implicit model, which uses current cost and value inputs, or a growth-explicit model which uses estimated future cost and value inputs. In either model, the objective is to estimate the value on the *special assumption* that the property is complete, from which appropriate deductions are then made in order to estimate the value of the property in its present condition. The more appropriate of these alternatives will be the one prevailing in the market for the class of property on the *valuation date*. Inputs from one model should not be used in the other, and the report should make clear which approach is being adopted.

### Valuation Inputs

C11. The exact valuation inputs used will vary with the valuation model being used but will normally include those listed in this section. The inputs will also vary depending on whether a growth-implicit or growth-explicit model is being used, see para C10 above. Typical inputs include:

(a) Completed property

If a growth-implicit model is used, this will reflect the value of the *investment property* as if complete, ie its value on the assumption that on the *valuation date* it had already been completed in accordance with the current specification. If a growth-explicit model is used, this will reflect the projected value of the property upon completion, ie the expected value of the property on the date when it is anticipated to be complete.

(b) Leasing

If lessees for the property after completion have still to be identified, allowance will need to be taken of the time and costs that it would be realistic to allow for stabilised occupancy to be reached, ie the period required to reach realistic long-term occupancy levels. The costs during this period could include fees, marketing, incentives, maintenance and unrecoverable service charges. The income from anticipated future leases may be based on current *market rents* if a growth-implicit model is used or anticipated future rents if a growth-explicit model is used. If there are leasing agreements in place that are conditional on the project, or a relevant part, being completed, these should be reflected in the valuation.

(c) Construction costs

The benefit of any work carried out prior to the *valuation date* will be reflected in the current value, but will not determine that value. Similarly, previous payments under the actual building contract prior to the *valuation date* are not relevant to current value. In contrast, the sums remaining to be paid under any binding construction contract in existence at the *valuation date* are often the best evidence of the construction costs required to complete. However, if there is a material risk that the contract may not be fulfilled, eg due to a dispute or insolvency of one of the parties, it may be more appropriate to reflect the cost of engaging a new contractor to complete the outstanding work. If there is no fixed price contract in place and a growth-explicit model is being used, then it may be appropriate to use prospective cost, ie reflecting the reasonable expectation of market participants on the *valuation date* of costs on the dates when they are likely to be incurred.

(d) Finance costs

These represent the cost of finance for the project from acquisition through to the anticipated repayment of the loan. As the lender may perceive the risks during construction to differ substantially from the risks following completion of construction, the finance cost during each period should be considered separately. Even if the entity is self-funding the project, appropriate market rates of interest should be allowed to reflect those which would be obtainable by a typical buyer of the property in the market at the date of valuation.

(e) Other costs

These will include legal and professional costs that would be reasonably incurred by a buyer in completing the construction and in letting the *investment property*. Except where there are leasing agreements in place, allowance will also need to be made for the reasonable costs of marketing. However, any costs that would be incurred in an actual transfer of the property on the *valuation date* should be ignored.

(f) Buyers profit and risk

Allowance should be made for the return that would be required by a buyer of the partially completed *investment property* in the marketplace. This should reflect the risks associated with the completion of the construction programme and in achieving the anticipated income or capital value on the *valuation date*. The buyer's return can be expressed as a target profit, either a lump sum or a percentage return on cost or value.

All significant risks should be identified and evaluated. Typical risks associated with any partially completed construction project will include variations in construction cost, finance costs and the construction programme. Additional risks associated with *investment property* under construction include fluctuations in the value of the completed project between inception and completion, and the time that will be required to secure lessees and a stabilised income. The risks associated with generating income from the property after completion should be identified and evaluated separately from the risks associated with completing construction. If a growth-implicit model is used, the valuation inputs will reflect current values and costs so the risk of these changing between the *valuation date* and the anticipated completion date should be evaluated. If a growth-explicit model has been used based on prospective values and costs, the risk of those projections proving to be inaccurate should be evaluated.

Alternatively, if a discounted cash flow method is used to produce the valuation, the discount rate may be the minimum rate of return that would be required by a typical buyer in the market.

The profit anticipated by the entity at the commencement of the development project is irrelevant to the valuation of its interest in the project once construction has commenced. The valuation should reflect those risks remaining at the *valuation date* and the discount or return that a buyer of the partially completed project would require for bringing it to a successful conclusion.

(g) Other considerations

In situations where there has been a change in the market since a project was originally conceived, the project under construction may no longer represent the highest and best use of the land. In such cases, the costs to complete the project originally proposed may be irrelevant as a buyer in the market would either demolish any partially completed structures or adapt them for an alternative project. The value of the *investment property* under construction would need to reflect the current value of the alternative project and the costs and risks associated with completing that project.

**Special Considerations for Financial Reporting**

C12. Financial statements are normally produced on the assumption that the entity is a going concern, see IVS 300 *Valuations for Financial Reporting* para 4. It is therefore normally appropriate to assume that any contracts, eg for the construction or letting of the property on completion, would pass to the buyer in the hypothetical exchange, even if those contracts may not be assignable in an actual exchange. An exception would be if there was evidence of an abnormal risk of default by a contracted party on the *valuation date*.

**Special Considerations for Secured Lending Valuations**

C13. As indicated in IVS 310 *Valuations of Property Interests for Secured Lending*, the appropriate *basis of valuation* for secured lending is *market value*. However, in considering the value of any property that is under construction as security, regard should be had to the fact that many contracts either become void or voidable in the event of one of the parties becoming subject to formal insolvency proceedings. Therefore, it may not be appropriate to make an assumption that a buyer of the partially completed project would have the benefit of existing building contracts and any associated warrantees and guarantees. Similarly with an agreement to lease, care should be taken in assuming that the benefit of any agreement entered into by the borrower acting as lessor would be transferable to a buyer.

# IVS 250 Financial Instruments


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## STANDARD

1. The principles contained in the General Standards apply to valuations of financial instruments. This standard only includes modifications, additional requirements or specific examples of how the General Standards apply for valuations to which this standard applies.

### Scope of Work (IVS 101)

2. When valuations are being undertaken by the holding entity that are intended for use by external investors, regulatory authorities or other entities, to comply with the requirement to confirm the identity and status of the valuer in IVS 101 para 2(a), reference shall be made to the control environment in place, see Commentary paras C31 to C35 below.

3. To comply with the requirement to identify the asset or liability to be valued as in IVS 101 para 2(d) the following matters shall be addressed:

   - the class or classes of instrument to be valued,
   - whether the valuation is to be of individual instruments, a portfolio of identical instruments or a whole portfolio of assets.

**Implementation (IVS 102)**

4. There are no additional requirements for financial instruments.

**Reporting (IVS 103)**

5. To comply with the requirement to disclose the valuation approach and reasoning in IVS 103 para 5(l), consideration shall be given to the appropriate degree of reporting detail. This will differ for different categories of financial instrument. Sufficient information should be provided to allow users to understand the nature of each class of instrument valued and the primary factors influencing the values. Information that adds little to a users' understanding as to the nature of the asset or that obscures the primary factors influencing value shall be avoided. In determining the level of disclosure that is appropriate, regard shall be had to the following:

   - Materiality

     The value of an instrument or class of instruments in relation to the total value of the holding entity's assets and liabilities or the portfolio that is valued.

   - Uncertainty

     The value of the instrument may be subject to material uncertainty on the *valuation date* due to the nature of the instrument, the model or inputs used or to market abnormalities. Disclosure of the cause and nature of any material uncertainty should be made.

   - Complexity

     For complex instruments a more detailed description of the nature of the instrument and the factors influencing value is normally appropriate.

   - Comparability

     The instruments that are of particular interest to users may differ with the passage of time. The usefulness of the valuation report, or any other reference to the valuation, is enhanced if it reflects the information demands of users as market conditions change, although to be meaningful the information presented should allow comparison with previous periods.

- Underlying assets

  If the cash flows of an instrument are generated from or secured by specific underlying assets, information about matters affecting the current value of those assets will help users to understand the reported value of the instrument.

6. When financial instruments are valued for inclusion in a financial report prepared under IFRS, IFRS 7 requires specific disclosures depending upon where the instrument is classified within the hierarchy of valuation inputs, see IVS 300 *Valuations for Financial Reporting.*

**Effective Date**

7. This effective date of this standard is 1 January 2012, although earlier adoption is encouraged.

## COMMENTARY

### Introduction

C1. A financial instrument is a contract that creates rights or obligations between specified parties to receive or pay cash or other financial consideration, or an equity instrument. The contract may require the receipt or payment to be made on or before a specific date or be triggered by a specified event. An equity instrument is any contract that creates a residual interest in the assets of an entity after deducting all of its liabilities.

C2. Valuations of financial instruments are required for many different purposes including, but not limited to:

- acquisitions, mergers and sales of businesses or parts of businesses,
- financial reporting,
- regulatory requirements, in particular banking solvency requirements,
- internal risk and compliance procedures,
- establishing the net asset value of insurance company funds,
- pricing and performance measurement of investment funds.

C3. Financial instruments can be broadly divided into either "cash instruments", which include loans, deposits, securities and bonds, or "derivative instruments", which derive a return from one or more underlying assets.

C4. A thorough understanding of the instrument being valued is required to identify and evaluate the relevant market information available for identical or similar instruments. Such information includes prices from recent transactions in the same or a similar instrument, quotes from dealer brokers or pricing services, indices or any other inputs to the valuation process, such as the appropriate interest rate curve, or pricing volatility.

### Markets for Financial Instruments

C5. Liquid instruments, such as stock in a major company, a government bond or a futures contract for a recognised commodity, are traded on major exchanges and real time prices are readily available, both to active market participants and through various media outlets. Some liquid derivative instruments, eg forward stock options or commodity futures, are also traded on exchanges.

C6. Many types of instruments, including many types of derivatives or non-liquid cash instruments, are not traded on public exchanges

and have varying degrees of illiquidity. Trades of these instruments are negotiated in what is termed the over the counter (OTC) market.

C7. Although the overall size of the market for OTC traded instruments is many times greater than that for instruments traded on public exchanges, the volume of trades varies significantly. Some common or "vanilla" swaps are traded daily in large volumes whereas for some bespoke swaps, there is often no trade at all after the initial deal is struck, either because the terms of the contract prohibit assignment or because there is no market for that class of instrument.

C8. Valuation techniques are most likely to be required for instruments that are traded in the OTC markets or that are normally traded on a public exchange but where that market has become inactive. It is these situations that are the main focus of this standard.

**Credit Risk**

C9. Understanding the credit risk is an important aspect of valuing any debt instrument. Some of the common factors that need to be considered in establishing and measuring credit risk include the following:

- Counterparty risk

  The financial strength of the issuer or any credit support providers will involve consideration of not only the trading history and profitability of the relevant entity but also consideration of performance and prospects for the industry sector generally.

- Subordination

  Establishing the priority of an instrument is critical in assessing the default risk. Other instruments may have priority over an issuer's assets or the cash flows that support the instrument.

- Leverage

  The amount of debt used to fund the assets from which an instrument's return is derived affects the volatility of returns to the issuer and can affect credit risk.

- Collateral asset quality

  The assets to which the holder of an instrument has recourse in the event of default must be considered. In particular, it needs to be understood whether recourse is to all the assets of the issuer or only to specified assets. The greater the value and quality of the assets to which an entity has recourse in the event of default, the lower the credit risk of the instrument.

- Netting agreements

  Where derivative instruments are held between counterparties, credit risk may be reduced by a netting or offset agreement that limits the obligations to the net value of the transactions, ie if one party becomes insolvent, the other party has the right to offset sums owed to the insolvent party against sums due under other instruments.

- Default protection

  Many instruments contain some form of protection to reduce the risk of non-payment to the holder. Protection might take the form of a guarantee by a third party, an insurance contract, a credit default swap or more assets to support the instrument than are needed to make the payments. The default risk is also reduced if subordinated instruments take the first losses on the underlying assets and therefore reduce the risk to more senior instruments. When protection is in the form of a guarantee, an insurance contract or a credit default swap, it is necessary to identify the party providing the protection and assess that party's creditworthiness. Considering the credit worthiness of a third party involves not only the current position but also the possible effect of other guarantees or insurance contracts that it might have written. If the provider of a guarantee has also guaranteed many correlated debt securities, the risk of its non-performance might increase significantly.

C10. For parties for which limited information is available, it might be necessary to look to information available for entities with similar risk characteristics. Credit indices are published that may assist this process. If secondary trading in structured debt exists, there might be sufficient market data to provide evidence of the appropriate risk adjustment. The varying sensitivities of different liabilities to credit risk should be taken into account in evaluating which source of credit data provides the most relevant information. The risk adjustment or credit spread applied is based on the amount a market participant would require for the particular instrument.

**Own Credit Risk**

C11. Because the credit risk associated with a liability is important to its value, it might appear to follow that when valuing the interest of the issuer of a liability, the credit risk of the issuer is relevant to its value in any transfer of that liability. Where it is necessary to assume a transfer of the liability regardless of any actual constraints on the ability of the counterparties to do so, eg in order to comply with financial reporting requirements, there are various potential sources for reflecting own credit risk in the valuation of liabilities. These include the yield curve for the entity's own bonds or other debt

issued and credit default swap spreads or by reference to the value of the corresponding asset. However, in many cases the issuer of a liability will not have the ability to transfer it but can only settle the liability with the counterparty.

C12. When adjusting for own credit risk, it is also important to consider the nature of the collateral available for the liabilities being valued. Collateral that is legally separated from the issuer normally reduces the credit risk. If liabilities are subject to a daily collateralisation process, there might not be a material own credit risk adjustment because the counterparty is protected from loss in the event of default. However, collateral provided to one counterparty is not available to other counterparties. Thus, although some collateralised liabilities might not be subject to significant credit risk, the existence of that collateral might affect the credit risk of other liabilities.

**Liquidity and Market Activity**

C13. Financial instruments range from those that are normally regularly traded on public exchanges in high volumes to bespoke instruments agreed between two parties that are incapable of assignment to a third party. This range of instrument types means that consideration of the liquidity of an instrument or the current level of market activity is important in determining the most appropriate valuation approach.

C14. Liquidity and market activity can be distinguished. The liquidity of an asset is a measure of how easily and quickly it can be transferred in return for cash or a cash equivalent. Market activity is a measure of the volume of trading at any given time, and is a relative rather than an absolute measure; see the IVS *Framework.*

C15. Although separate concepts, illiquidity or low levels of market activity pose valuation challenges through a lack of relevant market data, ie data that is either current at the *valuation date* or that relates to a sufficiently similar asset to be reliable. The lower the liquidity or market activity, the greater the reliance that will be needed on valuation approaches that use techniques to adjust or weight the inputs based on the evidence of other transactions to reflect either market changes or differing characteristics of the asset.

**Valuation Inputs**

C16. Except for liquid instruments that are traded on public exchanges, where current prices are both observable and accessible to all market participants, valuation inputs or sources of data may come from different sources. Commonly used input sources are broker dealer quotations and consensus pricing services.

C17. Although not as reliable as the evidence of a contemporary and relevant trade, where such information is not available, broker dealer quotations can provide the next best evidence of how market participants would price the asset. However, problems associated with broker dealer quotations that can affect their reliability as a valuation input include the following:

- Broker dealers will normally only be willing to make markets and provide bids in respect of more popular instruments and may not extend coverage to less liquid issues. Because liquidity often reduces with time, quotations may be harder to find for older instruments.
- A dealer's prime interest is in dealing, not supporting valuation, and they have little incentive to research a quotation provided for a valuation as thoroughly as they would for an actual buy or sell enquiry. This can impact on the quality of the information.
- There is an inherent conflict of interest where the broker dealers are the counterparty to an instrument.
- Broker dealers have an incentive to weight advice to buyer clients in a way that favourably reflects the holding.

C18. Consensus pricing services operate by collecting price information about an instrument from several participating subscribers. They reflect a pool of quotations from different sources, with or without statistical adjustment to reflect standard deviations or the distribution of the quotations.

C19. Consensus pricing services overcome the conflict of interest problems associated with single broker dealers. However, the coverage of such services is at least as limited as that for single broker dealer quotations. As with any data set used as a valuation input, understanding the sources and how these are statistically adjusted by the provider is essential to understanding the reliance that should be given to it in the valuation process.

**Valuation Approaches**

C20. Many types of instruments, particularly those that are traded on exchanges, are routinely valued using computer-based automated valuation models that use algorithms to analyse market transactions and produce valuations on the required asset. These models are often linked to proprietary trading platforms. It is beyond the scope of these standards to examine such models in detail, although as with other semi- or non-automated valuation models or approaches, these standards set a context for their use and the reporting of the results.

C21. Whether automated or manual, the various valuation methods used in financial markets are mostly based on variations of either the *market approach,* the *income approach* or the *cost approach* described in the IVS *Framework.* This standard describes the commonly used methods and matters that need to be considered or the inputs needed when applying these methods.

C22. It is important when using a particular valuation method or model to ensure that it is calibrated with observable market information on a regular basis. This ensures that the model reflects current market conditions and identifies any potential deficiencies. As market conditions change, it might become necessary either to change the model(s) used or to make additional adjustments to the valuations. Those adjustments should be made to ensure that the outcome most closely results in the required valuation objective.

**Market Approach**

C23. A price obtained from trading on a recognised exchange platform on or very close to the time or date of valuation is normally the best indication of the *market value* of a holding of the identical instrument. In cases where there have not been recent relevant trades, the evidence of quoted or offered prices may also be relevant.

C24. Although there will be no need for adjustment of the price information if the instrument is identical, the information recent enough to be relevant and the holding similar, some adjustments may be necessary where this is not the case. Examples of where adjustment or weighting of the evidence of traded prices may be required are:

- where the instrument being valued has different characteristics to the ones for which prices are available,
- where there are differences in the size or volume of the reported trade to the holding being valued,
- where the trade was not between willing parties acting independently,
- the timing of the trade, which may be accentuated by the closure of exchanges.

C25. A further factor that can create a difference between an exchange traded price and the instruments to be valued can arise where transfer of the holding results in either the creation of a controlling interest or prospect of a change of control.

### Income Approach

C26. The value of a financial instrument may be determined using a discounted cash flow method. The cash flows may be fixed for the life of the instrument or variable. The terms of an instrument determine, or allow estimation of, the undiscounted cash flows. The terms of a financial instrument typically set out:

- the timing of the cash flows, ie when the entity expects to realise the cash flows related to the instrument,
- the calculation of the cash flows, eg for a debt instrument, the interest rate that applies, ie the coupon, or for a derivative instrument, how the cash flows are calculated in relation to the underlying instrument or index (or indices),
- the timing and conditions for any options in the contract, eg put or call, prepayment, extension or conversion options,
- protection of the rights of the parties to the instrument, eg terms relating to credit risk in debt instruments or the priority over or subordination to other instruments held.

C27. In establishing the appropriate discount rate, it is necessary to assess the return that would be required on the instrument to compensate for the time cost of money and risks related to:

- the terms and conditions of the instrument, eg subordination,
- the credit risk, ie uncertainty about the ability of the counterparty to make payments when due,
- the liquidity and marketability of the instrument,
- the risk of changes to the regulatory or legal environment,
- the tax status of the instrument.

C28. Where future cash flows are not based on fixed contracted amounts, estimates of the probable income will need to be made in order to provide the necessary inputs. The determination of the discount rate will also require assumptions about the risks. The discount rate also needs to consistent with the cash flows, eg if the tax flows are gross of tax then the discount rate should be derived from other gross of tax instruments.

C29. Depending upon the purpose of the valuation, the inputs and assumptions made into the cash flow model will need to reflect either those that would be made by market participants, or those that would be based on the holder's current expectations or targets. For example, if the purpose of the valuation is to determine *market value*, or fair value as defined in IFRS, the assumptions should reflect those of market participants. If the purpose is to measure

performance of an asset against management determined benchmarks, eg a target internal rate of return, then alternative assumptions may be appropriate.

**Cost Approach**

C30. The substitution principle inherent in the *cost approach* is applied to the valuation of financial instruments through the use of the replication method. This method provides an indication of the current value of an instrument or portfolio by reproducing or "replicating" its risks and cash flows in a hypothetical, or synthetic, alternative. This alternative is based on a combination of securities and/or simple derivatives in order to estimate the cost of offsetting, or hedging, the position at the *valuation date*. Portfolio replication is often used to simplify the procedures applied to value a portfolio of complex financial instruments (eg expected insurance claims or structured products) by substituting a replicating portfolio of assets that are easier to value and therefore more efficiently risk managed on a daily basis.

**Control Environment**

C31. Compared with other asset classes, the volume of financial instruments in circulation is vast but the number of active market participants relatively few. The nature and volume of instruments and their frequency of valuation means that valuation is often undertaken using computer-based models linked to trading platforms. As a consequence of these factors, many instruments are routinely valued by the holding entity, even where the valuation is to be relied upon by external parties, eg investors or regulatory authorities. The incidence of valuation by independent third party experts is less common than for other asset classes.

C32. Valuation by the holding entity creates a significant risk to the perceived objectivity of valuations. Where valuations are for external consumption, steps should be taken to ensure that an adequate control environment exists to minimise threats to the independence of the valuation.

C33. The control environment consists of the internal governance and control procedures that are in place with the objective of increasing the confidence of those who may rely on the valuation in the valuation process and conclusion.

C34. As a general principle, valuations produced by an entity's "front office" brokerage and market making activities that are to be included in financial statements or otherwise relied on by third parties should be subject to "back office" scrutiny and approval. Ultimate authority for such valuations should be separate from,

and fully independent of, the risk taking functions. The practical means of achieving a separation of the function will vary according to the nature of the entity, the type of instrument being valued and the materiality of the value of the particular class of instrument to the overall objective. The appropriate protocols and controls should be determined by careful consideration of the threats to objectivity that would be perceived by a third party relying on the valuation.

C35. Examples of typical components of the control environment include:

- establishing a governance group responsible for valuation policies and procedures and for oversight of the entity's valuation process, including some members external to the entity,
- a protocol for the frequency and methods for calibration and testing of valuation models,
- criteria for verification of certain valuations by different internal or external experts,
- identifying thresholds or events that trigger more thorough investigation or secondary approval requirements,
- identifying procedures for establishing significant inputs that are not directly observable in the market, eg by establishing pricing or audit committees.

# Valuation Applications

## IVS 300 Valuations for Financial Reporting

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## INTRODUCTION

Valuations are required for different accounting purposes in the preparation of the financial reports or statements of companies and other entities. Examples of different accounting purposes include measurement of the value of an asset or liability for inclusion on the statement of financial position, allocation of the purchase price of an acquired business, impairment testing, lease classification and valuation inputs to the calculation of depreciation charges in the profit and loss account.

The Guidance section of this Application makes references to various requirements under the International Financial Reporting Standards (IFRSs). Although the IFRSs are the most widely adopted *Financial Reporting Standards* globally, national standards are also extensively used. Although it is impractical to make reference to national accounting standards in an international guidance document, many are similar to or converging with IFRSs. The guidance given may therefore be relevant for valuations for use in Financial Reporting Standards other than IFRSs.

## DEFINITIONS

In this Application the following definitions apply:

**Financial Reporting Standards**: any recognised or adopted standards for the preparation of periodic statements of an entity's financial position. These may also be referred to as accounting standards.

**International Financial Reporting Standards (IFRS)**: standards and interpretations adopted by the International Accounting Standards Board (IASB). They comprise:

(a) International Financial Reporting Standards,

(b) International Accounting Standards, and

(c) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

**Unit of Account**: the level at which an asset to be valued is aggregated or disaggregated with other assets.

## STANDARD

1. Valuations undertaken for inclusion in a financial statement shall be provided to meet the requirements of the Financial Reporting Standards that are applicable. The principles contained in the General Standards (IVS 101, 102 and 103) also apply except as specifically modified by a requirement of the relevant accounting standard or by this standard.

### Scope of Work (IVS 101)

2. To comply with the requirement to confirm the purpose of the valuation in IVS 101 para 2(c) the scope of work shall include identification of the applicable Financial Reporting Standards including the specific accounting purpose for which the valuation is required. The accounting purpose is the use for which the valuation is required in the financial statements, eg measuring the carrying amount, undertaking an allocation of the purchase price following a business combination, impairment testing, lease classification or for calculating the depreciation charge for an asset.

3. In addition to the requirement to identify the asset to be valued in IVS 101 para 2(d) the scope of work shall include confirmation of how that asset is used or classified by the reporting entity. The required accounting treatment for identical or similar assets or liabilities can differ according to how they are used by an entity. For example:

    - the treatment of *real property* owned by an entity may differ depending on whether it is occupied for the purpose of the entity's business, is held as an investment, is surplus to requirements or, in the case of a development company, is treated as stock in trade,
    - financial instruments that are held to collect contractual cash flows that consist solely of payments of the principal and interest may be treated differently to other forms of instruments,
    - *intangible assets* acquired by a business merger or acquisition may be treated differently from similar assets already owned by an entity.

    Where an asset is utilised in conjunction with other separately identifiable assets the unit of account shall be identified. The relevant Financial Reporting Standard may stipulate how the unit of account, or degree of aggregation, is to be determined for different asset types or for different accounting purposes.

To comply with IVS 101 para 2(e) the specific *basis of value* shall be clearly identified. Examples of bases required in accounting standards include fair value, net realisable value and recoverable amount. The definition will be provided in the relevant accounting standard.

4. To comply with IVS 101 para 2(i) any assumptions to be made shall be stated. The appropriate assumptions will vary depending on how an asset is held or classified. Most Financial Reporting Standards provide that financial statements are produced on the assumption that the entity is a going concern unless management either intends to liquidate the entity or cease trading or has no realistic alternative but to do so. Except in the case of financial instruments it is therefore normally appropriate to include an assumption that the asset or assets will continue to be used as part of the business of which they form part. This assumption does not apply in cases where it is clear that there is either an intention to liquidate the entity, to dispose of a particular asset or that there is a requirement to consider the sum that could be recovered from disposal or retirement of the asset.

5. It will also be necessary to state the assumptions that will be made to define the unit of account, eg whether the asset is to be valued on a stand-alone basis or in combination with other assets. The relevant accounting standard may have stipulations as to the assumptions, or valuation premise that can be made.

6. It would not normally be appropriate for a valuation prepared for inclusion in a financial statement to be made on the basis of a *special assumption*.

7. In considering any restrictions referred to under IVS 101 para 2(j) consideration shall be given to:

   (a) the extent and form of any references to the valuation that may appear in the published financial statements,

   (b) the extent of the valuers' duty to respond to any questions on the valuation raised by the entity's auditor.

   Appropriate references to these matters shall be included in the scope of work.

**Implementation (IVS 102)**

8. There are no additional requirements when undertaking valuations for financial reporting.

### Reporting (IVS 103)

9. In addition to the minimum requirements in IVS 103 *Reporting*, a valuation report for use in a financial statement shall include appropriate references to matters addressed in the scope of work in accordance with paras 2 to 7 above.

10. The report shall also contain any information that the reporting entity is required to disclose by the relevant Financial Reporting Standards. Examples of disclosures required about fair value measurements include methods and significant assumptions used in the measurement and, or whether, the measurement was determined by reference to observable prices or recent market transactions. Some standards also require information about the sensitivity of the measurement to changes in significant inputs.

11. Where the effect on value of any assumption made is material, the effect of that assumption shall be disclosed in the report.

12. To comply with the requirement to state restrictions on use, distribution or publication in IVS 103 para 5(j) the report shall include reference to any conditions on how it may be reproduced or referred to in the published financial statements of the entity.

### Effective Date

13. This standard is effective from 1 January 2012, although earlier adoption is encouraged.

## APPLICATION GUIDANCE

This section provides background information on common valuation requirements under IFRSs. IFRSs are published by the International Accounting Standards Board (IASB). The IFRS collectively comprise individually numbered standards and interpretations. Those standards originally published before 2001 are denoted IAS (International Accounting Standards). Those published subsequently are denoted IFRS. The various extracts from and references to IFRSs in this guidance are reproduced with the permission of the IFRS Foundation.

The references to IFRS and other IASB publications are to those in issue at the date on which this Valuation Application is published. IFRSs and their interpretation change over time. Accordingly references in this document are liable to become out of date. This document should not be used as substitute for referring to current IFRSs and interpretations published by IASB and IFRS Foundation. More information on IFRSs and other related publications can be obtained from www.ifrs.org.

This guidance is produced to assist valuation professionals and users understand certain valuation requirements under IFRSs. Although the guidance is intended to reflect generally accepted valuation practice at the date of publication it does not impose any mandatory requirements. References to accounting requirements are subject to the provisions of the relevant IFRS and in the event of a conflict between this guidance and the IFRS, the IFRS prevails. Although similar requirements may exist in other Financial Reporting Standards, IVSC makes no assertion as to the relevance of this guidance to such standards.

### Fair Value

G1. Fair value is either the required measurement basis or a permitted option for many types of asset or liability under IFRSs. IFRS 13 *Fair Value Measurement* contains the following definition:

"Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[9]

This definition replaces earlier definitions appearing in various IFRSs. It should also be noted that this definition differs from that appearing in the IVS *Framework* and that is commonly used for purposes other than financial reporting.

G2. This definition and the associated commentary in IFRS 13 clearly indicate that fair value under IFRS is a different concept to *fair value* as defined and discussed in the IVS *Framework*. The commentary

[9] © IFRS Foundation.

in IFRS 13 and, in particular, the references to market participants, an orderly transaction, the transaction taking place in the principal or the most advantageous market and to the highest and best use of an asset, make it clear that fair value under IFRSs is generally consistent with the concept of *market value* as defined and discussed in the IVS *Framework*. For most practical purposes, therefore, *market value* under IVS will meet the fair value measurement requirement under IFRS 13 subject to some specific assumptions required by the accounting standard such as stipulations as to the unit of account or ignoring restrictions on sale.

**Aggregation**

G3. Fair value under IFRSs applies to the "unit of account" for an asset or liability as specified in the relevant standard. This is usually the individual asset or liability, but in some circumstances can apply to a group of related assets. IFRS 13 requires that, in the case of assets, it is necessary to determine whether the maximum value to market participants would be to use the asset in combination with other assets and liabilities as a group or to use the asset on a stand-alone basis. This requirement to state how individual assets are assumed to be aggregated with other potentially complementary assets is consistent with the requirements of IVS 101 *Scope of Work* and IVS 103 *Reporting*.

**Valuation Inputs and Fair Value Hierarchy**

G4. IFRS 13 includes a "Fair Value Hierarchy" that classifies valuations according to the nature of the available inputs. In summary, the three levels of the hierarchy are as follows:

- Level 1 inputs are "quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access on the measurement date".
- Level 2 inputs are "inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly".
- Level 3 inputs are "unobservable inputs for the asset or liability".[10]

This hierarchy also appears in IFRS 7 *Financial Instruments: Disclosures*

G5. IFRS 13 requires the level in the hierarchy of any asset or liability measured at fair value to be disclosed in the financial statements. There are additional accounting requirements in relation to valuations produced using Level 3 inputs. It is therefore appropriate

[10] © IFRS Foundation.

for a valuation report provided for use in financial statements prepared under IFRSs to include sufficient information on the valuation inputs used to enable the reporting entity to correctly categorise assets within this hierarchy.

**Liabilities**

G6. IFRS 13 provides that the measurement of a liability assumes that it is transferred to a market participant on the measurement date; it is not assumed to be settled with the counterparty or otherwise extinguished. Where there is not an observable market price for the liability, it is stated that its value should be measured using the same method as the counterparty would use to measure the value of the corresponding asset. The fair value of a liability reflects the non-performance risk associated with a liability, but deems this to be the same before and after the assumed transfer. Non-performance risk includes the effect of the entity's own credit risk.

G7. There are special provisions in IFRS 13 relating to situations where there is no corresponding asset for a liability, as is the case with many non-financial liabilities. There is also a requirement to ignore any contractual or other restrictions on an entity's ability to transfer a liability in assessing its fair value.

**Depreciation**

G8. IAS 16 includes a requirement for an entity to account for the depreciation of property, plant and equipment. Depreciation in the context of financial reporting is a charge made against income in the financial statements to reflect the consumption of an asset over its useful life to the entity. There is a requirement to depreciate separately components of an asset that have a cost that is significant in relation to the whole. Components that have a similar useful life and that are depreciated in a similar manner may be grouped. In the case of property, land is not normally depreciated. Valuations are often required to support the calculation of the depreciable amount.

G9. The term depreciation is used in different contexts in valuation and in financial reporting. In the context of valuation, depreciation is often used to refer to the adjustments made when using the *cost approach* to the cost of reproducing or replacing the asset to reflect obsolescence in order to indicate the value of the asset when there is no direct sales evidence available. In the context of financial reporting, depreciation refers to the charge made against income to reflect the systematic allocation of the depreciable amount of an asset over its useful life to the entity.

G10. In order to assess the depreciation charge to be made, the "depreciable amount" has to be determined. This is the difference, if any, between the "carrying amount" of the asset and its "residual value". In order to determine the "residual value", the "useful life" of the asset has also to be determined. These terms are defined in IAS 16 as follows:

- Depreciable amount is the cost of an asset or other amount substituted for cost in the financial statements, less its residual value.
- Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation or amortisation and accumulated impairment losses thereon.
- Residual value is the estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
- Useful life is (a) the period over which an asset is expected to be available for use by an entity, or (b) the number of production or similar units expected to be obtained from the asset by an entity.

G11. It should be noted that the carrying amount may be based on either historic cost or fair value, less accumulated depreciation (amortisation) and accumulated impairment losses. The residual value and the useful life have to be reviewed at least at every financial year end.

**Depreciation: Land and Buildings**

G12. IAS 16 recognises that land normally has an unlimited useful life, which means that it should be accounted for separately and not depreciated. The first step in establishing the depreciable amount attributable to a property, or a part of a property, is therefore to establish the value of the land component. This is normally done by establishing the value of the land at the date of the relevant financial statement and then deducting this from the carrying amount for the property interest, ie the land and buildings combined, in order to establish the element that can be attributed to the buildings. This is a notional value as it would not be capable of being realised as buildings usually cannot be sold without the land on which they sit.

G13. Having established the notional value for the building component, the residual value of the building needs to be estimated. In order to do this, the useful life needs to be established. It is important to note that this may not be the same as the remaining economic life as would be recognised by a typical market participant. Under IAS 16 the useful life is specific to the entity. If the property would not be

available to the entity for the whole of its life or if the entity determines that the building will be surplus to its requirements in a shorter period, this will be the useful life.

G14. The residual value is a value current as of the date of the financial statement but on the assumption that the asset was already at the end of its useful life and in a condition commensurate with that assumption. Buildings may have an economic life that extends beyond the period for which they will be available to or required by the entity and therefore may have a significant residual value.

**Depreciation: Plant and Equipment**

G15. The useful life of an item of plant or equipment is more likely to coincide with the economic life of the item as rates of obsolescence are generally higher than for buildings, with the result that economic lives are shorter. However, the distinction between the useful life to the entity and remaining economic life should still be considered.

**Depreciation: Componentisation**

G16. Where the carrying amount is based on historic cost, the cost of those components that both have a significant cost in relation to the total and that have a materially different useful life should be readily identifiable.

G17. Where the carrying amount is based on the fair value of the item, an allocation will need to be made of the fair value of the item between the components. Although it may be possible to determine the value attributable to a component of an item of plant or equipment if there is an active market for those components, in other cases the components will not be actively traded. The latter is normally the case with components of a building, eg buildings are rarely sold without the mechanical and electrical services needed for heating, lighting and ventilation, and the installed plant could not be sold without the building. Where the value of the individual components cannot be reliably determined, the value attributable to the whole is apportioned to the components. The ratio of the cost of the item to the cost of the whole may be an appropriate basis for such an apportionment.

**Leases**

G18. Under IAS 17, leases are classified for inclusion in financial statements as either operating leases or finance leases.[11] Valuations may be required to determine how a lease is classified, and if classified as a *finance lease*, to determine the carrying

[11] The IASB is currently reviewing the accounting treatment of leases and the initial proposals involve major changes, including removal of the current distinction between operating and finance leases.

amount of the asset and liability. These lease types are defined in IAS 17 as follows:

- A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not be eventually transferred.
- An operating lease is a lease other than a finance lease.

G19. For leases of property (*real estate*) special rules apply. Other than for *investment property*, the land and buildings elements of a property interest have to be considered separately for classification as either a finance lease or an operating lease. The provisions in respect of *investment property* are described in paras G29 to G32. IAS 17 does not apply to biological assets as defined in IAS 41.

**Lease Classification**

G20. The classification test depends on the substance rather than the form of the contract. For example, a contract between two parties for the use of an asset in return for a payment may not be termed a lease but if the conditions set out in IAS 17 are met, then it will be necessary to account for the contract as a lease.

G21. The following examples are listed in IAS 17 as situations that could be indicative of a finance lease, either individually or in combination. These are not absolute tests but illustrations:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term,

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value[12] at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised,

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred,

(d) at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset,

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications,

(f) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee,

(g) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee,

[12] See para G33.

(h) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.[13]

G22. IAS 17 emphasises that the criteria listed are examples and indicators and may not be conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then value, or if there are regular reviews of the rent, to the then market level or by reference to an inflation index.

G23. Lease classification is made at the inception of the lease. Classification involves an assessment of the degree to which economic benefits are transferred by a lease. In many cases a qualitative assessment of the lease terms will quickly indicate the correct classification without the need for a valuation of the different lease interests. However, valuations may be required to help establish benefits accruing to the lessor and lessee respectively, eg in estimating the residual value at the end of the lease to establish if the lease is for a major part of the asset's economic life.

**Classification of Property Leases**

G24. Where a lease is of land and a building or buildings together, IAS 17 requires that the two elements be considered separately for the purposes of classification. If it appears that the element of the lease attributable to the building could be a finance lease, it will be necessary to make an allocation of the initial rent based on the relative fair values of the interests in each element at the inception of the lease.

G25. For most property leases the interest in the leased land and buildings reverts to the lessor at the end of the lease. There are also often provisions for the rent to be reviewed periodically to reflect changes in the value of the property, and frequently an obligation on the lessee to return the buildings back to the lessor in good repair. These are normally indicators that the lessor did not transfer substantially all the risks and rewards of ownership of either the buildings or the land to the lessee when the lease was granted. Consequently, many leases of land and buildings are readily identifiable as operating leases.

G26. Finance leases of land and buildings will generally arise where the lease is clearly created as a way of funding the eventual purchase of the property by the lessee, eg by means of an option to acquire the lessor's interest for a nominal sum after the specified rental

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payments have been made. Occasionally, leases that are not clearly structured as finance agreements may meet some of the criteria of a finance lease, eg where the rental payments do not reflect the underlying value of the property. In such cases, a more detailed analysis of the value of the risks and benefits transferred from lessor to lessee may be required in order to determine the correct classification.

G27. Where a lease is of a plot of land and a building is constructed upon it, allocating the rent to each element is a task that can be undertaken reliably where there is an active market for land for similar development in the locality. In other situations, eg where the lease is of part of a multi-let building with no identifiable land attributable to any particular lease, reliable allocation may be impossible. IAS 17 makes the proviso that where a reliable allocation cannot be made, the whole lease should be treated as a finance lease, unless it is clear that both elements are operating leases. If it were clear that both elements were operating leases from the outset, the allocation exercise would not be necessary.

G28. In practice, leases of part of a multi-let building will normally be operating leases and the whole property will be classified as *investment property* by the lessor. In such cases, allocation will be unnecessary. In cases where the building element is clearly a finance lease, the land element is likely to be identifiable. It will be comparatively rare for the building element to meet the criteria for classification as a finance lease and for the land element not to be clearly identifiable. However, if such a case is identified, an allocation between the land and the building element should not be attempted based on unreliable criteria. In such circumstances, the whole of the leased property should be accounted for as a finance lease.

**Leased Investment Property**

G29. Under IAS 17, it is not necessary to make an allocation between the land and buildings elements of an *investment property* held under a lease and accounted for using the fair value model.

G30. *Investment property* is frequently held by an investor under a lease, eg a long lease of land on which it has developed buildings, which are then leased as an investment. Because land does not normally depreciate, a lease of land would appear to be correctly classified as an operating lease and therefore not included on the statement of financial position. However, in recognition of the fact that many substantial investment properties are held on this basis, IAS 40 provides that at initial recognition an *investment property* held under a lease shall be accounted for as though it were a *finance lease* under IAS 17.

G31. Although the foregoing provisions mean that questions of classification and allocation do not generally arise in relation to *investment property*, a potential anomaly remains. The value of the investor's interest in an *investment property* held under a lease reflects the difference between the payments under the superior lease and the receipts or potential receipts under the sub lease or leases, see IVS 230 *Real Property Interests*. However, IAS 17 provides that it is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets.

G32. In order to comply with this requirement, IAS 40 provides that where a valuation of an *investment property* held under a lease is net of all payments expected to be made, it is necessary to add back any recognised lease liability to arrive at the carrying amount. It should be noted that this is an accounting adjustment only and should neither be reflected nor anticipated in the valuation of the investor's (lessor's) interest.

**Valuing the Lease Asset or Liability**

G33. Where a lease is identified as a finance lease, lessees are required to account for the asset and liability based on either the fair value of the leased asset or the present value of the minimum lease payments, whichever is lower, each determined as at the inception of the lease. IFRS 13 *Fair Value Measurement* does not apply to leases.

G34. In the context of IAS 17 the value of the asset is considered separately from any liability created by the lease. When accounting for a lessee's interest in a finance lease it is therefore necessary to measure the asset by assessing the value of the benefit that a market participant would accrue from the right to use the asset for the duration of the lease. When dealing with leases of property, other than *investment property*, it is important to note that this is not the same as the value of the lessee's interest created by the lease (see IVS 230 *Real Property Interests*), as the latter reflects the lease liability as well as the value of the asset.

G35. The minimum lease payments are defined in IAS 17. In summary, they are the payments over the lease term that the lessee is required to make, excluding any contingent rent, taxes and amounts paid to the lessor for services. The minimum lease payments include any residual value guaranteed by the lessee to the lessor. Since contingent rents are excluded from the calculation of the minimum lease payments and the payments should be clear from the face of the lease, valuations will not normally be required.

G36. IAS 17 provides that the present value of the minimum lease payments should be calculated using a discount rate equivalent to the "interest rate implicit in the lease" or, if this is not practicably determinable, the lessee's "incremental borrowing rate". The calculation of the interest rate implicit in the lease requires the fair value of the unencumbered leased asset at the date of the lease inception and its residual value at the end of the lease.

G37. The depreciation requirements in IAS 16 also apply to leased assets and, therefore, paras G8 to G17 may also be relevant.

**Purchase Price Allocation**

G38. Following a business combination, ie the acquisition of a controlling interest in one or more other businesses, IFRS 3 requires the acquirer to account for the transaction by recognising the acquiree's separately identifiable assets acquired and liabilities assumed at fair value. Under IFRS 3 goodwill is the difference between the acquisition price paid in the transfer of the business and the fair value of the acquiree's net identifiable assets acquired.

G39. A business's tangible assets are generally readily identifiable and can be separately valued. The identification and valuation of the separately identifiable *intangible assets* can be more challenging but the Commentary to IVS 210 *Intangible Assets*, includes relevant guidance.

G40. IFRS 3 contains exceptions to the above for the recognition and/or measurement of some identifiable assets and liabilities. Particular requirements apply to contingent liabilities, income taxes, employee benefits, indemnification assets, reacquired rights, share-based payment awards and assets held for sale.

**Impairment Testing**

G41. Impairment arises where the carrying amount of an asset exceeds the amount that can be recovered from either its continued use and/or the sale of the asset. Under IAS 36 *Impairment of Assets*, an entity is required to review certain categories of asset at the date of each statement of financial position to determine whether there is any indication that an asset may be impaired. Impairment might be indicated by a reduction in the value of the asset because of market or technological changes, obsolescence of the asset, asset underperformance in comparison to the expected return, or an intention to discontinue or restructure operations. Certain assets (goodwill and intangibles with an indefinite life or not yet available for use) would be tested for impairment on an annual basis.

G42. If impairment is considered to have arisen, the carrying amount of the asset, whether derived from either historic cost or a previous valuation, should be written down to the "recoverable amount". This is the higher of the asset's "value in use" or its "fair value less costs to sell".

**Impairment Testing – Recoverable Amount**

G43. The recoverable amount is the higher of the value in use and fair value less costs to sell. It is not always necessary to determine both these amounts; if either exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

**Impairment Testing – Value in Use**

G44. Value in use is defined in IAS 36 as the present value of the future cash flows expected to be derived from the asset or cash-generating unit. The cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

G45. Value in use is specific to the entity as it reflects the cash flows that the entity expects to obtain from continuing use of an asset over its anticipated useful life, including any proceeds from its ultimate disposal.

G46. IAS 36 provides that the following shall be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset,

(b) expectations about possible variations in the amount or timing of those future cash flows,

(c) the time value of money, represented by the current market risk free rate of interest,

(d) the price for bearing the uncertainty inherent in the asset,

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.[14]

G47. The expected cash flows have to be tested for reasonableness by ensuring that the assumptions on which the entity's projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist

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when those actual cash flows were generated make this appropriate. Cash flows are estimated for the asset in its current condition and therefore the expected cash flows should not reflect any increase due to any restructuring or reconditioning of the asset to which the entity is not currently committed.

G48. The appropriate discount rate will reflect the return that market participants would require for an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset.

G49. IAS 36 sets out detailed considerations for assessing value in use.

**Impairment Testing – Fair Value less Costs to Sell**

G50. The fair value less costs to sell of an asset or cash-generating unit is the amount obtainable from its sale in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. Except where the owning entity is compelled to sell on the *valuation date* without adequate time for exposure to the market, it is not a forced sale.

G51. The costs to sell are the costs directly attributable to the transaction, eg legal fees, marketing costs, removal costs, unrecoverable transaction taxes and any costs directly incurred in preparing the asset or cash-generating unit for sale. They exclude consequential costs, eg those involved in reorganising the business following the disposal.

## Annexe – Property, Plant and Equipment in the Public Sector

### International Public Sector Accounting Standards

A1. The International Federation of Accountants' International Public Sector Accounting Standards Board (IPSASB) develops accounting standards for public sector entities, referred to as International Public Sector Accounting Standards (IPSAS). The extracts from IPSAS 17 and IPSAS 21 in paras A6, A8 and A10 are from the *2010 IFAC Handbook of International Public Sector Accounting Pronouncements* of the IPSAS Board, published by the International Federation of Accountants (IFAC) in May 2010 and are used with permission of IFAC.

A2. IPSAS and their interpretation change over time. Accordingly, references in this document are liable to become out of date. This document should not be used as a substitute for referring to current IPSAS as published by IFAC. The current versions of IPSAS can be obtained from www.ifac.org/PublicSector.

A3. IPSAS contain similar principles to IFRS but related to the public sector environment. This includes a requirement for certain assets and liabilities to be measured at fair value. As in the case of IFRS, the IVSB considers that fair value in this context is met by applying *market value* as defined in the IVS *Framework*. Many types of property, plant and equipment held by public sector bodies are specialised for the delivery of a particular service rather than as a means of generating cash flows and are rarely, if ever, exchanged in a market transaction. This annexe identifies specific provisions within IPSAS that affect the application of fair value to such assets.

### Types of Public Sector Property Plant and Equipment Assets

A4. Property in the public sector comprises conventional cash-generating and non-cash-generating property assets as well as *specialised property* assets, including heritage and conservation assets, infrastructure assets, public buildings, public utility plants and recreational assets. As with private sector assets, public sector assets fall into operational and non-operational categories. Non-operational assets include investment and surplus assets. These categories are accounted for in different ways.

A5. Many "heritage assets" are held in the public sector. A heritage asset is an asset having some cultural, environmental or historical significance. Heritage assets may include historical buildings and monuments, archaeological sites, conservation areas and nature reserves, and works of art. Heritage assets often display the following characteristics, although these characteristics are not necessarily limited to heritage assets:

- their economic benefit in cultural, environmental, educational and historic terms is unlikely to be fully reflected in a financial value based purely on market price,
- legal and/or statutory obligations may impose prohibitions or severe restrictions on disposal by sale,
- they are often irreplaceable and their economic benefit may increase over time even if their physical condition deteriorates,
- it may be difficult to estimate their useful lives, which in some cases could be hundreds of years.

**Operational Property, Plant and Equipment**

A6. Like its IFRS counterpart, IAS 16, IPSAS 17 *Property, Plant and Equipment* permits two models for the recognition of operational assets in the statement of financial position: a cost model and a fair value model. Where the fair value model is applied, a current revaluation of the asset is required. Where an entity adopts the fair value revaluation option, the assets are included in the statement of financial position at their fair value. IPSAS 17 paras 45 to 47 stipulate the following:

> "The fair value of items of property is usually determined from market based evidence by appraisal. The fair value of items of plant and equipment is usually their market value determined by appraisal."
>
> "If no market evidence is available to determine the market value in an active and liquid market of an item of property, the fair value of the item may be established by reference to other items with similar characteristics, in similar circumstances and location."
>
> "If there is no market-based evidence of fair value because of the specialised nature of the item of plant and equipment, an entity may need to estimate fair value using … depreciated replacement cost, or the restoration cost or service unit approaches …"

A7. Although there is no IPSAS equivalent of IFRS 13 *Fair Value Measurement*, in line with the established policy of convergence between IPSAS and IFRS, fair value should be estimated in a manner that is consistent with IFRS.

**Absence of Market Evidence**

A8. For some public sector assets, it may be difficult to establish their value because of the absence of market transactions for these assets. Some public sector entities may have significant holdings of these assets. IPSAS 17 para 47, gives the following guidance:

"… the fair value of vacant government land that has been held for a long period during which time there have been few transactions may be estimated by reference to the market value of land with similar features and topography in a similar location for which market evidence is available. In the case of specialised buildings and other man-made structures, fair value may be estimated by using depreciated replacement cost, or the restoration cost or the service units approach (see IPSAS 21). In many cases, the depreciated replacement cost of an asset can be established by reference to the buying price of a similar asset with similar remaining service potential in an active and liquid market. In some cases, an asset's reproduction cost will be the best indicator of its replacement cost. For example, in the event of loss, a parliament building may be reproduced rather than replaced with alternative accommodation because of its significance to the community."

A9. Because of the lack of evidence of comparable market transactions for many public sector assets, the *market approach* often cannot be used. The above paragraph sanctions the use of alternative valuation methods to measure the fair value of an asset, all of which fall within the *cost approach* described in the IVS *Framework*. IPSAS 21, referred to below, contains some guidance on these methods.

**Impairment**

A10. IPSAS 21 *Impairment of Non-Cash-Generating Assets* contains similar provisions to IAS 36, see IVS 300. The test for a non-cash-generating asset for impairment, which will include most property, plant and equipment held for the provision of a public service, requires the carrying amount to be adjusted to the higher of its fair value less costs to sell or its value in use. IPSAS 21 para 14, provides that the value in use of a non-cash-generating asset is the present value of the asset's remaining "service potential". The standard then gives further guidance on methods for assessing the remaining service potential as follows:

(a) Depreciated Replacement Cost Approach – IPSAS 21 paras 41 to 43:

> "Under this approach, the present value of the remaining service potential of an asset is determined as the depreciated replacement cost of the asset. The replacement cost of an asset is the cost to replace the asset's gross service potential. This cost is depreciated to reflect the asset in its used condition. An asset may be replaced either through reproduction (replication) of the existing asset or through replacement of its gross service potential. The depreciated replacement cost is measured as the reproduction or replacement cost of the asset,

whichever is lower, less accumulated depreciation calculated on the basis of such cost, to reflect the already consumed or expired service potential of the asset.

The replacement cost and reproduction cost of an asset are determined on an 'optimized' basis. The rationale is that the entity would not replace or reproduce the asset with a like asset if the asset to be replaced or reproduced is an overdesigned or overcapacity asset. Overdesigned assets contain features which are unnecessary for the goods or services the asset provides. Overcapacity assets are assets that have a greater capacity than is necessary to meet the demand for goods or services the asset provides. The determination of the replacement cost or reproduction cost of an asset on an optimized basis thus reflects the service potential required of the asset.

In certain cases, standby or surplus capacity is held for safety or other reasons. This arises from the need to ensure that adequate service capacity is available in the particular circumstances of the entity. For example, the fire department needs to have fire engines on standby to deliver services in emergencies. Such surplus or standby capacity is part of the required service potential of the asset."

(b) Restoration Cost Approach – IPSAS 21 para 44:

"Restoration cost is the cost of restoring the service potential of an asset to its pre-impaired level. Under this approach, the present value of the remaining service potential of the asset is determined by subtracting the estimated restoration cost of the asset from the current cost of replacing the remaining service potential of the asset before impairment. The latter cost is usually determined as the depreciated reproduction or replacement cost of the asset whichever is lower. Paragraphs 41 and 43 include additional guidance on determining the replacement cost or reproduction cost of an asset."

(c) Service Units Approach – IPSAS 21 para 45:

"Under this approach, the present value of the remaining service potential of the asset is determined by reducing the current cost of the remaining service potential of the asset before impairment to conform with the reduced number of service units expected from the asset in its impaired state. As in the restoration cost approach, the current cost of replacing the remaining service potential of the asset before impairment is usually determined as the depreciated

reproduction or replacement cost of the asset before impairment, whichever is lower."

A11. IPSAS 17 recognises that some heritage assets have service potential other than their heritage value, eg a historic building being used for office accommodation. In these cases, they may be recognised and measured on the same basis as other items of property, plant and equipment. For other heritage assets, their service potential is limited to their heritage characteristics, eg monuments and ruins. The existence of alternative service potential can affect the valuation approach adopted.

# IVS 310 Valuations of Real Property Interests for Secured Lending

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## INTRODUCTION

Loans from banks and other financial institutions are often secured by the collateral of the borrower's *real property* interests. The lending may be by way of a mortgage or other forms of fixed or floating charge. The common factor is that the lender has the power to recover the loan by taking control of the collateral in the event of default by the borrower. Different types of property may be offered as collateral.

## STANDARD

1. The principles contained in the General Standards and in IVS 230 *Real Property Interests* apply to valuations for secured lending unless these are modified by this standard. This standard includes only any modifications, additional requirements or specific examples of how the General Standards apply.

**Scope of Work (IVS 101)**

2. To comply with the requirement to confirm the identity and status of the valuer in IVS 101 para 2(a), the scope of work shall additionally include a disclosure of any material involvement that the valuer has with either the property to be valued, the borrower or a prospective borrower. The materiality of existing or past involvement is a matter of professional judgement for the valuer but the principal criteria is whether the involvement would be likely to give rise to doubt in the mind of a reasonable person as to the ability of the valuer to provide an impartial valuation if it were discovered after the valuation had been carried out.

3. To comply with the requirement to identify the assets to be valued in IVS 101 para 2(d), the *real property* interest to be used as the collateral for securing the loans or other financing arrangements shall be clearly identified, together with the party in whom the interest is currently vested.

4. The *basis of value* to be specified in accordance with IVS 101 para 2(e) will normally be *market value*. Some lenders request valuations on the assumption of a forced sale or impose a time limit for the hypothetical disposal of the property. Because the impact on price of any constraint on the marketing period will depend upon the circumstances at the time that sale takes place, it is not realistic to speculate on the price that could be obtained without knowledge of those circumstances. A valuation may be provided on the basis of defined *special assumptions* recorded in the scope of work. In such cases, a statement should be made that the value will be valid only at the *valuation date* and may not be achievable in the event of a future default, when both market conditions and the sale circumstances may be different.

5. Valuations for secured lending are often required on the *special assumption* that there has been a change in the state or condition of the property. To comply with the requirement to state any assumption in IVS 101 para 2(i) any *special assumptions* that are necessary shall be included in the scope of work. Examples of *special assumptions* that are commonly made in secured lending valuation include:

   (a) that a proposed building had been completed at the *valuation date*,

   (b) that a proposed lease of the property had been completed at the *valuation date*,

   (c) that a specified occupancy level had been reached by the *valuation date*,

   (d) that the seller had imposed a time limit for disposal that was inadequate for proper marketing.

**Implementation (IVS 102)**

6. There are no additional requirements when undertaking valuations for secured lending.

**Reporting (IVS 103)**

7. In addition to those matters required by IVS 103 *Reporting*, a valuation report for secured lending shall include appropriate references to matters addressed in the scope of work in accordance with paras 2 to 5 above. The report shall also include comment on factors that are relevant to a lenders assessment of the performance of security over the life of the proposed loan. Examples of these factors include:

   (a) current activity and trends in the relevant market,

   (b) historic, current and anticipated future demand for the type of property and location,

   (c) any potential, and likely demand for, alternative uses that exist or can be anticipated at the *valuation date*,

   (d) the impact of any events foreseeable at the *valuation date* on the probable future value of the security during the loan period. An example would be a tenant exercising an option to break a lease,

   (e) where the *market value* is provided subject to a *special assumption*, the report shall include:

      (i) an explanation of the *special assumption,*

      (ii) a comment on any material difference between *market value* and the *market value* subject to the *special assumption*,

      (iii) a comment that such value may not be realisable at a future date unless the factual position is as described in the *special assumption*.

8. Where the proposed loan is to support a purchase of a property interest, there will normally be a sale price agreed or confirmed. Enquiries should be made to establish this price and the result of those enquiries referred to in the report. Where there is a difference between a recent or pending transaction price and the valuation, the report shall comment on the reasons for this difference.

**Effective Date**

9. This standard is effective from 1 January 2012, although earlier adoption is encouraged.

## APPLICATION GUIDANCE

### The Property Interest

G1. The existence or creation of other interests will impact on the value of the *real property* interest offered as security. It is therefore important that all interests in the subject property are identified, together with the parties in whom those interests are vested. Where detailed information on title has not been provided or is unavailable, the assumptions that have been made concerning the *real property* interest should be clearly stated. It is also good practice to recommend that these matters be verified before any loan is finalised.

G2. Caution is required where property offered as security is subject to a lease to a party related or connected with the borrower. If this lease has a more favourable income stream than would be obtainable in the market, it may be appropriate to disregard the existence of the lease in a valuation of the property as security.

### Incentives

G3. It is not uncommon for a seller of property, especially a property developer or trader, to offer incentives to buyers. Examples of such incentives include rental income guarantees, contributions to the buyer's removal or fitting out costs, or the supply of furnishings or equipment. *Market value* ignores any price inflated by special considerations or concessions. Where such exist, it is appropriate to comment on the effect that any incentives being offered have on the actual selling prices achieved as the incentives may not be available to the lender in the event that it had to rely on the security.

### Valuation Approaches

G4. All valuation approaches used for developing and supporting an indication of *market value* are based on market observations. Although the three approaches identified in the IVS *Framework* can be used to provide an indication of *market value* for secured lending, if the property is so specialised that there is insufficient evidence to use either the *market approach* or *income approach*, it is unlikely that the property would be regarded as suitable security. Therefore, the *cost approach* is seldom used in valuations for this purpose except as a check on the reasonableness of the value determined using another approach.

### Property Types

G5. Different types of property have different characteristics as security. It is important that the valuation of the relevant interest addresses these in order to properly provide the lender with adequate information on the suitability of the property as security and to help

the lender identify any risk factors associated with the property over the duration of the loan.

**Investment Property**

G6. *Investment property* is usually valued for lending purposes on an asset-by-asset basis, although some lenders may lend against the value of a defined portfolio. In such instances, the distinction needs to be made between the value of the individual *investment property*, assuming it is sold individually, and its value as part of the portfolio.

G7. Consideration should be given to the expected demand for and marketability of the property over the life of the loan and appropriate advice on current market conditions provided in the report. This advice should not involve predicting future events or values but should reflect current market expectations of the future performance of the investment based on current trends. However, if such information suggests a significant risk to future rent payments, the impact of this risk on the valuation should be considered and commented upon in the report.

G8. It is normally outside the scope of the valuation assignment to advise on the ability of a tenant to meet future rent payments and other lease obligations beyond reflecting the information available on the tenant that is in the public domain and available to all market participants.

G9. If the income from a property is critically dependent on a tenant or tenants from a single sector or industry or some other factor which could cause future income instability, the impact should be considered in the valuation process. In certain cases, an assessment of the value of the property based on an alternative use, assuming vacant possession, may be appropriate.

**Owner-Occupied Property**

G10. An owner-occupied property valued for lending purposes will normally be valued on the assumption that the property is transferred unencumbered by the owner's occupancy, ie the buyer is entitled to full legal control and possession. This does not preclude consideration of the existing owner as part of the market, but it does require that any special advantage attributable to the owner's occupancy, which may be reflected in a valuation of the business, be excluded from the valuation.

**Specialised Property**

G11. A *specialised property* may have significant value only as part of the business of which it is part. In valuations for secured lending, unless otherwise instructed, such properties are valued on the

*special assumption* that the business has ceased and therefore the underlying security will reflect the value for an alternative use. The valuation will involve consideration of the costs and risks that would be involved in achieving that use.

G12. A valuation may be required of a *specialised property* where the property is part of a going concern business. In such circumstances, the value is dependent on the continuing profitability of the business. In such circumstances, the distinction between the value of the property as part of the business and the value of the property if the business had vacated or closed should be made.

**Trade Related Property**

G13. The value of *trade related property* normally reflects its income generating potential due to the buildings or other structures only being suitable for a specific type of trade. The specialised nature of such property means that there may be a significant difference in its value as part of an operating concern and its value if there was no business in occupation. If the business had ceased, any buyer intending to trade would need time to re-establish a new business in the property and would incur start-up and other costs in equipping the property, obtaining any necessary permits and licences, etc. Where a lender is relying on the underlying value of the property interest as security, a valuation for loan security should comment on the impact on the value of the property interest of the cessation of any existing business in occupation. In some cases, the value for a potential alternative use may represent the *market value*.

**Development Property**

G14. Properties held for development or sites intended for development of buildings are valued taking into account existing and potential development entitlements and permissions. Any assumptions as to zoning issues and other material factors need to be reasonable and reflect those that would be made by market participants.

G15. The approach to the valuation of development properties will depend on the state of development of the property at the *valuation date* and may take into account the degree to which the development is pre-sold or pre-leased. Additional considerations may include, but are not limited to, the following:

(a) estimating the development period from the date of valuation, and the need to reflect any intended phasing of the development project,

(b) determining the effect of additional development requirements on costs and revenues, using present value discounting where appropriate,

(c) identifying, anticipated market trends over the period of the development,

(d) identifying the risks associated with the development,

(e) considering the impact of any special relationships between the parties involved in the development.

G16. If the completed development will consist of multiple individual units the valuation method adopted should reflect the anticipated timing of both the completion of the construction of each unit and a realistic estimate of the rate at which individual sales will take place. When reporting, a clear distinction should be made between the value of the completed development to a single buyer who would assume the cost and risk of onward sales of the individual units in return for a profit margin, and the sum of the individual anticipated prices for each individual unit.

G17. For further guidance on the value of a development property where construction has yet to commence or where construction is in progress see the Commentary to IVS 233 *Investment Property under Construction.*

**Wasting Assets**

G18. Specific considerations arise in relation to the valuation of a wasting asset for secured lending, ie one which will generally depreciate in value over time. Examples include mines or quarries. The estimated life and the rate of value erosion over that life should be identified and clearly stated in the report.

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**RICS Valuation – Professional Standards (March 2012)**

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