RICS Valuation – Professional Standards

Incorporating the International Valuation Standards

March 2012

RICS

the mark of property professionalism worldwide

Global and UK edition

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

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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. 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. 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. 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: • 'basis of value' now refers to 'assumptions', not 'principles'; • 'cost approach' is a new definition; • the definition of 'fair value' has been revised; • 'income approach' is a new definition; • 'goodwill' is a new definition; • 'investment property' is a new definition; • the definition of 'investment value' has been extended; • 'market approach' is a new definition; • the definition of 'market rent' has been revised; • the definition of 'market value' has been revised; • 'real estate' and 'real property' are two new definitions; • the definition of 'special assumption' has been revised; • 'special purchaser' has been revised to refer to 'a particular buyer'; • the definition of 'synergistic value' has been revised; and • '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. 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: • (a) a reference to 'other intended users'; • (e) a replacement of the word 'property' by 'assets or liabilities'; • (i) wording that requires the responsible valuer to be named; • (p) a requirement to confirm compliance with IVS where appropriate. 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: • (a) a reference to ‘other intended users’; • (e) a replacement of the word ‘property’ by ‘assets or liabilities’; • (i) wording that requires the responsible valuer to be named; • (p) a requirement to confirm compliance with the IVS where appropriate. 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: • (a) This item has been extended to refer to ‘other intended users’. • (c) A reference to assets held as a group or portfolio is now included. • (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. • (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. • (m) The words 'without further verification' have been added. • (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: • (a) This item has been extended to refer to 'other intended users'. • (c) A reference to assets held as a group or portfolio is included. • (f) The revision reinforces the need to identify the correct basis of value when adopting fair value. • (h) A reference to VS 1.7.4 has been added. • (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. • (p) This item has been extended to require a comment, as appropriate, that the valuation complies with the IVS. • (q) The requirements to note the valuation reasoning are revised to be similar to those in the IVS. • (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). • (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.

RICS would like to thank the Chartered Institute of Public Finance and Accountancy (CIPFA) for its help in revising UK appendix 5.

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

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The Institute of Revenues Rating and Valuation 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.

Contents

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

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Valuation standards

VS 1 Compliance and ethical requirements

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Appendices

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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. (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.

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 that 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.

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 as 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: • the request is made by the directors of a company, but the client is the company and the directors have a separate legal standing; • 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. 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*. 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. 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. 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*. 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. 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. Examples of different classes and categories include assets that are: • freehold or leasehold; • owner-occupied; • held as an investment; • *specialised property*; and • property held for specified purposes (mineral-bearing land or waste management assets). 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. 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). 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. (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. 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. For some purposes the valuer may be required to state if he or she is acting as an *internal* or *external valuer*. Where the valuer is obligated to comply with additional requirements of independence, VS 1.8 will apply. 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. 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. Further guidance on *assumptions* and *special assumptions* can be found in Appendices 4 and 5, respectively. 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. If the client wishes to restrict the scope of the *member's* investigations, VS 2.4 will apply.

(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. 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*. 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: 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. 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).

(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. 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

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 affect 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;

- 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).

(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. 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). 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). 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. 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. 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. 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).

(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. *Special assumptions* must also be clearly stated (see VS 2.2). 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). Any *departures* from the standards must be stated and explained (see VS 1.2). 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. 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). 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). In the case of a revaluation, the report should refer to any agreement that further *inspections* are unnecessary (see VS 2.5). 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. 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.

	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). 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)). 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). 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.

(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. 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. 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. 'Negative values' must be stated separately and not set off against the positive values of assets (see VS 6.8). 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). 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 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.

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 paragraphs 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.

Appendices

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. (ii) VS 2.1(h) and VS 1.7 cover this in more detail. (iii) VS 1.7 to VS 1.9 cover this in more detail. (iv) VS 1.6 and VS 2.1(q) covers 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.

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.

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 are either owned separately from the land and buildings, or are 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]*.

Guidance notes

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.

Guidance notes

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 that 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 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).

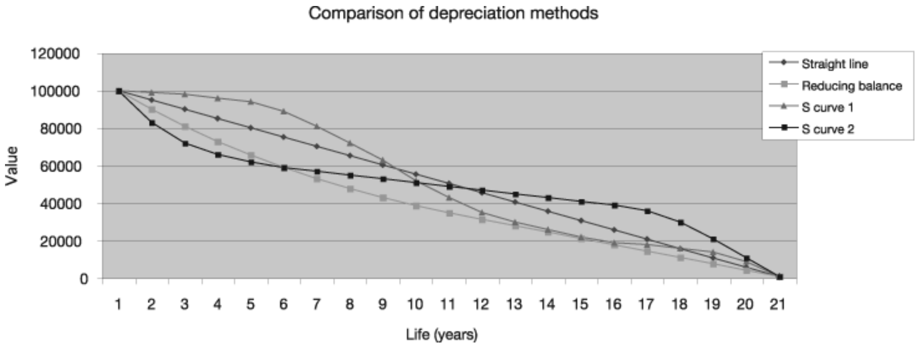
9.27 Although it is normally accepted that the S-curve realistically represents the pattern of depreciation over the life of most assets, the percentage for any given year will depend on decisions made as to the rates of depreciation at different times and when these change. In the absence of empirical 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	

Item for consideration	Ref. in GN	Comments
9 Depreciation method (a) Straight line (b) Reducing balance (c) S-curve	9.23–9.30 9.23–9.24 9.25 9.26–9.27	
10 Other considerations	10.1–10.4	
11 Final reconciliation	11.1–11.2	
12 Reporting (a) All items under VS 6.1 (b) Statement that *DRC* used (c) VS 6.5 (private sector) (d) VS 6.6 (public sector) (e) VS 6.7 (alternative values) (f) Alternative value statements	12.1	

Ensure file contains all relevant information on the decisions taken during the *DRC* process.

UK valuation standards

Introduction to the UK valuation standards

1 Purpose of the UK valuation standards

These standards are national association *valuation standards* that have mandatory status in the UK (see VS 1.3). They supplement, expand or amend the global *valuation standards* so that they meet UK statutory or regulatory requirements.

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

2 Arrangement of these standards

These standards have the same format as the global standards and are arranged in the following categories:

UK valuation standards
UK appendices
UK guidance notes.

3 Terms used in these standards

The terms used in these standards will have the same meaning as given in the Glossary to the global standards. Where terms have a specific meaning in context they will be defined in the standard, appendix or *guidance note* as required.

4 Summary of changes

Reference	Changes made
UKVS 1.1 and UKVS 1.13	Both these standards have been revised to refer to the current terminology of 'housing providers'.
UKVS 1.14	Paragraph 7 has been revised to refer to the current title of the HMRC Helpsheet.
UKVS 3.11 and UK appendix 14	This is a UK new standard and appendix dealing with the provision of valuations in connection with affordable rent.
UKVS 4.1	The first bullet point has been extended to refer to VS 4.1.

UK appendix 7	The list of terms has been revised to match the revised VS 6.1 list.
UK appendix 10	Paragraphs 1.2 and 2.3 have been revised to clarify the circumstances in which the valuer may provide a service that exceeds that set out in the specification.
UKGN 4	The introduction and paragraph 2 have been revised to reinforce the importance of establishing material features that may impact on value.

Various references to ‘basis of valuation’ have been changed to ‘*basis of value*’, and ‘date of valuation’ to ‘*valuation date*’, to be consistent with IVS terminology.

UKVS 1 Valuations for financial statements

UKVS 1.1 Basis of value

Valuations for inclusion in *financial statements* prepared in accordance with UK Generally Accepted Accounting Principles (UK GAAP) shall be on the basis of either:

- **(a) property other than *specialised property* – existing use value (EUV), as defined in UKVS 1.3, for property that is owner-occupied for the purposes of the entity's business; or *market value (MV)*, as defined in VS 3.2, for property that is either surplus to an entity's requirements or held as an investment; or**
- **(b) for *specialised property – depreciated replacement cost (DRC)*.**

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

Commentary

1. This statement will take precedence over VS 4 where the client requires a valuation that complies with UK GAAP.

2. Accounting standards are issued by the Accounting Standards Board (ASB). They are published as Financial Reporting Standards (FRS) and are gradually superseding an earlier form of standard known as Statements of Standard Accounting Practice (SSAP). SSAPs that have not been superseded by FRS are still in force. These standards are freely available at www.frc.org.uk/asb.

3. The relevant accounting standards can be found in FRS 15, *Tangible Fixed Assets*, and SSAP 19, *Accounting for investment properties*. Information on the accounting concepts and explanations for some of the terms used are provided in UK appendix 1.

4. With the aim of converging UK GAAP and *International Financial Reporting Standards* (*IFRS*), the ASB has indicated an intention to amend FRS 15. This commentary will be revised when the new FRS 15 is issued.

5. The frequency of valuations, whether providing full or interim valuations, is discussed in UK appendix 1. Both *internal* and *external valuers* may carry out full valuations, but a full valuation by an *internal valuer* is subject to review by an *external valuer*. The review must include the valuation of a sample of the entity's properties that is sufficient for the *external valuer* to express an opinion on the overall accuracy of the valuation. The *external valuer* must also be satisfied that the sample represents a genuine cross-section of the entity's portfolio. An interim valuation, which can be carried out on a restricted basis, may be undertaken by either an *external* or *internal valuer*.

6. The valuer should agree with the client the appropriate *basis of value* when confirming the *terms of engagement*. For different categories of property, different bases may be required. It should be noted that under FRS 15, *depreciated replacement cost (DRC)* is recognised as a separate *basis of value* for reporting purposes. When settling the terms the valuer should indicate that although the definition of *DRC* may differ from that in UK appendix 1, the resultant valuation is the same. Further guidance on the identification of categories and the appropriate basis is in that appendix.

7. Clients may ask the valuer to liaise with their auditors either before the report is made or subsequently. UK appendix 3 provides information about the relationship between the valuer and the auditor.

8. FRS 15 refers to *open market value* (*OMV*) rather than *market value*, as it was published in 1999 when *open market value* was still a basis supported by RICS. As stated in the Glossary, there is no material difference between these two bases, and the correct application of either will produce the same figure. However, the term '*open market value*' should not be used in reporting, although the valuer can include an explanatory note that its replacement, *market value*, produces the same figure.

Publication statement

9. VS 6.12 requires the valuer to include a draft statement in the publication containing a reference to the report. UK appendix 6 provides examples of published references where the valuation is in accordance with UK GAAP.

Statements of recommended practice

10. Statements of recommended practice (SORPs) supplement accounting standards and other legal and regulatory requirements to reflect factors prevailing, or transactions undertaken, in a specialised industry or sector. SORPs are issued by the sectoral body recognised for the purpose by the ASB.

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

12. The following SORPs contain specific valuation requirements, and further information is provided in the relevant UKVS:

- *Code of Practice on Local Authority Accounting*: issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) and covered in UKVS 1.12;
- *Accounting by registered social landlords:* issued by the National Housing Federation (NHF) and covered in UKVS 1.13; and
- *Financial Statements of Authorised Funds (Collective Investment Schemes)*: issued by the Investment Management Association and covered in UKVS 2.3.

13. The following SORPs generally provide that these *valuation standard*s shall apply, but the valuer will need to check that any specific requirements, which may provide extended related party definitions affecting on the specific requirements of independence, are reflected in the report:

- *Accounting for Further and Higher Education*: issued by Universities UK;
- *Financial Reports of Pension Schemes*: issued by the Pensions Research Accountants Group (PRAG);
- *Charity Accounts and Reports*: issued by the Charity Commission. This SORP relates only to *financial statements*. Where valuations are required for acquisitions or disposals, UK appendix 13 will apply;
- *Accounting for Insurance Business*: issued by the Association of British Insurers; and
- *Investment trusts*: issued by the Association of Investment Companies.

UKVS 1.2 Valuation date

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

Commentary

1. There is no general restriction on the *valuation date* in these standards.

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

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

4. Where a preliminary valuation is reported in advance of the valuation, it must be clearly marked as a draft and VS 6.11, Preliminary valuation advice, will apply.

UKVS 1.3 Existing use value

Valuations based on existing use value (EUV) shall adopt the definition settled by RICS. Existing use value is to be used only for valuing property that is owner-occupied by a business, or other entity, for inclusion in *financial statements*.

Definition:

> **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 acted knowledgeably, prudently and without compulsion – assuming that the buyer is granted vacant possession of all parts of the asset required by the business, and disregarding potential alternative uses and any other characteristics of the asset that would cause its *market value* to differ from that needed to replace the remaining service potential at least cost.**

Commentary

1. The definition of existing use value (EUV) is the *market value* definition with one additional *assumption* and a further requirement to disregard certain matters. The definition must be applied in accordance with the conceptual framework of *market value* in VS 3.2, together with the following supplementary commentary.

' … the buyer is granted vacant possession … '

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

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

3. If parts of the property are unused and are surplus to the operational requirements of the business, their treatment will depend on whether they can be sold or leased separately at the *valuation date*. If they can be occupied separately then they should be allocated to a separate category as surplus property and valued on the basis of *market value*. If separate occupation is not possible any surplus parts will have no more than a nominal EUV, as they would contribute nothing to the service potential of the property and would not feature in a replacement at least cost.

'… disregarding potential alternative uses …'

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

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

'… disregarding … any other characteristics of the property that would cause its *market value* to differ from that needed to replace the remaining service potential at least cost.'

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

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

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

6. The underlying accounting concepts behind EUV are given in UK appendix 1.

7. While the definition of EUV has changed from that published in previous editions of the Red Book, the underlying principles have not. The previous definition was based on the *open market value* definition, which has now been removed from these standards. EUV now uses the *market value* definition, and the additional provisions have been reworded to define more precisely the requirements of the accounting standard. An EUV provided under the old or new definition should produce exactly the same result.

8. Many market valuations are based on the existing planning use of the property, as it usually generates the highest value. Such valuations have sometimes been described as 'existing use valuations'. However, this is incorrect and they should properly be expressed as *market values*. It is emphasised that EUV is only used when valuing property that is occupied by the owners of the interest and that is being valued for the purpose of their business for inclusion in *financial statements*.

9. Further guidance on the interpretation of EUV is contained in the RICS *guidance note*, *Valuation for financial statements under UK GAAP* (2011).

UKVS 1.4 Differences between existing use value and market value

Where there is a significant difference between the existing use value and *market value* of the same property if it were surplus, the valuer must provide an opinion on both bases and explain the reasons for this in the report. Any published reference to the report must refer to the valuations on both bases, except where the difference has no material effect on the aggregate value of the entity's properties.

Commentary

1. Where the property is of a type that is commonly traded in the market, with no higher value for an alternative use and no unusual features that could restrict marketability, there would normally be little material difference between EUV and *market value*. However, there will be cases where the difference between the two bases is material (as illustrated in the commentary to UKVS 1.3). Where a difference exists, this could be material to an overall assessment of the entity's financial position, and in such cases the valuer must report both bases. In the case of a company there is an obligation (under the *Companies Act* 1985, paragraph 1(2) of Schedule 7) for the directors to disclose if the *market value* of its assets is materially different from the figure that appears in the balance sheet.

2. Where the valuation involves a portfolio of properties and the difference between EUV and *market value* on an individual property does not make a material difference to the aggregate value of the properties, the valuer simply needs to indicate whether the *market value* of a particular property would be higher or lower than the reported EUV. There is no obligation to provide alternative valuations or reasons for the difference.

UKVS 1.5 Existing use value of adapted property

Where a property that is occupied by an entity for the purpose of its business has been adapted to suit the particular requirements of the entity's operations, the valuer should provide the existing use value of the property at the *valuation date* either:

- **(a) as in its state after adaptation; or**
- **(b) as in its state before adaptation and, as a separate amount, the *depreciated replacement cost* of the adaptation works.**

Commentary

1. In the case of property that has been adapted the choice of which of the two alternative bases to use will depend on the accounting policies being used. Although it is the client's responsibility to decide which policy to adopt, it is reasonable to expect that the client will be guided by the valuer's advice. Option (a) can only be used if the valuer believes that it is possible to identify an EUV for the property in its existing state.

2. The valuer must take care to agree with the client exactly what adaptations are to be valued and, in so doing, check that any associated fixtures and fittings are not also included in the client's plant register to avoid double counting.

3. In many cases adaptation works will be specific to the requirements of the occupier, so there will be no comparable evidence of what might be paid for a similarly adapted property in the market. Such adaptations may have a detrimental effect on value, as most purchasers would regard them as an encumbrance. In these circumstances FRS 15 permits the carrying amount (the figure entered into the balance sheet) to be the aggregate of the EUV of the unadapted property, the depreciated cost of the adaptations and all directly attributable costs of acquisition.

4. Where the report includes a valuation using *DRC*, and the separate amount calculated is significant in relation to the EUV of the property in its state before adaptation, the resultant total value must be expressed as subject to adequate potential profitability (see VS 6.5) or, in the case of property in the public sector, to the prospect and viability of continued occupation (see VS 6.6).

UKVS 1.6 Events after the balance sheet date

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

Commentary

1. Under FRS 21, *Events after the Balance Sheet Date*, an entity is required to adjust its statements to reflect adjusting events that occur between the balance sheet date and the date when the *financial statements* are authorised for issue.

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

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

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

UKVS 1.7 Costs to be excluded

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

Commentary

1. In determining the figure to enter into the balance sheet (the ‘carrying amount’), FRS 15 requires the addition of notional, directly attributable acquisition costs, where material, to the EUV. Likewise, where property is surplus to the entity’s requirements and valued on the basis of *market value*, there should be a deduction for expected, directly attributable selling costs, where material. If requested to advise on these costs, the valuer should report them separately and not amalgamate them with either the EUV or *market value*. The valuation should reflect the valuer's opinion of the consideration that would appear in the hypothetical sale and purchase contract.

2. FRS 15 states that directly attributable costs can include stamp duty, import duties and non-refundable purchase taxes, as well as professional fees. The valuer is alerted to a potential problem with a property that would, or would potentially, be subject to VAT in any transaction but the entity may not be able to reclaim that VAT. The decision whether or not to treat this as a directly attributable acquisition cost should be determined by the entity, together with its auditors. Even if this is the case the valuer should state clearly in the report what *assumptions* have been made and the likely impact of VAT in any transaction.

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

UKVS 1.8 Apportionments for depreciation

Where the valuer is required to advise on an apportionment of a valuation for depreciation purposes, or on the remaining useful economic life of the asset, the apportionment should be undertaken in accordance with the principles set out in UK appendix 1.

Commentary

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

2. The accounting principles for depreciation can be found in FRS 15. It advises that depreciation is applied over the future useful economic life of the asset to the entity.

3. As depreciation is normally applied only to property occupied by the entity, the apportionment will be of EUV or *DRC* based valuations. Depreciation should not be applied to property valued on the basis of *market value*, except as provided by SSAP 19 in relation to certain investment properties.

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

UKVS 1.9 Treatment of leasehold interests

Where the interest to be valued is leasehold the valuer shall, where appropriate, clarify with the client and refer in the report to the treatment of:

- **(a) leases at rack rent or with short terms unexpired; and/or**
- **(b) inter-company leases.**

Commentary

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

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

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

(b) Inter-company leases

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

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

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

Accounting standards

6. Property leases are treated as either operating leases or finance leases under SSAP 21, *Accounting for leases and hire purchase contracts*. If 90% or more of the value of a leased asset is transferred to the lessee, the lease is usually classified as a finance lease. However, under IAS 17, *Leases*, the test is whether substantially all the risks and rewards of ownership are transferred from the lessor to the lessee. Listed companies in the UK have to adopt *IFRS*, and under the policy of converging UK GAAP and *IFRS*, SSAP 21 is likely to be changed (see UKGN 1, Land and buildings apportionments for lease classification under IFRS).

UKVS 1.10 Mineral bearing land or waste disposal sites

Where land is mineral bearing or suitable for waste disposal purposes, a modified existing use value basis may be adopted.

Commentary

1. Land that is mineral bearing or suitable for waste disposal purposes may have a different use at the *valuation date*. In this case the normal principles of EUV require some modification because the service potential reflects not only the current use, but also the potential future use.

2. Mineral extraction and landfill consume land over a period of time, so the concept of existing use includes the interim surface use of the land and its eventual consumption for mineral working or landfill. While landfill as a means of waste disposal is generally into worked-out mineral sites or other excavations, in some instances it is into landraising sites where there has been no previous excavation. Here future tipping land may be available for other uses temporarily, and can be let to produce income until such time as it is required.

3. Even though no *assumption* should be made that a planning permission or waste management licence would be granted (unless granted as part of the earlier consent to extract or fill), the valuation should still include any element of hope value, as reflected in the market.

4. The normal concept of existing use is also modified to include the after-use value, though this may involve a change of use. Where the value of the after-use is a significant proportion of the valuation, the valuer must identify it separately. In any assessment of after-use, proper consideration must be given to restoration liabilities. This includes site monitoring after waste disposal, which may be imposed on the operator as a condition of land tenure under planning law or in site licensing.

5. Where the report includes mineral-bearing or waste-disposal land valued on the basis of this *valuation standard*, this must be clearly stated, together with a reference to any *assumptions* that have been made. Further details can be found in the RICS *guidance note*, *Mineral-bearing land and waste management sites* (2011).

UKVS 1.11 Plant and equipment

The valuation of plant and equipment for inclusion in *financial statements* shall be on the basis of the value of plant and equipment to the business (VPEB).

Definition:

> **An opinion of the price at which an interest in the plant and equipment utilised in a business would have been transferred at the *valuation date*, assuming that:**
>
> **(a) the plant and equipment will continue in its present use in the business;**
>
> **(b) there is adequate potential profitability of the business, or continuing viability of the undertaking, both having due regard to the value of the total assets employed and the nature of the operation; and**
>
> **(c) the transfer is part of an arm's length sale of the business wherein both parties had acted knowledgeably, prudently and without compulsion.**

Commentary

1. This basis is used to establish the plant and equipment's value as part of an undertaking that is expected to continue in operation for the foreseeable future. In order to calculate the VPEB the valuer must consider the value of the assets as a total integrated package, rather than the sum of the individual values. Therefore, any incompatibility of particular plant assets, imbalances between the capacity of different production sections, poor plant layout and similar factors which may affect the overall efficiency of the manufacturing facility should be recognised and taken into account.

2. VPEB is normally the net current replacement cost. This is established by depreciating the gross current replacement cost to reflect the value attributable to the remaining portion of the total useful economic working lives of the assets.

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

4. The depreciation applied to the gross current replacement cost should take due account of the age, condition, economic and functional obsolescence, and environmental and other relevant factors, including any residual value at the end of the asset's useful economic working life.

5. Where suitable market evidence is available to the valuer, the net current replacement cost should always be compared with the cost of acquiring a similar asset in the open market, taking due account of the costs of transport and installation.

UKVS 1.12 Local authority asset valuations

Valuation of local authority assets for accounting purposes shall be in accordance with the *IFRS*-based *Code of Practice on Local Authority Accounting* (the 'Code') published by the Chartered Institute of Public Finance and Accountancy (CIPFA).

Commentary

1. This statement applies to the valuation of local authority assets to be provided from 1 April 2011.

2. The Code sets out the core valuation requirements and will be developed and updated annually.

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

4. The Code is based on *IFRS* with specific adaptation and interpretation for the public sector.

5. UK appendix 5 contains guidance on the specific valuation requirements of the Code.

6. Local authorities are the following:

- **England:** a county council, a district council, a London borough council, the Common Council of the City of London in its capacity as a local authority, a parish or town council, the Council of the Isles of Scilly;
- **Wales:** a county council or a county borough council;

- **Scotland:** the council;
- **Northern Ireland:** a county council, a district council and the police authority for Northern Ireland; and
- **Police and fire authorities.**

UKVS 1.13 Valuations for registered social housing providers

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

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

(b) *market value* (for housing stock that is surplus).

Definition:

Existing use value for social housing (EUV-SH) is the estimated amount for which a property should exchange on the *valuation date* between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion – subject to the following *special assumptions* that the property will continue to be let by a body pursuant to delivery of a service for the existing use:

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

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

(c) any subsequent sale would be subject to all of the above *special assumptions*.

Commentary

1. A registered social housing provider is registered by the Homes and Communities Agency (HCA) Tai Cymru or Communities Scotland under the *Housing Associations Act* 1985, the *Housing Act* 1988 or, in Northern Ireland, the *Department of the Environment under the Housing (Northern Ireland) Order* 1992.

2. *Financial statements* for registered social housing providers are prepared broadly in accord with UK GAAP (see UKVS 1.1), but are subject to the provisions of a SORP published by the National Housing Federation and its equivalents in Scotland, Wales and Northern Ireland. The SORP interprets the requirements of the ASB having regard to the nature of social housing providers' obligations.

3. Properties owned by a registered social housing provider may be shown in the accounts at historic cost, net of housing association grant (HAG), or at valuation. Where the properties are shown at valuation, the figure should be the lower of replacement cost less HAG, or the recoverable amount less any HAG recovery. The terms ‘replacement cost’ and ‘recoverable amount’ are defined in the value to the business model discussed in UK appendix 1.

4. In this context the valuer should determine replacement cost by applying the basis of EUV-SH. This basis is similar to *market value*, but with additional *assumptions* reflecting the continued use of the property for social housing. Although it shares some of the characteristics of EUV, it should not be confused with this basis. The essential similarity is that both are aimed at establishing the service potential of the properties, but in the case of EUV-SH, it is specifically for the delivery of the registered social housing provider’s objectives. Therefore any value that may attach to the sale of the properties with vacant possession for use other than social housing must be ignored.

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

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

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

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

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

10. The registered social housing provider’s portfolio may include properties not used for housing purposes, for example, lock-up shops. These properties should be valued to *market value*.

11. The SORP requires that where the value of properties is included in the balance sheet, a full valuation should be undertaken at least once every five years, or through a rolling programme which produces valuations of each property within that period. In the interim, annual reviews should also be undertaken.

UKVS 1.14 Trading stock

Land and/or buildings and other assets held as *trading stock* and works in progress shall be valued in accordance with Statement of Standard Accounting Practice 9 (SSAP 9), *Stocks and long-term contracts*.

Commentary

1. Land and/or buildings and other assets held as *trading stock* and works in progress are not fixed assets and therefore require special rules where their value is to be included in the accounts. They are normally stated in the accounts at cost or, if lower, net realisable value.

2. Net realisable value is defined in SSAP 9 as:

> the actual or estimated selling price (net of trade but before settlement discounts) less:
>
> i. all further costs to completion; and
>
> ii. all costs to be incurred in marketing, selling and distributing.
>
> © ASB, SSAP 9

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

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

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

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

7. In the case of farming stock valuations, the valuer is referred to BIM55410 – Farming: stock valuation: BEN 19 (now help sheet IR 232 issued by HMRC).

8. Further information on the principles of the valuation of land and buildings in the course of development can be found in UK appendix 2.

UKVS 1.15 Central government asset valuations

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

Commentary

1. The *Government Financial Reporting Manual* (FReM) sets out detailed requirements that entities must follow when dealing with accounting for tangible fixed assets.

1.1.1 The Government Financial Reporting Manual (FReM) is the technical accounting guide to the preparation of financial statements. It complements guidance on the handling of public funds published separately by the relevant authorities in England and Wales, Scotland and Northern Ireland[1]. The Manual is prepared following consultation with the Financial Reporting Advisory Board (FRABO) and is issued by the relevant authorities.

1.1.2 The Government FReM applies directly to:

- all entities ('reporting entities'), and to funds, flows of income and expenditure and any other accounts (referred to collectively as 'reportable activities') that are prepared on an accruals basis and consolidated within Whole of Government Accounts (with the exception of the accounts of any reportable activities that are not covered by an Accounts Direction);

but not to

- Local Government, those Public Corporations that are not Trading Funds, and NHS Trusts and NHS Foundation Trusts. (The NHS Manuals, the NHSFT FReM and the IFRS based Code of Practice on Local Authority Accounting are compliant with this Manual other than for specifically agreed divergences.)

1.1.3 In addition, the Welsh Assembly Government and the Department of Health, Social Services and Public Safety in Northern Ireland will apply the principles outlined in this Manual in the accounting guidance that they issue in respect of Local Health Boards in Wales, and Health and Social Services Trusts in Northern Ireland.

1.1.4 The Manual is kept under constant review. It is updated to reflect developments in International Financial Reporting Standards (IFRS)[2], and, where appropriate, comments received from users. The authoritative version of the Manual for any given financial year will be available by the start of the financial year to which it relates. In the event that late changes are required (for example, because of a new IFRS or Interpretation) amendments to the Manual will be issued by the relevant authorities after following due process[3]. The Manual is available on a dedicated website: www.financial-reporting.gov.uk.

[1] The relevant authorities are HM Treasury, the Welsh Assembly Government, Scottish Government Finance and the Department of Finance and Personnel, Northern Ireland.

[2] The use of IFRS in general text in this Manual should be taken to include International Accounting Standards (IAS) and Interpretations of IAS and IFRS issued by the Standards Interpretations Committee (SIC) or the International Financial Reporting Interpretations Committee (IFRIC).

[3] Due process includes consideration of proposed policies by the relevant authorities, followed by consultation with the preparers of financial statements covered by the requirements of this Manual and then consideration by the Financial Reporting Advisory Board.

2. The FReM also provides guidance under the following headings:

- When *DRC* is used;
- The site value of a *specialised property*;
- Calculating the cost of the buildings and site improvements of a *specialised property*;
- Assessing depreciation;
- Guidance on the valuation policy outlined in the FReM;
- Valuation of property assets;
- Valuation of non-property assets (other than infrastructure assets); and
- Enhancements.

This FReM is available at www.hm-treasury.gov.uk/frem_index.htm, and the guidance at www.hm-treasury.gov.uk/d/guidance_on_asset_valuation.pdf. The valuer should check the version applicable to the relevant financial year before preparing valuations.

UKVS 2 Valuations for financial statements – specific applications

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

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

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

Commentary

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

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

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

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

4. Valuers requiring further information about the regulatory requirements may access the full text of the rules through the FSA website (www.fsa.gov.uk).

5. Valuers may be requested to provide valuations for inclusion in an application for admission to the alternative investment market (AIM). On initial application, the company is only required to reveal the value of property as shown in its latest accounts. The values do not have to be current unless they are shown as such in the accounts. Where the valuer is requested to provide current valuations, these must be given in accordance with the particular accounting standards that the company has adopted. For that purpose, UKVS 1.1 will apply. However, where the company has been listed on the AIM for at least 18 months, the publications must comply with the FSA rules and this *valuation standard*.

UKVS 2.2 Takeovers and mergers

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

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

Commentary

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

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

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

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

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

UKVS 2.3 Collective investment schemes

Valuations for collective investment schemes shall be in accordance with the requirements of the Financial Services Authority (FSA) Collective Investment Schemes Sourcebook (COLL).

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

Commentary

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

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

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

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

UKVS 2.4 Unregulated property unit trusts

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

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

Commentary

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

2. There is no regulatory requirement for an independent valuation, but most trust deeds require an independent valuer. If the trustee and/or the manager requests an independent valuer, the valuer must check the criteria and confirm that he or she meets them (see VS 1.7).

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

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

UKVS 2.5 Adequacy of financial resources of insurance companies

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

Commentary

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

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

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

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

(c) SORPs, issued by industry or sectoral bodies recognised for this purpose by the ASB; or

(d) IAS;

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

3. Valuations for this purpose will therefore be in accordance with the relevant IVS (see VS 4) or UKVS 1.1, and must include a statement that they comply with the provisions of the sourcebook.

4. The INSPRU sourcebook is freely available from the FSA website (www.fsahandbook.info).

UKVS 2.6 Adequacy of financial resources for financial institutions

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

Commentary

1. European directives require financial institutions to make assessments of the adequacy of their financial resources. In the UK the FSA Prudential sourcebook for banks, building societies and investment firms (BIPRU) sets out detailed rules for which such assessments shall be made.

2. BIPRU 3.4 states:

> 3.4.66 (1) The requirement about monitoring of property values … are as follows:
>
> (a) the value of the property must be monitored on a frequent basis and at a minimum once every three years for residential real estate;
>
> (b) more frequent monitoring must be carried out where the market is subject to significant changes in conditions;
>
> (c) statistical methods may be used to monitor the value of the property and to identify property that needs revaluation;
>
> (d) the property valuation must be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices; and
>
> (e) for loans exceeding €3 million or 5% of the capital resources of the firm, the property valuation must be reviewed by an independent valuer at least every three years.
>
> (2) For the purposes of (1), 'independent valuer' means a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.
>
> 3.4.77 The property must be valued by an independent valuer at or less than the market value. In those EEA States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or less than the mortgage lending value.
>
> © FSA Handbook 2008, BIPRU 3.4.66 and 3.4.77

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

3. The definition of *market value* is the same as adopted in these standards (see VS 3.2).

4. With regard to mortgage lending value, which is not normally used in the UK, reference should be made to Appendix 8.

5. The full BIPRU is freely available from the FSA website (www.fsahandbook.info).

UKVS 3 Valuation of residential property

UKVS 3.1 Residential property mortgage valuations

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

Commentary

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

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

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

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

3. In Scotland the accepted procedures for buying residential property differ from those in England, Wales and Northern Ireland. Due to time restrictions it may be difficult to issue *terms of engagement* within the requirements of VS 1.4. Therefore, RICS Scotland has issued advice (reproduced in UK appendix 12) that aims to reflect best endeavours on behalf of the *member* or *firm*.

Loan classification

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

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

UKVS 3.2 Repossession proceedings

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

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

Commentary

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

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

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

4. The conceptual framework for *market value* in VS 3.2 applies, but the second *special assumption* does slightly modify ‘and without compulsion’. While a mortgagee is not compelled to sell, there is a requirement to capitalise a non-performing asset. There is therefore less flexibility than a typical owner-occupier would have. In certain market conditions this could affect the price that could be achieved.

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

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

UKVS 3.3 Projected market value of residential property

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

Definition:

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

Commentary

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

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

3. The definition of PMV is based on *market value*, save for the stipulation that the valuer's estimate should reflect what the amount is forecast to be at a future, specified date. The IVS Framework, paragraphs 30–35, should therefore apply, with the exception that the phrase 'on the *valuation date*' is modified as follows:

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

The *valuation date* is the date on which the estimate is given, but represents the valuer's opinion of anticipated market changes during the period up to the specified date. It reflect facts, market sentiment and public forecasts existing at the *valuation date*. The PMV is therefore time-specific as at a given date and, because markets and market conditions may change, may be incorrect or inappropriate at another time. The definition also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might otherwise occur.

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

5. The purpose of PMV is simply to illustrate the valuer's opinion of whether the market is likely to fall, rise or remain static in the period that it is anticipated will be necessary to complete the sale. Values can change rapidly due to unpredictable events, thus an earlier provision of a PMV is not a substitute for a current *market value*.

UKVS 3.4 Valuations for home finance products

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

Commentary

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

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

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

2. The regulations apply to 'regulated mortgage contracts' (see UKVS 3.1.4 and UKVS 3.1.5). The full regulations may be obtained from the FSA website (www.fsahandbook.info).

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

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

Lifetime mortgages

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

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

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

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

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

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

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

Home reversion

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

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

11. In the absence of any specific valuation requirements, valuations for home reversion products should be provided in accordance with Appendix 5, Valuations for commercial secured lending. However, they should be treated in the same way as under UKVS 3.1 in most respects, except as mentioned in paragraphs 12 and 13.

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

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

Sale and rent back

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

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

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

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

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

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

(d) A valuer may be considered independent if:

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

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

Valuations for prospective lenders to sale and rent back companies

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

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

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

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

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

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

Home purchase plan

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

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

UKVS 3.5 RICS HomeBuyer Service

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

Commentary

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

2. The HBS comprises:

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

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

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

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

UKVS 3.6 The Home Report in Scotland

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

Commentary

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

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

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

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

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

Mandatory documentation

4. Mandatory documentation of the Home Report includes:

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

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

Optional documentation

5. Optional documentation providing guidance for the Home Report includes:

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

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

6. Paper versions of all the documents are available from RICS Scotland, and digital versions can be found on the RICS Scotland website (www.rics.org/singlesurvey).

UKVS 3.7 Shared ownership

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

Commentary

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

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

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

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

UKVS 3.8 Shared equity schemes

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

Commentary

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

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

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

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

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

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

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

UKVS 3.9 Secured lending valuations for registered social housing providers

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

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

Commentary

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

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

UKVS 3.10 Trustee mortgage valuations

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

Commentary

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

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

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

UKVS 3.11 Affordable rent and market rent

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

Commentary

1. This standard applies only in England.

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

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

4. Gross market rent has the same meaning as *market rent*, as defined in VS 3.3. The valuer will provide a *market rent* as specified in UK appendix 14.

5. Valuations for this purpose do not fall within any of the exceptions specified in VS 1.1.5, and therefore VS 2 to VS 6 are of mandatory application, subject to the additional requirements set out in UK appendix 14.

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

UKVS 4 Regulated purpose valuations

UKVS 4.1 Regulated purpose valuations

Regulated purpose valuations are:

- **valuations for *financial statements* under VS 4.1 and UKVS 1.1;**
- **valuation reports for inclusion in shareholder prospectuses and circulars to be issued by UK companies under UKVS 2.1;**
- **valuations in connection with takeovers and mergers under UKVS 2.2;**
- **valuations for collective investment schemes under UKVS 2.3; and**
- **valuations for unregulated property unit trusts under UKVS 2.4.**

Commentary

1. Valuations provided for these purposes fall under VS 1.9. UKVS 4.2 and UKVS 4.3 provide more stringent requirements that must be complied with where this standard applies.

UKVS 4.2 Exclusion of certain properties

Where a regulated purpose valuation includes:

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

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

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

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

Commentary

1. There are many circumstances where conflicts of interest may arise (see VS 1.7). This standard deals specifically with the conflict that may arise where the valuer or *firm* could be involved in the introduction and acquisition of property by the client and in the provision of a regulated purpose valuation of the same property.

2. This standard requires that where the specified circumstances occur, the

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valuation should be provided by another *firm*. This will remove any perception that there could be pressure applied to justify earlier advice provided by the original valuer or the *firm*.

UKVS 4.3 Disclosures

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

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

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

Commentary

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

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

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

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

5. Where a reference to a report is to be published, the statement for inclusion in the publication (see VS 6.12) should refer to all the information given in complying with this standard. A note of the enquiries made and the source of the information used in complying with this standard must be retained in the file.

UK appendices

UK appendix 1
Accounting concepts and terms used in FRS 15 and SSAP 19

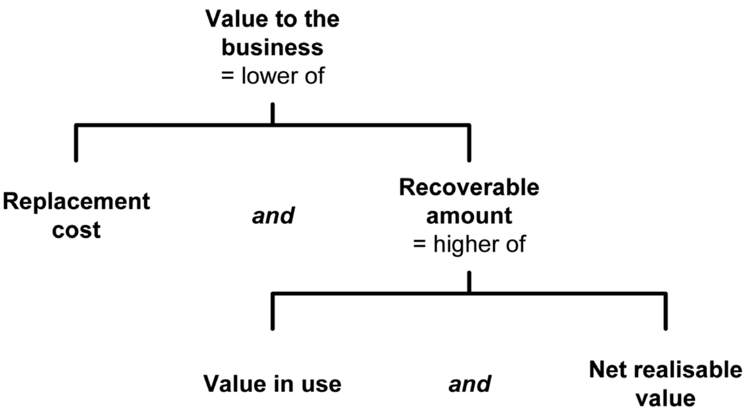
1 Introduction

1.1 This appendix provides information on the accounting concepts and some of the terms used in FRS 15, *Tangible Fixed Assets*, and SSAP 19, *Accounting for Investment Properties*.

2 The required accounting concept

2.1 The Accounting Standards Board's (ASB) FRS 15 requires entities that revalue their tangible fixed assets to carry those assets in *financial statements* at current value. Current value is determined using the 'value to the business model' set out in the FRS in appendix IV, paragraph 19. This can be portrayed diagrammatically, as shown in Figure 1.

Figure 1: Value to business model



The terms used in Figure 1 are the following:

- ‘Replacement cost’ is the expense of purchasing, at the least cost, the remaining service potential of the asset at the balance sheet date. It is an entry value.
- ‘Value in use’ is the present value of the future cash flows obtainable as a result of an asset’s continued use, including those resulting from its ultimate disposal.
- ‘Net realisable value’ is the amount for which an asset could be disposed, less any direct selling costs. It is an exit value.

2.2 Valuers should apply the concept of replacement cost to land and buildings on the following bases:

- *market value* for non-specialised properties, but existing use value (EUV) for properties that are owner-occupied for the purposes of the business; or
- *depreciated replacement cost (DRC)* for specialised properties, subject to adequate potential profitability.

2.3 The value to the business model (Figure 1) prescribes that the value of a tangible fixed asset in the accounts must be set at a level that is sufficient to reflect the cost in the market of replacing its service potential. This is also referred to as the ‘deprival value’, which is the price of the asset that, if the organisation were deprived of a particular asset, the entity or any other potential owner-occupier would pay in the market to replace that asset for the same use to enable operations to continue.

2.4 In considering the concept of deprival value in relation to EUV, the actual circumstances of the owner-occupier should not be taken into account as this would be an assessment of *worth*. There is also a risk that the actual owner-occupier could be vested with the characteristics of a *special purchaser*, whose bid therefore has to be ignored under the definition of EUV. To avoid reflecting any additional bid that may be made by the actual owner-occupier because of its particular circumstances, the valuer may find it helpful to consider a bid that would be made by a hypothetical purchaser to occupy the property for the same use and in a similar manner to the actual occupier.

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

2.6 While the value to business model (Figure 1) assists valuers in understanding the context in which valuations for *financial statements* are required, it should be noted that the use of the word ‘value’ in the expression ‘value in use’ does not mean that a valuer is necessarily competent to determine this figure. The term should not be regarded as an alternative valuation basis for fixed assets and should not be used by valuers when preparing valuations. The valuer’s role will normally be confined to providing advice on the replacement cost and/or the net realisable value.

2.7 Notwithstanding this caution, *members* with a particular knowledge of, or skill in, an asset class or industry may be competent to assist in the calculation of value in use. Requirements and guidance on the measurement of value in use can be found in FRS 11, *Impairment of Fixed Assets and Goodwill*.

3 Frequency of valuations

3.1 FRS 15 does not require annual revaluations, although the objective of a revaluation policy is to reflect current values as at the balance sheet date. Full guidance can be found in paragraphs 44–46 and 52 of the FRS, but in summary:

- where properties are revalued, the requirements of the FRS will be met by a full valuation at intervals of no more than five years and an interim valuation in year three;
- if there has been a material change in value, further interim valuations should be undertaken in years one, two and four; and
- for portfolios of properties, full valuations on a rolling basis may be carried out so that all properties are covered over a five-year cycle, subject to interim valuations on the remainder of the portfolio where it is likely there has been a material change in value. For this approach to be acceptable, the properties must be broadly similar in character, and it must be possible to subdivide the portfolio into groups of a broadly similar spread.

3.2 An interim valuation may be carried out on a restricted basis, although the FRS makes clear that an *inspection* of the property or the locality should still be undertaken 'to the extent that this is regarded professionally necessary'.

3.3 SSAP 19 states that property companies holding a substantial proportion of investment properties must have an external valuation at least every five years.

4 Small companies

4.1 The Financial Reporting Standard for Smaller Entities (FRSSE) sets out simplified financial reporting standards that may be adopted by small companies or groups as defined in the *Companies Act* 2006, or by other entities that would also qualify if they were incorporated, with the exception of building societies. The current version of the FRSSE can be found at www.frc.org.uk/asb.

4.2 Where an entity adopts an accounting policy of revaluation in respect of a tangible fixed asset, its carrying amount is to be its *market value* (or the best estimate thereof) as at the balance sheet date.

4.3 Where the directors believe that *market value* is not an appropriate basis, current value (that is, the lower of replacement cost and recoverable amount) may be used instead. Where current value is adopted, the *basis of value* is to be the same as set out in UKVS 1.1, Valuations for financial statements.

4.4 Valuations should be carried out at least every five years.

UK appendix 2 Property categorisation for company accounts

1 Introduction

1.1 This appendix provides guidance on the identification of categories and *bases of value* of property referred to in UKVS 1.

1.2 FRS 15 provides that where a tangible fixed asset is revalued, all other assets of the same class should also be revalued. The three classes of assets referred to in company legislation are:

- land and buildings;
- plant and machinery; and
- fixtures, fittings, tools and equipment.

However, the standard provides that entities may, within reason, adopt narrower classes for valuation purposes.

1.3 Even though FRS 15 requires only three classes of assets, *members* should agree and identify the types of property that should be valued in compliance with VS 2.1(e). They should either report those values separately, or provide a breakdown where an aggregated figure is reported.

2 Categories of property

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

- owner-occupied;
- held as an investment;
- *specialised property*;
- *trading stock*;
- fully equipped as an operational entity;
- held for non-specialised or specialised development;
- land and buildings in the course of development;
- minerals;
- surplus to requirements;
- joint development contracts and joint ventures; and
- options and other contractual rights that may be saleable and of value.

3 Basis of value

Owner-occupied

3.1 Owner-occupied property will be valued to EUV (UKVS 1.3).

3.2 This property would usually be valued on the basis of vacant possession. In order to comply with the *Companies Act 1*985, Schedule 4, paragraph 44, it may be necessary to divide the amounts within the valuation among freehold, long leasehold (over 50 years) and short leasehold properties.

Property held as an investment

3.3 Property that is held as an investment will be valued to *market value*.

3.4 This is property held to earn a present or future rental income and/or for the preservation or gain of capital value.

3.5 In some cases *investment properties* may include those held for possible future occupation by the undertaking (sometimes called 'reserve' properties), or for future development, either for the purposes of the undertaking or to create an *investment property*.

Specialised property

3.6 *Specialised property* (as defined in the Glossary) is valued using the *DRC* approach referred to in FRS 15 (see GN 6, Depreciated replacement cost method of valuation for financial reporting).

3.7 In deciding whether or not a property is specialised the valuer must be satisfied that it is impossible to provide an EUV. Property that might otherwise be regarded as specialised because of its construction, arrangement, size or location, and that is normally only sold as part of a sale of the business in occupation, may be properly valued by reference to its trading potential, or by a logical extrapolation of any available market evidence.

Trading stock

3.8 *Trading stock* will be valued at cost or net realisable value.

3.9 This is not a fixed asset and is dealt with in different ways in *financial statements* according to whether or not it is classified as long-term contract work.

3.10 Where valuations for this purpose are required, *trading stock* is governed by SSAP 9 (see UKVS 1.14, Trading stock) and is not included in the valuation prepared under FRS 15.

Property that is fully equipped as an operational entity

3.11 Property that is fully equipped as an operational entity will be valued to EUV if owner-occupied, or *market value* if surplus or held as an investment (see GN 2, Valuation of individual trade related properties).

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

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

Property held for non-specialised development

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

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

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

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

the valuer will need to agree with the client whether the property should be correctly classified as land and buildings in course of development. In this case, paragraph 3.12 will apply.

Property held for specialised development

3.17 Property that is held for specialised development will be valued to *market value*.

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

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

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

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

Land and buildings in the course of development

3.21 Where land and buildings in the course of development are to be revalued, they are to be included in the *financial statement* at their current value.

3.22 In estimating the EUV for social housing (EUV-SH) as defined in UKVS 1.13, the valuer will need to reflect the costs, including any appropriate allowances for risk and profit, that are required to complete the project at the *valuation date*. Unless advised that the development is to be terminated or curtailed, the valuer may assume that all contracts in place at the *valuation date* will remain in place and can be transferred to a hypothetical buyer.

Minerals

3.23 Minerals will be valued to *market value* or EUV, depending on the circumstances.

3.24 Unless the minerals have been severed from the surface, the valuation may include elements of value of the surface and minerals. These elements may include the value of the land required for extraction in the future, which can be let to produce income in the meantime.

3.25 Additional *assumptions* must be made for the possibility that surface land scheduled for mineral extraction may have other uses at the *valuation date*, and may have a future use once the mineral workings have ceased.

Property that is surplus to requirements

3.26 Property that is surplus to requirements will be valued to *market value*.

3.27 This is property that the directors of the undertaking declare to be no longer required for occupation for the purposes of the existing use within the foreseeable future.

Joint developments contacts and joint ventures

3.28 Joint development contracts and joint ventures will be valued to *market value*.

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

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

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

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

3.32 The valuation of a joint development contract will therefore involve an assessment of the value of the right to receive a financial benefit at a future date, contingent upon performance. The developer, as the recipient of potential future benefit under the contract, must fulfil the obligation to perform all of the terms of the contract. The valuer should consider and interpret all relevant factors, including political, financial, fiscal, legislative, social, economic, market trends and so on, in assessing the developer's probable reward.

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

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

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

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

UK appendix 3 Relationship with auditors

1 Introduction

1.1 This appendix provides guidance to valuers on their relationship with auditors when valuations are to be included or disclosed in published *financial statements*. It also provides an indication of the information that auditors are likely to require.

2 Auditors' role

2.1 Auditors have a statutory obligation to express an opinion on whether or not the accounts:

- give a true and fair view, and have been properly prepared in accordance with the *Companies Act* 1985 (in particular, in accordance with its disclosure requirements); and
- have been prepared in accordance with applicable accounting standards.

2.2 The Auditing Practices Board's Statement of Auditing Standards 520 (SAS 520), *Using the Work of an Expert*, states that:

> – when using the work performed by an expert, auditors should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit;
>
> – when planning to use the work of an expert the auditors should assess the objectivity and professional qualifications, experience and resources of the expert;
>
> – the auditors should obtain sufficient appropriate audit evidence that the expert's scope of work is adequate for the purposes of their audit; and
>
> – the auditors should assess the appropriateness of the expert's work as audit evidence regarding the financial statement assertions being considered.
>
>

This involves an assessment of whether the substance of the expert's findings is properly reflected in the *financial statements*, or supports his or her assertions. It also takes account of:

- source data used;
- *assumptions* and methods used;

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- when the expert carried out the work;
- reasons for any changes in *assumptions* and methods compared with those used in the prior periods; and
- results of the expert's work in light of the auditors' overall knowledge of the business and the results of other audit procedures.

2.3 When assessing whether the expert has used appropriate source data the auditors may consider:

- making enquiries regarding any procedures undertaken by the expert to establish whether the source data are sufficient, relevant and reliable; and
- reviewing or testing the data used by the expert.

2.4 The appropriateness and reasonableness of the *assumptions* and methods used, as well as their application, are the responsibility of the expert. The auditors do not have the same expertise and therefore cannot necessarily challenge the expert's *assumptions* and methods. However, they will seek to obtain an understanding of those used and consider whether they are reasonable, based on their knowledge of the business and the results of other audit procedures. They will also need to decide if they are compatible with the methods used for the preparation of the *financial statements*.

2.5 If the results of the expert's work are not consistent with other audit evidence, the auditors will attempt to resolve the inconsistency through discussions with the entity and the expert. Additional procedures, including the possibility of engaging another expert, may also assist in resolving the inconsistency.

3 Directors' responsibility

3.1 The inclusion of information relating to the valuation of assets in the accounts of a company is the directors' responsibility, under the *Companies Act* 1985, Schedule 4, paragraph 43, which states:

> Where any fixed assets of the company (other than listed investments) are included under any item shown in the company's balance sheet at an amount determined on any basis mentioned in paragraph 31, the following information shall be given:
>
> – the years (so far as they are known to the directors) in which the assets were severally valued and the several values, and;
>
> – in the case of assets that have been valued during the financial year, the names of the persons who valued them or particulars of their qualifications for doing so and (whichever is stated) the bases of valuation used by them.
>
> © *Companies Act* 1985, Schedule 4, paragraph 43

3.2 Paragraph 31 of Schedule 4 to the *Companies Act* 1985 is headed 'Alternative Accounting Rules'. This is the provision in the Act that allows the use of valuations in accounts instead of historical costs. These can be in respect of land and buildings, plant and equipment or, in some cases, fixtures and fittings, furniture or stock in trade.

3.3 There are provisions that mirror that of the *Companies Act* 1985 in the *Companies (Northern Ireland) Order* 1986.

4 The auditors' requests and the valuer's response

4.1 The valuer should provide the auditors with a copy of the agreed *terms of engagement* with the client and any subsequently agreed variations of those terms.

4.2 The auditors may ask the valuer to produce information and explanations relating to the purposes of the audit. Legal advice obtained by RICS indicates that there is no legal relationship between the auditors and an *external valuer*. An *external valuer* can therefore refuse to produce the file, and even refuse to answer an auditor's questions. This does not apply to an *internal valuer*, who is an officer of the company within the meaning of the *Companies Act* 1985 and 2006. However, if an *external valuer* refuses to cooperate this could constitute a limitation on the scope of the auditors' work. It may therefore lead the auditors to qualify the reports on the accounts and make some comment that it was not possible to obtain all the information and explanations necessary to the valuation.

4.3 The valuer should therefore be prepared, and have the directors' permission, to cooperate reasonably and responsibly with any auditors. Indeed, prior to issue of the report, the valuer should bring to the auditors' attention and discuss as appropriate matters relating to the valuation which may have an impact upon the audit and the auditors' responsibilities. Additionally, there will be occasions when the valuer will welcome the opportunity to verify information and *assumptions* relevant to valuations. In some cases a discussion between the auditors and the valuer before the latter starts to fulfil the client's instructions can be helpful to both parties, and will promote smooth completion of the audit.

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

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

1 Introduction

1.1 This appendix provides information on the accounting concepts and standards governing the consideration of depreciation, and associated apportionments, for the purposes of *financial statements*.

1.2 The relevant accounting standards can be found in FRS 15, *Tangible Fixed Assets*. It applies to all tangible fixed assets, with the exception of *investment properties*, as defined in SSAP 19, *Accounting for Investment Properties*. Both FRS 15 and SSAP 19 deal with depreciation of assets carried in an entity's accounts either at cost or valuation. This appendix refers expressly to land and buildings, but the information on depreciation applies equally to plant and equipment.

1.3 Depreciation, in accordance with accounting conventions, should not be confused with the deductions made in the course of valuation, for instance, in a *depreciated replacement cost* valuation. The valuer provides the amount for the asset that is included in the balance sheet. The accountant then calculates the provision for depreciation from the asset valuation, or an apportionment if required, without regard to the way in which the value of the asset was determined.

2 Depreciation

2.1 Depreciation is defined in FRS 15 as:

> The measure of the cost, or revalued amount, of the economic benefits of a tangible fixed asset that have been consumed during the period. Consumption includes the wearing out, using up or other reduction in the useful economic life of the tangible fixed asset whether from use, effluxion of time or obsolescence through either changes in technology or demand for goods and services produced by the asset.
>
> © ASB, FRS 15

2.2 FRS 15 requires that depreciation should be allocated on a systematic basis over the future useful economic life of a fixed asset. The depreciation method used should reflect, as fairly as possible, the pattern in which the asset's economic benefits are consumed by the entity. The future useful economic life of an asset is defined in FRS 15 as the period over which the entity (in whose accounts the asset is carried) expects to derive economic benefit from the asset. All buildings have a limited life due to physical, functional and environmental changes that affect their useful economic life to the business.

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

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

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

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

3 Depreciable amount

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

3.2 FRS 15 defines the depreciable amount as the cost of a tangible fixed asset (or where an asset is revalued, the revalued amount) less its residual value.

3.3 Residual value is defined as the net realisable value of an asset at the end of its useful economic life. It is based on the price prevailing at the date of the acquisition or revaluation of the asset, and does not take account of future price changes.

3.4 Net realisable value is defined in FRS 11, *Impairment of Fixed Assets and Goodwill*, as the amount at which an asset could be disposed of, less any direct selling costs. It should be determined using a basis consistent with that used to determine the carrying amount of the asset. For example, where an asset is valued on an existing use basis, the residual value should also be measured on an existing use basis. The carrying amount of a tangible fixed asset is its cost or revalued amount, less accumulated depreciation.

3.5 Tangible fixed assets may be carried in *financial statements* on one of the following bases, the selection of which will normally constitute the first stage in the calculation of the depreciable amount:

(a) cost less subsequent depreciation as appropriate. Whether acquired or self-constructed, the tangible fixed asset should initially be measured at its cost. This could be either:
   (i) the price paid for a completed property, plus directly attributable costs as set out in paragraphs 7–16 and 19–30 of FRS 15; or
   (ii) the cost of the land and of erecting the building, plus directly attributable costs as indicated previously;

(b) a professional valuation made in a previous year, less subsequent depreciation as appropriate; or

(c) a current professional valuation.

3.6 Directors may ask the valuer to provide an estimate of residual value in order to calculate the depreciable amount. Paragraph 95 of FRS 15 states that where the residual amount is material, it should be reviewed at the end of each accounting period.

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

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

3.9 FRS 15 indicates in paragraphs 83 and 84 that land and buildings are separate components of a tangible fixed asset and, for depreciation purposes, should be accounted for separately. Therefore, where a property is carried in the balance sheet at cost, or has been the subject of a past or present valuation, it will be necessary for the valuer to ascertain the amount applicable to the buildings and to the land, by an apportionment of the cost or valuation.

4 Apportionment

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

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

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

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

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

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

4.5 Gross current replacement cost is defined as either:

- the actual cost of constructing the asset if this was incurred close to the relevant date; or
- the estimated cost of erecting the building, or a modern substitute building with the same gross internal area as that existing, at prices current to the relevant date. This figure may include fees, any irrecoverable VAT, finance charges appropriate to the construction period, if required by the accounting policy, and other associated expenses directly related to the construction of the building. A definition of the directly attributable costs that may be included can be found in paragraphs 7–16 and 19–30 of FRS 15.

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

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

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

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

4.10 The inclusion and exclusion of plant and equipment in a valuation of land and buildings should normally follow GN 5.

5 Valued as an operational entity

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

- land;
- buildings;
- fixtures and fittings; and
- trading potential.

5.2 Paragraph 85 of FRS 15 suggests that it would not be appropriate to treat the trading potential associated with the property as a separate component of the value of the asset if its value and life were inherently inseparable from that of the property (see also GN 2, Valuation of trade related properties).

6 Future useful economic life

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

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

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

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

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

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

7 Investment properties

7.1 It should be noted that under SSAP 19 periodic charges for depreciation are not required for *investment properties* except for those held on lease when the unexpired term is 20 years or less.

8 Depreciation of a wasting asset

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

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

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

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

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

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

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

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

UK appendix 5
Valuation of local authority assets

1 Introduction

1.1 The *financial statements* of local authorities from 2010/11 onwards must be in accordance with the *International Financial Reporting Standards* (*IFRS*)-based Code of Practice on Local Authority Accounting (the 'Code'), published by Chartered Institute of Public Finance and Accountancy (CIPFA).

1.2 This appendix provides guidance to valuers on the application of the Code to the valuation requirements. It has been developed in conjunction with CIPFA.

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

1.4 The valuation requirements are the following:

- Apart from infrastructure, community and assets under construction, the *basis of value* for all assets is to be *fair value* (including council housing which will reflect the social housing nature of assets and therefore are to be valued based on EUV-SH – see section 3).
- Leases of land and buildings are to be separated into land and building elements, and classified and accounted for separately (see section 4).
- *Investment property* is to be valued at *fair value*, including *investment property* under construction where its *fair value* can be reliably determined (see section 5).
- Assets held for sale shall be valued at *fair value* less costs to sell (see section 6).
- For depreciation purposes assets are to be recognised on a component basis where components have a significant cost and the components have materially different asset lives, or different depreciation methods are used (see section 7).
- Residual values are to be based on current prices at the balance sheet date.

1.5 The valuer's role is to provide assistance on the identification and classification of assets and, essentially, to provide the *fair value* of those assets in accordance with the Code where such a value is required.

1.6 Subject to any *assumptions* that the Code requires, *fair value* is the same as *market value*. For further guidance on *fair value* see VS 3.5.

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

2 Classification of assets

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

- **Property plant and equipment**: Authorities shall account for all tangible fixed assets in accordance with International Accounting Standards (IAS) 16, *Property, Plant and Equipment*, except those more specifically listed in this appendix or where the Code has detailed interpretations or adaptations to fit the public sector (see section 3).
- **Leases and lease type arrangements**: Authorities shall account for leased assets in accordance with IAS 17, *Leases*, except where the Code has detailed interpretations or adaptations to fit the public sector (see section 4).
- ***Investment property***: Authorities shall account for *investment property* in accordance with IAS 40, *Investment Property*, except where the Code has detailed interpretations or adaptations to fit the public sector (see section 5).
- **Assets held for sale**: Authorities shall account for assets held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, except where the Code has detailed interpretations or adaptations to fit the public sector (see section 6).

2.2 Although there is no requirement to do so in the Code, authorities may wish to divide the classifications into further groups, and the valuer will report accordingly.

3 Valuation of property plant and equipment

3.1 Infrastructure, community assets and assets under construction (excluding *investment property* where the *fair value* can be reliably determined) shall be measured at historical cost, and the option given in IAS 16 to measure at *fair value* is withdrawn. Examples of this category of asset are given in section 8.

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

3.3 Pending the formal clarification by the International Accounting Standards Board (IASB) on the application of *fair value* to property, the Code requires the following values to be reported:

- For land and buildings, *fair value* is to be interpreted as the amount that would be paid for the asset in its existing use. This requirement is met by providing a valuation on the basis of EUV in accordance with UKVS 1.3.
- Where it is significantly different, *market value* (that is, the valuation does not disregard alternative uses) is to be reported. A statement should be made that no account has been taken of issues such as reducing the service potential or disruption, and the associated costs that would be incurred in achieving that alternative use.

Authorities will use the EUV in their *financial statements*. The *market value* will be used to inform the asset management plans/strategies of authorities.

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

3.5 The use of *depreciated replacement cost* (*DRC*) is recognised in appropriate circumstances. The valuer must have regard to the requirements of VS 6.6, Depreciated replacement cost in the public sector, and VS 6.7, Comparison of depreciated replacement cost valuations and alternative market values. In addition GN 6, Depreciated replacement cost method of valuation for financial reporting, contains detailed information on the use and application of *DRC* when valuing for *financial statements*.

3.6 The *fair value* of council dwellings shall be measured using EUV-SH (as defined in UKVS 1.13). The guidance on this, *Guidance on Stock Valuation for Resource Accounting*, published by the Office of the Deputy Prime Minister in 2005, is to be revised, but its advice on the valuation approach is unlikely to be changed and may be followed pending the publication of the revision. In Scotland and Wales the *basis of value* is also is EUV-SH, but there is no specific valuation guidance covering the housing revenue account.

3.7 The Code requires that where assets are revalued, the entire class (that is, one of the classes listed in section 2) shall be revalued. However, a full valuation may be on a rolling basis, which would typically be over a five-year cycle, within a short period, provided the valuations are kept up to date. More frequent valuations would be required where assets experience significant and volatile changes that result in the *fair value* differing materially from the carrying amount.

3.8 The detailed requirements with regard to private finance initiative (PFI) and public-private partnership (PPP) arrangements are in chapter 4, section 3, of the Code. In broad terms the arrangement is initially recognised under IAS 16 and measurement is based on cost. Subsequent measurement of the infrastructure is the same as other property under IAS 16, and the detailed requirements are set out in the Code in chapter 4, paragraphs 3.2.8 to 3.2.11.

3.9 With regard to playing fields, it is essential to establish their status before deciding on the *basis of value*. Until they have been declared ‘held for sale’ they remain part of the existing use, and paragraph 7.10 of GN 6 should be considered.

3.10 In considering the *market value* of playing fields, the valuer should take particular care to establish with the local planning authority what alternative planning permission would be available. Planning permission for building on the land is often found to be not forthcoming due to a local shortage of open space.

4 Leases and lease type arrangements

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

4.2 Where the valuer is requested to provide advice to assist in the classification of a lease as being financial or operational, the guidance in IVS 300, paragraphs G20 to G28, Lease Classification, applies. In addition, the information on the approach to classification in UKGN 1, Land and building apportionments for lease classification under IFRS, may also be of assistance.

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

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

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

Held as lessee

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

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

Held as lessor

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

4.9 Finance lease: The asset is recognised as a receivable at an amount equal to the net investment in the lease. The Code provides that the finance income shall be calculated so as to produce a constant periodic rate of return on the net investment. The valuer is not involved in this calculation.

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

5 Valuation of investment property

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

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

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

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

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

6 Valuation of assets held for sale

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

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

6.3 The Code requires the valuer to provide the *market value* of the property.

7 Accounting for depreciation

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

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

7.3 IAS 16 also provides that:

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

However:

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

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

7.5 For this purpose the 'asset' is the non-land element recognised in the accounts. A full explanation of the principles and the accounting requirements is set out in the CIPFA Local Authority Accounting Panel (LAAP) Bulletin 86, *Componentisation of Property, Plant and Equipment under the 2010/11 IFRS-based Code* (2010), which should be read in conjunction with this advice.

7.6 The bulletin sets out six steps in the consideration of materiality. Briefly these are:

1. Identify a de-minimis threshold for assets to be disregarded for componentisation.

   This step is the consideration of the non-land element as a whole before considering any components.

2. Assess the materiality of the non-land element in relation to overall assets (excluding the land element).

   This step is the identification of individual assets that are below the de-minimis level and can be disregarded for componentisation on the basis that any adjustment to depreciation charges would not be material. Also groups of similar assets that individually are below de-mininis for componentisation may be collectively material for componentisation.

   Note that when assessing the materiality of individual assets relative to overall assets, it may be more practical to use carrying values (instead of cost), as a basis upon which to determine materiality. However, cost must be used when determining the significance of components (of an asset) relative to that asset.

3 Set the policy for componentisation to determine which components will be depreciated separately.

4 Discuss of componentisation principles between professionals.

5 Consult relevant professionals to determine useful lives of significant components.

6 Attribute value to significant components.

The bulletin stresses that accountants and other professionals are required to use professional judgment when establishing materiality levels; assessing the significance, useful lives and depreciation methods of components; and apportioning asset values over recognised components. Discussions with external auditors should be held at key stages in the process.

7.7 The consideration of components is, as a minimum, required where an asset:

- is subject of enhancement expenditure;
- is acquired (with or without expenditure, for example, donated assets); and
- is revalued.

Identification of components

7.8 The two key considerations are the identification of the significant components of the asset and the useful life of those components in relation to the useful life of the asset (that is, the non-land element) as a whole.

7.9 When considering the number of components in the non-land element, it is not possible to specify what is 'significant' on a universal basis. What is significant for one building may not be significant for other similar buildings. However, the following comments may assist the valuer when providing advice:

- A structure may have many separate components, and the number to be identified will need to be established during the discussions on materiality, the agreed thresholds and any asset management requirements.
- It is likely that where many components are identified, most may have a similar life and therefore they may be aggregated for depreciation purposes. It is only those elements that normally depreciate at a different rate from the non-land element as a whole, or require a different method of depreciation, that should be identified.
- The pattern of the authority's expenditure on similar types of building will give an indication of those elements of the asset that have needed extensive repair or renewal before the expected life had been reached. For instance, there may be a rolling programme for the renewal of roofs on schools.
- Different criteria may be required where a building is identified as being close to the end of its useful life, because the proportions of the component values will change over time, or when the expected life is short, the identification of components may be irrelevant.
- For specialised buildings the *DRC* approach may have been developed on a component approach, and so the identification of the components would reflect the details of the calculation.

7.10 The apportionment process is set out in the following steps:

Step 1: The apportionment of the land value should be based on the same approach as currently adopted by the valuer. Deducting this figure from the total asset value provides the carrying amount of the non-land element of the asset.

Step 2: The de-minimis threshold should be applied to the non-land element to establish whether or not the asset will be considered for componentisation. Where assets are material and will therefore be reviewed for significant components, it is recommended that the minimum level of apportionment for the non-land element of assets (that are not classified as social housing) is:

- plant and equipment and engineering services; and
- structure.

To assist in asset management, the authority may wish to identify more components for all its assets, but there is no requirement for this to be done. Even where the cost of a component is significant in relation to the total cost of the non-land element of an asset, from an accounting perspective it is not necessary to identify that component separately, if its useful life and required method of depreciation is in line with the overall asset. In the case of social housing the level of componentisation will be governed by the separate accounting requirements for the Housing Revenue Account.

Step 3: The estimate of the plant and equipment element should reflect its value as part of the existing building. Various methods may be used ranging from a *DRC* approach to a best estimate. Having established this figure, it is deducted from the non-land element and the remaining figure represents the apportioned value of the structure.

Step 4: Where the authority has decided to recognise more than the two minimum components for specific assets, each component will be separately identified and depreciated over its separate life and/or method of depreciation. Where the original valuation is derived from a *DRC* approach, this should be straightforward. In other cases, particularly for plant and equipment components, it is recommended that a simplified cost calculation is made, with the difference between the value of the asset and its plant and equipment components relating to the remainder (for example, the structure) of the asset. It should not be overlooked that whatever approach is adopted, the sum of the component costs cannot exceed the reported overall value of the asset.

7.11 This appendix does not cover the de-recognition and recognition of components (that is, when enhancement expenditure takes place). This is discussed in detail in LAAP Bulletin 86, which complies with the requirements of the Code in chapter 4, paragraphs 1.2.47–1.2.48 and 42.10.

8 Examples of asset categories measured at cost

Assets under construction

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

Infrastructure assets

8.2 Examples of infrastructure assets are as follows:

- roads;
- sea defences;
- bridges;
- permanent ways;
- water drainage; and
- street furniture.

Community assets

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

8.4 Examples of community assets are as follows:

- parks (but not a golf course within a park);
- historic buildings (but not used for, say, a museum/office accommodation);
- works of art, museum exhibits and statues;
- civic regalia;
- cemeteries and crematoria (land only); and
- allotments (where there are restrictions on alternative uses).

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

- Is the intent to hold the asset forever?
- Does the asset have an indeterminable useful life?
- Are there restrictions on disposal?

To qualify as a community asset, the answers for questions (1) and (2) have to be 'yes', while an affirmative answer to question (3) is not obligatory but a helpful contributory factor.

UK appendix 6 Examples of published references to valuation reports

1 Introduction

1.1 The following examples are intended to be illustrative only of the typical degree of detail required for published references to valuation reports. The valuer must have due regard to the requirements of VS 6.12 and Appendix 6(n), and produce a statement that reflects the scope and nature of the property valued.

2 Valuation by an external valuer

2.1 The company's freehold and leasehold properties were valued on 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 FRS 15 (and any other regulatory requirements).

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

- **owner-occupied property:** valued to existing use value (EUV) assuming that the property would be sold as part of the continuing business;
- ***investment property:*** valued to *market value* assuming that the property would be sold subject to any existing leases; and
- **surplus property and property held for development:** valued to *market value* assuming that the property would be sold with vacant possession in its existing condition.

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

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

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

2.5 A statement regarding disclosures should be made in accordance with VS 1.9 and UKVS 4.3.

3 Valuations by an internal valuer

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

> The company's freehold and leasehold properties were valued by an internal valuer, Joe Smith FRICS, the company's 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.

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

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

UK appendix 7
FSA Listing Rules

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

1 Introduction

1.1 This specification is supplementary to Appendix 6, Minimum contents of valuation reports. It does not replace it, but provides guidance on the content of reports prepared for this purpose. Where the valuation is of a portfolio of properties, GN 3 is relevant.

1.2 The FSA Handbook allows valuations for inclusion in prospectuses or shareholders circulars to be in a condensed form in specified circumstances. However, a condensed report must still meet the requirements of VS 6, particularly VS 6.13 on published references to them. A condensed report must be distinguished from a publication statement under VS 6.11.

2 Reports for inclusion in prospectuses

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

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

3 Reports for inclusion in circulars

3.1 When a UK-listed company proposes an acquisition or disposal of property, and the transaction is classified under the FSA Listing Rules as either a class 1 transaction (where the size of the transaction exceeds 25% of the value of the company) or a 'related party' transaction, the company must seek shareholder approval. In either instance, it must include a property valuation report by an expert valuer in the circular to shareholders. The company decides the classification of the transaction, but full definitions may be found in the FSA Listing Rules.

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

4 Status of the valuer

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

4.2 The independent expert must disclose any material interest (if any) in the issuer. This includes the following circumstances:

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

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

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

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

5 Valuation requirements: the Prospectus Rules

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

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

5.3 The effective *valuation date* can be up to one year prior to the date of publication of the prospectus, provided that the issuer affirms in the prospectus that no material changes have occurred since the *valuation date*. If the valuer has previously provided a valuation for accounting purposes and the date of that valuation is within the time limit, the condensed report will relate to that valuation and no additional valuation will be required.

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

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

6 Valuation requirements: the Listing Rules

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

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

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

7 Framework for condensed reports

7.1 A condensed report does not need to include descriptive details of the properties, but must include the minimum information required by VS 6.1 and UKVS 4. The following framework is similar to that in Appendix 6, but with comments specific to the preparation of reports under the Prosectus Rules and Listing Rules.

Item	Comment
(a) Identification of the client and any other intended users	The report must be addressed to the client or its representatives.
(b) The purpose of the valuation	This may include a comment that the report is a condensed version prepared for the relevant rules.
(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	A brief overview of the asset(s) being valued is required – i.e. the number of interests involved, whether freehold or leasehold, type (e.g. retail, industrial, leisure), location (e.g. throughout UK, in central London) and whether held as investment(s) for development or for owner occupation.

UK appendices

(f) The *basis*, or *bases*, *of value*	For prospectuses the basis required is the same as required for inclusion in the company's accounts. For circulars the basis is *market value*.
(g) The *valuation date*	This must be within one year of the publication date for a prospectus and 42 days for a circular.
(h) Disclosure of any material involvement, or a statement that there has not been any previous material involvement	As this is a regulated purpose valuation, the disclosures required by UKVS 4.3 must be included.
(i) The identity of the valuer responsible for the valuation and, if required, a statement of the status of the valuer	This comment must confirm that the valuer is acting as an *external valuer* and as an independent expert under the rules.
(j) Where appropriate, the currency to be adopted	This is relevant where the portfolio includes property in different states.
(k) Any *assumptions*, *special assumptions*, reservations, special instructions or *departures*	All *assumptions* must be stated together with any reservations that may be required (see Appendix 3). Where property is located in more than one state, any variation of *assumptions* in each state must be made clear. *Special assumptions* (see Appendix 4) must be clearly stated and confirmed as agreed with the client. Where the valuation reflects marketing constraints (VS 2.3), restricted information (VS 2.4) or limited *inspection* (VS 2.5), the report must include full particulars. Any departures from the standards must be stated and explained (VS 1.2).
(l) The extent of the valuer's investigations	The report must record the date(s) and extent of the *inspection(s)* undertaken. Where a substantial number of properties are being valued, a generalised statement of these aspects is acceptable, provided that it is not misleading.
(m) The nature and source of the information to be relied on by the valuer	A summary of the information relied upon is acceptable, provided that it is not misleading. Valuers should also include any additional information that has been available to, or established by, them that they believe to be crucial to the reader's ability to understand and benefit from the valuation.

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(n) Any consent to, or restrictions on, publication	As this condensed report will be published in its entirety, it will be appropriate to include consent for publication in the specific prospectus or circular in it, but otherwise to reserve the valuer's rights to it being reproduced or referred to in any other document.
(o) Any limits or exclusion of liability to parties other than the client	For prospectuses, the report should not include any disclaimer to the effect that liabilities to the *third parties* are excluded. For circulars, the report may include a disclaimer to the effect that liabilities to *third parties* are excluded but may not disclaim responsibility to the company, its directors or its shareholders. A statement that the report may not be used for any other purpose than that stated may be included, provided that the purpose of the valuation report is clearly stated in the report as being for inclusion in the issuer's prospectus.
(p) Confirmation that the valuation will be undertaken in accordance with these standards and that it also complies with the IVS, where appropriate	Where the report is for inclusion in a prospectus and the company has adopted *IFRS*, confirmation is also required that the valuation accords with these standards and with the IVS.
(q) A statement of the valuation approach and reasoning	This is as Appendix 6.1(q).
(r) A statement that the valuer has the knowledge, skills and understanding to undertake the valuation competently	This is as Appendix 6.1(r).
(s) The opinions of value in figures and words	The valuations are to be summarised in the same categories determined under (e), identifying separately freeholds and leaseholds. Any negative values (liabilities) must be reported separately. The aggregate values and numbers of properties in each category are to be stated. Where the value of any individual property amounts to more than 5% of the aggregate valuation, the property must be specifically identified and the individual value disclosed. It may be appropriate to state that further details of individual properties are available for *inspection*, or on request, if this has been agreed with the client.

	Subject to any agreement that certain property information be kept confidential, the report should not omit information that would assist the reader to interpret the valuations. The following disclosures therefore must also be made, where appropriate: • reports must include a statement about the extent to which the values are supported by market evidence, or are estimated using other valuation techniques (which shall be disclosed) because of the nature of the property, limited transactions or any combination of these factors; • where *special assumptions* have been made, alternative figures may be required to illustrate their effect; and • for property in the course of development, the *market value* will reflect the value of the completed property, assuming that it is completed at the *valuation date*, less the anticipated costs to complete, including the costs of finance and other holding costs. Statements must be also be made as to whether or not: • any allowance has been made for liability for taxation which may arise on disposal, whether actual or notional; • the valuation reflects costs of acquisition, disposal or reorganisation.
(t) Signature and *date of the report*	The report must be signed by the person who accepts responsibility for it (see VS 1.5). The *date of the report* is to be the same as the date of issue, or such other date that is the same as any other documentation to be published.

UK appendix 8 Takeovers and mergers

1 Introduction

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

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

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

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

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

2 Status of the valuer

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

2.2 The valuer must be able to demonstrate compliance with VS 1.6, Knowledge and skills, and with any legal or regulatory requirements which apply.

2.3 The Code contains various provisions relating to the independence of advisers. Where potential conflicts are identified it may not be possible to resolve them by isolating information or assigning different personnel to the transaction. Chinese walls may not be regarded as adequate (see Appendix 1). Where doubt exists, the compliance unit or a similar disinterested unit of the valuer's *firm* must consult the Panel. Otherwise, legal advice should be sought.

3 Basis of value

3.1 The *basis of value* will normally be *market value* as defined in VS 3.2. If the company's accounts are prepared under UK GAAP with the consent of the Panel, the *basis of value* set out in UKVS 1.1 may be used.

3.2 The *basis of value* must be clearly stated in the valuation report. Only in exceptional circumstances should it be qualified, in which case the valuer must explain the meaning of the words used. Similarly, *special assumptions* (see VS 2.2) should not normally be made in a valuation, but if *assumptions* are permitted by the Panel, they should be fully explained (see VS 6.1(k)).

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

(a) the value after the development has been completed;

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

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

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

4 Reporting the valuation

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

4.2 The Code requires that the opinion of value must be contained in the offer document, and the valuation report must also be put on display (see VS 6.12, Publication statement). Where the valuation report includes material that may be commercially sensitive, the Panel may allow publication in a summarised form.

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

UK appendix 9 Collective investment schemes

1 Introduction

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

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

1.3 For more detailed information about collective investment schemes, the full text of the sourcebook is available on the FSA website (www.fsa.gov.uk). There is also the FSA Collective Investment Scheme Information Guide, which provides some general background material on the regulatory structure surrounding scheme regulation in the UK.

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

2 Basis of value

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

3 The valuer

3.1 The COLL requirements for an appropriate valuer is given in the following extract:

(7) An appropriate valuer must be a person who:

(a) has knowledge of and experience in the valuation of immovables of the relevant kind in the relevant area;

(b) is qualified to be a standing independent valuer of a non-UCITS[1] retail scheme or is considered by the scheme's standing independent valuer to hold an equivalent qualification;

(c) is independent of the ICVC[2], the depositary and each of the directors of the ICVC or of the manager and trustee of the AUT[3]; and

(d) has not engaged himself or any of his associates in relation to the finding of the immovable for the scheme or the finding of the scheme for the immovable.

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[1] UCITS: undertakings for collective investment schemes in transferable securities

[2] ICVC: investment company with variable capital

[3] AUT: authorised unit trust

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

(1) The following requirements apply in relation to the appointment of a valuer:

(a) the authorised fund manager must ensure that any immovables in the scheme property are valued by an appropriate valuer (standing independent valuer) appointed by the authorised fund manager; and

(b) the appointment must be made with the approval of the trustee or depositary at the outset and upon any vacancy.

(2) The standing independent valuer in (1) must be:

(a) for an AUT, independent of the manager and trustee; and

(b) for an ICVC, independent of the ICVC, the directors and the depositary.

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

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

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

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

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

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

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

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

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

(f) any valuation by the standing independent valuer must be undertaken in accordance with UKPS 2.3 of the *RICS Valuation Standards* (The Red Book) (6th edition published January 2008), or in the case of overseas immovables on an appropriate basis, but subject to COLL 6.3 (Valuation and pricing).

(4) In relation to an immovable:

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

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

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

UK appendix 10 RICS residential mortgage valuation specification

1 Introduction

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

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

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

1.2 The agreed specification is limited to providing advice on the property being valued, and not the lending policies of the lender. Any additional advice relating to the property, and individual lender policy requirements on *inspection* or suitability of construction, will need to be agreed with the lender and included in their *terms of engagement*. Where the instruction is to provide one valuation of two or more individual securities, the valuation approach will not be in accordance with this specification but should comply with Appendix 5, Valuations for commercial secured lending.

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

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

1.5 The specification has been arranged under the following headings:

- application of the Red Book;
- *inspection*;
- *basis of value*;
- factors that may have a material impact on value;
- *assumptions* and *special assumptions*;
- the form of the valuation report; and
- reporting factors that have a material impact on value.

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

2 Application of the Red Book

2.1 Valuers are reminded that the Red Book applies to the provision of valuation advice for residential mortgages. In addition to the general requirements of VS 1, Compliance and ethical requirements, VS 1.8, Additional criteria for independence, will apply because the FSA requires that the 'property shall be valued by an independent valuer at or less than market value'. An independent valuer is defined as 'person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process'.

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

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

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

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

2.3 Valuers must not accept instructions to make recommendations as to the length of the mortgage term or the amount to be advanced, as these decisions are solely the responsibility of the lender.

2.4 When agreeing *terms of engagement* the valuer must comply with the requirements of VS 2.1. Reference to this specification will provide the information required under the minimum terms (a) to (m) of VS 2.1, but terms (n) to (t) will require specific mention.

2.5 It is recognised that some lenders may have standard *terms of engagement* that refer to this specification. The valuer must ensure that in confirming the terms, whether as a generic standing instruction or for an individual instruction, all the requirements within VS 2.1 are addressed. Where generic standing *terms of engagement* are in place, these must be assumed to apply in all subsequent cases, subject to any specific amendments that may be required.

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

2.7 In certain cases, consideration should be given as to whether the valuer has the appropriate knowledge and skills to undertake the valuation competently on standard terms. This includes where the property is known to be exceptional; has extensive grounds; is of architectural or historical interest; is located in a conservation area; or is of unusual construction. If the valuer does not have appropriate knowledge and skills, the instruction should be declined (see VS 1.6). Where it is discovered on arrival at the property that it is exceptional, etc., or even includes some commercial property element, the valuer should consider referring back to the lender and seeking further instructions.

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

3 Inspection

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

3.2 The valuer will inspect the property to be valued.

3.3 The visual *inspection* covers as much of the exterior and interior of the property as is readily accessible without undue difficulty or risk to personal safety. Although personal judgment has to be used, this *inspection* should include all of the property that is visible when standing at ground level within the boundaries of the site and adjacent public/communal areas, and when standing at the various floor levels.

3.4 More specifically, and subject to the *assumptions* set out in section 5, are the following:

1. Roof voids and underfloor voids are not to be inspected. Furniture and effects are not to be moved, and floor coverings are not to be lifted. Cellars and basements should be inspected where there is safe access.
2. The availability of services, including green technologies, should be recorded but are not tested.
3. The *inspection* includes garaging, car parking, other outbuildings (excluding leisure complexes) of permanent construction and any other structures attached to the dwelling. If relevant, their impact on the value of the property is to be noted.
4. The valuer is not expected to comment on the size, condition or efficiency of any leisure facility in the grounds of the property. However, comment may be expected where:
   - (a) there is obvious evidence of serious disrepair;
   - (b) the siting of the installation (for example, of a swimming pool) is a potential hazard to the dwelling, or poses a threat in other terms; and
   - (c) the installation covers an unacceptably large area in relation to the confines imposed by site boundaries.

3.5 The land within the ownership should be inspected, subject to the comments in paragraph 2.6 and 2.7, and any material matters recorded and reported. This includes any obvious access restrictions and easements.

3.6 Where there are locational factors that may impact value they should be recorded and reported. Certain problems, such as flooding, mining settlement, subsidence, woodworm, invasive vegetation, radon gas, mundic and other issues are particularly prevalent in certain districts. If appropriate, the valuer should make some reference to these defects, even if the subject property does not appear to be affected at the time of the *inspection*. Where appropriate, the valuer should advise that an environmental assessment or a mining report should be obtained.

3.7 The energy-efficiency rating provided within the Energy Performance Certificate (EPC) is to be considered, if it is available.

3.8 In Scotland the valuer is not required to read the Home Report documents unless carrying out the original Single Survey, in which case the valuer is not required to read the Property Questionnaire.

3.9 Where the property is a flat or maisonette, the following additional requirements will apply:

- The external *inspection* will be of the main building within which the flat or maisonette is located.
- The external *inspection* will include the primary communal access areas to the property and any communal areas on the floor on which the flat or maisonette is located.
- Where communal services are provided it may be assumed that the right to use these and have them maintained passes with the property, subject to an appropriate and reasonable service charge.
- The general standard of management and maintenance may have an impact on the service charge, and the possibility of the owner having to contribute to capital expenditure may have a substantial effect on the value. The valuer does not have to provide any estimates of such costs, but will draw attention to them in the report.

3.10 To be able to respond to a future enquiry, legible notes (which may include photographs) of the findings, and particularly, the limits of the *inspection* and the circumstances in which it was carried out must be made and retained. The notes should also include a record of any comparable transactions and/or valuations considered when arriving at the valuation.

3.11 In relation to *inspections* generally, regard should be had to the RICS *guidance note*, *Surveying safely* (2011).

4 Basis of value

4.1 The *basis of value* to be adopted is *market value*.

4.2 Where an existing property has, or has a reasonable prospect of obtaining, planning approval for future development, that value is to be excluded from the assessment of *market value* by way of a *special assumption* unless instructed otherwise by the lender.

5 Factors that may have a material impact on value

5.1 The *inspection*, and enquiries made, may reveal various factors that could have a material impact on the value. These include:

- the tenure of the interest offered as security and, if known, the terms of any tenancies to which that interest is subject;
- the location, age, type, accommodation, fixtures and features, and amenities of the property;
- the apparent general state of, and liability for, repair, form of construction and apparent major defects, liability to subsidence, flooding and/or other risks;
- any easements, servitudes, burdensome or restrictive covenants, and *third-party* rights; and
- any obligations relating to planning conditions, for instance Section 106 agreements or restrictions related to affordable housing conditions.

5.2 The valuation of a new-build property should be approached in the same way as any other valuation. There are, however, specific aspects of the new-build residential market that have led certain mortgage lenders to require an alternative approach to valuation. In all instances, the notified sale price must be treated with caution. The RICS *guidance note*, *The valuation of individual new-build homes* (2009), is relevant when valuing these types of property.

6 Assumptions and special assumptions

6.1 Considering the limited nature of an *inspection* for a mortgage valuation, the valuer is entitled to make reasonable *assumptions* with regard to the state of the property and other factors that may affect value.

6.2 Unless instructed otherwise the following *assumptions* and *special assumptions* may be made without verification:

(a) The property will be transferred with vacant possession.

(b) All required, valid planning permissions and statutory approvals for the buildings and for their use, including any extensions or alterations, have been obtained and complied with. It is not necessary for the valuer to make enquiries into town planning and other matters. These should be left to the lender's or borrower's legal advisers. Any obvious breach of planning control, however, should be reported. The lender should be advised of any obvious, recent and significant alterations and extensions, so that the lender's legal adviser is alerted to the possible need to make enquiries. The valuer is not obliged to search for statutory notices, although the lender's legal advisers may ask if any such matters that come to light during searches have a material effect on value. Consideration may have to be given to known or suspected planning restrictions or conditions. The valuer is under no duty to search, but may be called upon for advice as to any material effect on value, if they are disclosed.

(c) In the case of a building that has not yet been constructed, the valuer will, unless instructed otherwise, provide a valuation on a *special assumption* that the development had been satisfactorily completed, as at the date of the *inspection*, in accordance with planning permission and other statutory requirements.

(d) No deleterious or hazardous materials have been used in the construction. However, if the limited *inspection* indicates that there are such materials, this must be reported and further instructions requested.

(e) The site is not contaminated and is free from other environmental hazards. No enquiries regarding contamination or other environmental hazards are to be made but, if a problem is suspected, the valuer should recommend further investigation. The valuer will not carry out an asbestos inspection and will not be acting as an asbestos inspector in completing a mortgage valuation *inspection* of properties that may fall within the *Control of Asbestos Regulations* 2006 (SI 2005/2739).

(f) The property is not subject to any unusual or especially onerous restrictions, encumbrances or outgoings, and good title can be shown.

(g) The property and its value are unaffected by any matters that would be revealed by a local search (or their equivalent in Scotland and Northern Ireland), replies to the usual pre-contract enquiries or any statutory notice which may indicate that the property and its condition, use or intended use are, or will be, unlawful.

(h) An *inspection* of those parts that have not been inspected, or a survey *inspection*, would not reveal material defects or cause the valuer to alter the valuation materially.

(i) There is unrestricted access to the property, and the property is connected to, and has the right to use, the reported main services on normal terms.

(j) Sewers, main services and the roads giving access to the property have been adopted, and any lease provides rights of access and egress over all communal estate roadways, pathways, corridors, stairways and use of communal grounds, parking areas and other facilities.

(k) In the case of a newly constructed property, it has been built under a recognised builders warranty or insurance scheme approved by the lender, or has been supervised by a professional consultant capable of fully completing the CML Professional Consultant Certificate acceptable to the lender.

(l) There is no ongoing insurance claim or neighbour disputes.

6.3 Where the *inspection* reveals matters that affect any *assumption* or the value of the property, the details are to be included in the report together with, if appropriate, recommendations for further action to be taken.

6.4 Where the proposed security is part of a building comprising flats or maisonettes, the following *assumptions* will also be made, unless instructed to the contrary:

(a) The costs of repairs and maintenance to the building and grounds are shared equitably between the flats and maisonettes.

(b) There are suitable, enforceable covenants between all leaseholds, or through the landlord or the owner.

(c) There are no onerous liabilities outstanding.

(d) There are no substantial defects, or other matters requiring expenditure (in excess of the current or assumed amount of service charge payable on an annual basis), expected to result in charges to the leaseholder or owner of the subject property during the next five years that are equivalent to 10% or more of the reported *market value*.

6.5 Where the dwelling is leasehold and it is not possible to inspect the lease or details have not been provided, the following *assumptions* will be made, unless instructed to the contrary:

(a) The unexpired term of the lease is assumed to be 70 years, and no action is being taken by any eligible party with a view to acquiring the freehold or extending the lease term.

(b) There are no exceptionally onerous covenants upon the leaseholder.

(c) The lease cannot be determined, except on the grounds of a serious breach of covenant in the existing lease agreement.

(d) If there are separate freeholders, head and/or other subhead leaseholders, the terms and conditions of all the leases are in the same form and contain the same terms.

(e) The lease terms are mutually enforceable against all parties concerned.

(f) There are no breaches of covenant or disputes between the various interests concerned.

(g) The leases of all the properties in the building/development are materially the same.

(h) The ground rent stated, or assumed, is not subject to unreasonable review and is payable throughout the unexpired lease term.

(i) In the case of blocks of flats or maisonettes of over six dwellings, the freeholder manages the property directly, or there is an appropriate management structure in place.

(j) There is a dutyholder, as defined in the *Control of Asbestos Regulations* 2006, and there are in place an asbestos register and effective management plan, which does not require any immediate expenditure, pose a significant risk to health or breach the Health and Safety Executive (HSE) regulations.

(k) Where the subject property forms part of a mixed residential or commercially used block or development, there will be no significant changes in the existing pattern of use.

(l) Where the property forms part of a development containing separate blocks of dwellings, the lease terms of the property apply only to the block. There will be no requirement to contribute towards costs relating to other parts of the development, other than in respect of common roads, paths, communal grounds and services.

(m) Where the property forms part of a larger development whose ownership has since been divided, all necessary rights and reservations have been reserved.

(n) There are no unusual restrictions on assignment or subletting of the property for residential purposes.

(o) There are no outstanding claims or litigation concerning the lease of the subject property or any others within the same development.

(p) Where the property benefits from additional facilities within the development, the lease makes adequate provisions for the occupier to continue to enjoy them without exceptional restriction, for the facilities to be maintained adequately and for there being no charges over and above the service charge for such use and maintenance.

In respect of insurance, the following *assumptions* will be made, unless instructed to the contrary:

(a) the property can be insured under all-risks cover for the current reinstatement cost and is available on normal terms;

(b) there are no outstanding claims or disputes;

(c) where individuals in a block make separate insurance arrangements, the leases make provision for mutual enforceability of insurance and repairing obligations; and

(d) any landlord responsible for insurance is required to rebuild the property with the alterations that may be necessary to comply with current Building Regulations and planning requirements.

Reinstatement cost

6.6 An insurance reinstatement cost, often referred to as a 'fire insurance valuation', will not be provided unless specifically requested.

6.7 Where the lender requests that an insurance replacement cost be provided it shall be in accordance with Building Cost Information Service (BCIS) guidance. The rebuilding costs used refer to the expense of demolishing and clearing away the existing structure, and then rebuilding it to its existing design in modern materials, using modern techniques, to a standard equal to the existing property and in accordance with current Building Regulations and other statutory requirements. It excludes VAT, except on fees.

6.8 Where the building is not of modern materials, or is a protected building that is required to be reinstated exactly and is therefore outside the scope of BCIS guidance, the reinstatement cost should not be provided unless the valuer has expertise in that type of property. In these circumstances a professional cost assessment should be recommended.

6.9 Where the subject property is a flat or maisonette, the valuer should assess the reinstatement cost of that part of the total structure constituting the proposed security. It is the lender's responsibility to enquire whether a management committee or the landlord arranges insurance for the building as a whole, and whether that cover is adequate.

6.10 Any exceptional risks likely to affect the premiums for insurance purposes should be reported. There is, however, no obligation for the valuer to seek out such factors. The duty is limited to factors that come to notice during the ordinary course of *inspection*.

7 The form of the valuation report

7.1 The lender will often provide a general valuation report format. RICS is developing a residential valuation template that may be used when available. Whatever format is used the information provided in the report should comply with VS 6, Valuation reports. It should be sufficient to enable the prospective lender to understand the nature of the security being offered, although unnecessary detail should be avoided.

7.2 The valuer's duty is to prepare a report on the basis of the information or questions contained in the instructions received, unless there are obvious errors or inconsistencies.

7.3 If other *assumptions* are made in addition to those described in section 6, they must be explicitly stated in the report.

8 Reporting factors that have a material impact on value

8.1 In addition to reporting the value, an important part of the report is to identify those factors that may have materially impacted value, or may be expected do so in the future. Where such factors are identified the valuer will recommend appropriate action.

8.2 If it is suspected that hidden defects exist that could have a material effect on the value of the property, the valuer should recommend more extensive investigation. It may be appropriate, in exceptional circumstances, to defer making a valuation until the results of the further investigations are known.

8.3 If it is not reasonably possible to carry out any substantial part of the *inspection* this should be stated.

8.4 The report should include reference to:

(a) the form of construction;

(b) the existence of any obvious, recent and significant alterations and extensions;

(c) any obvious evidence of serious disrepair, or potential hazard, to the property, and any other matters likely to materially affect the value (although minor items of disrepair, poor design or lack of decoration that do not materially affect the value of the security do not need to be reported);

(d) items that are not serious at the date of *inspection*, but could become so if left unattended; and

(e) other items of disrepair or poor design, or a lack of maintenance that may adversely affect the structure in the future and lead to a material affect on in the value of the security.

8.5 Where there is a basic structural defect, such that renovation ceases to be possible or economic, a valuation should not be provided, subject to the lender's more specific reporting requirements.

8.6 Where the proposed security is part of a building comprising flats or maisonettes, the valuer should comment on:

(a) any apparent deficiencies in the management and/or maintenance arrangements observed during the *inspection* which materially affect the value;

(b) the current amount of the annual service charges payable, if available; and

(c) any situation where the apparent sharing of drives, paths or other areas might materially affect the value of the subject property.

8.7 If the valuer's *inspection* reveals anything that gives reason to suspect an encumbrance, for instance, easements and other rights pertaining to way, light and drainage, they must be reported even if the report is in the lender's format and no provision is made on the form for such information to be provided.

8.8 If the *inspection* reveals the possibility that third parties have the right of occupation this must be reported in all cases.

8.9 Where the valuer does not have the necessary expertise to estimate any repair and maintenance costs and their impact on value, specialist advice should be obtained or the instruction declined. One example would be a property of architectural or historic interest, listed as such, or in a conservation area. Another would be a property of unusual construction, where any remediation of defects may require planning permission, or other consent. The repairs may also have to be to a standard that would not be detrimental to the property's architectural or historic integrity, its future structural condition or the conservation of the building fabric.

Treatment of incentives

8.10 Sales incentives and the marketing of property, especially new-build homes, have become increasingly more innovative and sophisticated. Incentives can differ between development sites, between properties being sold and between the types of purchaser being attracted by the seller (owner-occupier or buy-to-let investor).

8.11 Where the property is a new-build, the valuer must obtain a copy of the developer's Disclosure of Incentives Form (DIF). More detailed guidance on the treatment of incentives and how to report on their impact is contained in *The valuation of individual new-build homes*.

8.12 Where the property is a new-build, it is recommended that the valuer considers including a statement to the following effect:

> It should be appreciated that the valuation provided is for the property as new. It may not be possible to obtain the valuation figure if the property is resold as second-hand, especially if comparable new property is on offer at the same time.

UK appendix 11 Application of the RICS residential mortgage valuation specification to related purposes

1 Introduction

1.1 This appendix contains guidance on various matters related to residential mortgage valuation advice that are not dealt with in the residential mortgage specification. These are:

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

1.2 Valuation advice may also be sought on a variety of other matters, such as mortgage rescue and accounts in arrears. Unless the instructions specify otherwise, the *basis of value* will be *market value*.

2 Re-inspections

2.1 A 're-*inspection*' is a further visit to a property for which the valuer has previously provided a report where the lender has either imposed conditions, or made a retention.

2.2 The cases that may arise include:

- consideration of the release of money by way of stage payments applicable to the stage of construction reached;
- whether the (new, or newly-converted or improved) property has been completed to the state assumed in the initial mortgage valuation report (where a mortgage offer has been made on this basis, but no advance has actually been made); and
- in circumstances where part of the advance has been retained until specified works have been undertaken, whether those works have apparently been completed as assumed in the initial valuation report, or as otherwise specified

by the lender, to a standard satisfactory to justify lending on them and without significant adverse effects on the value of the property.

2.3 The valuer may be asked to advise whether the previous valuation report (which must always be available to the valuer) is still sufficiently accurate for the lender to assess the adequacy of the security, when deciding whether or not to release a retention or stage payment. In this case the valuer's duty is to inspect only those parts of the property with which the lender is concerned. It is not the task of the valuer to inspect the whole property.

2.4 The lender must be advised if, during the re-*inspection*, the valuer:

- becomes aware of any material changes additional to those in the previous report that would materially affect the valuation of the proposed completed security;
- becomes aware of any other factors that might materially affect the valuation;
- is of the opinion that the valuation of the proposed completed security would be materially different from that previously reported;
- considers that the property may have been affected adversely by the works carried out;
- observes new defects and/or repair requirements and/or unsatisfactory workmanship; and/or
- becomes aware that the problem originally causing the need to carry out the remedial works is now affecting another part of the structure, or that part of the structure which is the subject of the required *inspection* is suffering from a further defect.

However, there is no requirement to provide a revised valuation unless requested to do so.

2.5 A new figure for reinstatement insurance purposes is not to be provided, unless requested by the lender.

3 Retype reports and transcriptions

3.1 A 'retype report' is the generic name applied to a request for a 'copy report' or 'transcription', which is commonly requested by brokers and lenders. When receiving instructions from a *third party* (e.g. broker) to complete a retype, the valuer should be clear as to the acceptability of such reports by the lender whose report form is being completed. The lender's requirements will usually be made clear in the lender's panel contract and guidance. These requirements will always prevail over any contrary instructions from *third parties*, particularly in respect of retype acceptability, timescales, applicable valuation dates and valuation definitions.

3.2 Some requests for a retype report can lead to a potential conflict of interest, which should be considered in relation to the specific guidance in Table 1 (see paragraph 3.10) and generally in VS 1.7 and Appendix 1.

3.3 Retype reports can be categorised as either:

- a copy report – a duplicate copy of a previous report stating exactly the same facts with an *inspection* date, *valuation date* and valuation figure the same as for the original report; or
- a transcription report – the transcription of data, which was presented in a previous report, to another report format stating the same facts with an *inspection* date, *valuation date* and valuation figure.

3.4 There may be minor amendments to meet lender requirements for additional data that can be presented in the transcription report if it was collected during the original *inspection*. Where additional data is requested that would require another visit to the site, the valuer should negotiate the appropriate fee for the additional work.

3.5 Where the valuer is aware that the value of the property has reduced to a level materially below the valuation at the original *inspection* date, the valuer should initially decline instructions. In the absence of a contract or agreement to provide a copy report stating both the original and current valuation figures, the valuer should offer to provide a revaluation at an appropriate fee.

3.6 Where the lender's requirements are for a valuation based on a different valuation definition from the original, the instructions should be declined. The valuer should then offer to provide a revaluation at an appropriate fee.

Retype reports in Scotland

3.7 After the introduction of the Home Report there is the option for the surveyor to provide a generic mortgage valuation report (MVR) in addition to the Single Survey. Buyers will be in the same position as before in having this report prior to making an offer. A lender may request a valuation for mortgage purposes on its own report forms. This can be provided prior to purchase provided that:

- the valuer is an approved panel member for the lender;
- the valuation in the MVR is replicated exactly in the retyped lender valuation; and
- no additional information other than that which is in the Single Survey and MVR is provided.

If the valuer is unable to comply with these requirements, the instruction should be declined and the lender will be required to source a valuation from another panel member.

3.8 However, if the valuation in the MVR is seen to be inappropriate at the date of the retype request due to changing market circumstances or the level of the offer from the prospective buyer, the valuer may seek the vendor's permission to 'refresh' the Single Survey and MVR. This creates an updated version to be put into the public domain and then provides the opportunity for the valuer to provide a valuation to the lender. If the vendor does not give permission, the lender will need to source another valuation from a different panel member.

3.9 Where a lender requires a valuation for mortgage purposes after the applicant has made a commitment to purchase then the valuer, provided he or she is an approved panel member for the lender, can provide additional information, to the lender without the need to 'refresh' the Single Survey and the MVR. If the valuation is seen to be inappropriate at the date of the retype request and a refreshed Single Survey is not instructed, the lender would be required to source another valuation from a different panel member.

3.10 Table 1 provides an indication of the circumstances under which a request for a retype report may give rise to a conflict of interest. Further guidance on conflicts of interest is given in Appendix 1, Confidentiality, threats to independence and objectivity, and conflicts of interest.

Table 1

Instruction source	Acceptable	Not acceptable (not applicable in Scotland)	Acceptable subject to conditions
Lender	*Different lender, same applicant*: acceptable, as this is an accepted industry practice *Same lender, different applicant*: acceptable, as most likely to be a full revaluation	*Different lender, different applicant*: not acceptable, as previous applicant and lender case may still be live	*Same lender, different applicant*: acceptable if applicant 'related' to previous applicant and change is administrative
Intermediary	*Same or different lender, same applicant*: acceptable, as this is an accepted industry practice	*Different lender, different applicant, or same lender different applicant*: not acceptable, as there's no proof that original applicant has ceased interest, so potential conflict	*Different intermediary, different lender, same applicant*: can proceed
Applicant	*Same applicant, different lender*: acceptable, as applicant has instructed the transfer of information, therefore it is implicit that the valuer has the personal details. It should be stated within the report that the applicant has instructed the valuer.		

4 Further advances

4.1 Where a property is already in mortgage to a lending institution, the lender may sometimes wish to consider whether a further advance, usually of a specified sum, can be made on the security of the property or the repayment of a loan rescheduled. The valuation may be of the property as it stands and/or with works proposed to it. The lender is expected to provide the valuer with the original report, or a copy, wherever possible.

4.2 The valuer's remit is to provide a report on all of the following:

- the current *market value* of the property in its existing state;
- the current *market value* in its future state, where defined works are contemplated on the *special assumption* that they have been satisfactorily completed;
- where previously provided, a revised estimate obtained for insurance purposes;
- any factors likely to affect its value materially; and
- changes in the accommodation or its amenities since the previous *inspection* report.

5 Buy to let

5.1 Buy-to-let valuations will encompass a number of different categories. The main three are:

Category 1: a single individual residential unit let to a single household on a single assured shorthold tenancy (AST) where it neither forms, nor is intended to form, part of a portfolio;

Category 2: a single residential unit let on a single AST, but to individuals on a sharing basis up to a maximum of four individuals; and

Category 3: licensable houses in multiple occupation (HMOs) and multiple units held on a single title. They will include categories of properties not capable of being valued on an *assumption* of owner occupation and/or by adopting a traditional comparable methodology. These will be valued only after confirmation of direct *terms of engagement* with the instructing lender and referring to the lender's specific guidance.

5.2 The following comments apply to all categories:

1. The valuer must be sufficiently experienced in the residential investment market and have a sound knowledge of the rentals in the locality.
2. The valuer should be aware of the impact of rental incentives in respect of properties suitable for buy-to-let investment. Guaranteed rents that are above *market rent* and cashbacks in lieu of rental income for a number of years may have an effect on price. The valuer should consider these impacts and report accordingly.
3. The lender may use either or both the *market rent* and the *market value* to determine the size and type of loan to be extended to the borrower. The *market rent* figure may therefore be critical in the underwriting of the loan and should not be viewed just as a guide or confirmation of the current or future rent passing.
4. The valuer should fully research, document and retain comparable rental evidence, and either decline to provide a market rent figure, or clearly state limitations as to accuracy if there is insufficient or limited evidence.
5. If the property is likely to incur higher than average maintenance costs due to its age/type, existing condition or intensity of occupation this should be identified within the report, as the proportion of rent required for reinvestment will exceed normal levels and reduce net income accordingly. Excessive

service charges and/or ground rents should also be considered in this regard, as they will similarly affect net income.

6 Where the lender advises the valuer that the borrower intends to let a vacant property for residential purposes, the lender should also instruct on whether the valuer is to value the property:

(a) with vacant possession;

(b) subject to an AST at *market rent*; or

(c) subject to such other terms as the lender advises.

5.3 Where *market rent* is to be provided it shall comply with VS 3.3, Market rent, on the *special assumption* that it is an unfurnished, six-month AST. This should be a sustainable rent and not one distorted by temporary factors of high demand, such as seasonal workers, holiday lets, asylum seekers or other special cases. A simple adoption of the current rent passing (if known) will not be appropriate where market conditions have changed since commencement of the existing tenancy.

5.4 Comparable evidence for *market rent* should be as robust as those obtained for *market value*.

5.5 The following paragraphs provide comments that apply to the specified categories.

Category 1: Single assured shorthold tenancy

5.6 Individual residential properties that fall into category 1 may be purchased with a view to the owner letting them as investments. Many lenders have specific loans designed for this buy-to-let market. As the security offered is essentially a property that would be in the residential owner-occupier market, it is appropriate that the valuation is in accordance with that market.

5.7 The valuer should be aware of the impact of incentives in respect of properties suitable for buy-to-let investment. Guaranteed rents that are above *market rent* and cashbacks in lieu of rental income for a number of years may have an effect on the price. The valuer should consider these impacts and report accordingly. In some cases the lender may specifically request the valuer to give an opinion of the *market rent* on an AST under item 6(b) in paragraph 5.2.

5.8 In the case of item 6(a) in paragraph 5.2, the valuer must include in the report a sentence stating that the lender has advised that the property is to be let and that this may adversely affect the valuation reported (if the valuer believes this to be the case). In the case of item 6(b) or (c), the valuer must state in the report that a *special assumption* has been made that the property has been let on an AST on market terms, or such other stated terms as advised by the lender.

5.9 Many lenders use a standard pro-forma report for buy-to-let valuations. Where this is the case, the valuer does not need to comment on:

(a) the letting *assumptions* made; and/or

(b) the possible adverse effect on the capital value of letting.

This applies where the pro-forma, lender's *terms of engagement* or lender's guidance manuals (or equivalent) already state the *assumptions* and/or *special assumptions* that the lender wishes the valuer to make in the preparation of the report.

5.10 In the event that the property is already let and is to be conveyed subject to the letting, the lender may request that a *special assumption* be made that the property is vacant. The current rent passing should not necessarily be confirmed as the current *market rent*. The current *market rent* should be the figure that the valuer considers is the true value irrespective of whether the current rent passing is higher or lower.

5.11 Where the lender requires the valuation of more than one category 1 property for the same borrower, the valuation is to be on an 'individual property basis' and not as a parcel or portfolio of properties, unless otherwise instructed. In such case this specification does not apply, and the valuer should refer to Appendix 5, Valuations for commercial secured lending, and GN 3, Valuation of portfolios and groups of properties, unless covered in the following paragraphs.

Category 2: Shared houses

5.12 Where a property has been let to a group of tenants, typically a shared student house or as individual rooms, the *market value* may be assessed on a comparable basis. However, these properties may be located in areas comprising a high concentration of similar rented accommodation and limited owner-occupation. In this situation, the comparables used to determine the valuation may come principally from transactions of other similar *investment property* (rather than owner-occupied property) in the locality.

5.13 The rental value assessment should only be provided at a 'higher' shared occupancy rate, where there is a proven sustainable demand in the area for this type of letting arrangement and the property is suitable for this form of letting.

Category 3: Houses in multiple occupation/multi-unit properties

5.14 For this specialist area of valuation, the valuer must have knowledge of, and experience in, the valuation of the more complex residential *investment property* in the particular locality.

5.15 HMOs comprise individual units that cannot be sold separately and will have at least some shared facilities. If the property appears compliant with legislation/safety requirements having regard to the provisions of the *Housing Act* 2004, then it is reasonable to adopt the *income approach* method of valuation, assuming there is a continuing rental demand for this type of accommodation in the area. The valuation obtained should be logic checked against the tone of values for similar *investment property* in the vicinity.

5.16 The valuer should identify whether the property is subject to mandatory HMO licensing and if a copy of the licence has been seen.

5.17 The additional considerations for the category 3 scenarios include:

(a) management regulations for HMO;

(b) potential mandatory or discretionary licensing schemes;

(c) condition/fitness requirements – that is, Housing Health and Safety Rating System (HHSRS); and

(d) the possibility that planning consent will be required for the HMO usage, in addition to the usual local authority consents for the current property form and layout.

6 Valuations without internal inspection

6.1 The valuer may be asked for a valuation without the benefit of an internal *inspection*, and with or without the benefit of an earlier report. This may be called a 'desk-top', 'drive-by' or 'pavement' valuation, or an 'external appraisal', and may include reference to automated valuation models (AVMs).

6.2 When an opinion is provided on this basis, it must be confirmed in writing, and the manner of valuation and the restrictions under which it is given must be clearly stated (see VS 2.4, Restricted information). The lender must be informed that the value stated in such a fashion must not be disclosed to the borrower or any other party, unless required to do so by the FSA Mortgages and home finance: conduct of business sourcebook (MCOB).

6.3 Many lenders use a standard pro-forma report for valuations without an internal *inspection*. Where this is the case, the valuer does not need to comment on:

- the manner of valuation;
- the restrictions under which it is given;
- the non-disclosure to the borrower and/or other third parties; or
- where the pro-forma, lender's *terms of engagement* or lender's guidance manuals (or equivalent) already state the *assumptions*, restrictions and terms under which the valuer should prepare the report.

6.4 Where a desk-top opinion is sought without any form of *inspection* of the property itself, the valuer should exercise additional caution particularly as to the intended use of the valuation. It is likely to be used for a preliminary assessment prior to a more detailed investigation at a later date (and section 7 may also apply). The valuer should ensure that the source of information and the rationale used in arriving at the desk-top valuation are documented and retained, given that there will be no site notes.

7 Retrospective valuations

7.1 A valuation may be provided at any historical date. However, a lender may be seeking a retrospective valuation as part of an internal process of reviewing a specific loan. It is therefore important that the valuer establishes the reason for the request before accepting the instruction.

7.2 Where an instruction is accepted, the *terms of engagement* must incorporate the following statements:

- The valuation will be in accordance with the residential mortgage specification as at the *valuation date*. Previous specifications are available from the RICS Library.

- Where an *inspection* is not possible, or expressly forbidden, a statement to that effect will be made.
- Because the valuation is based on restricted information, it is provided solely for the internal use of the lender. It is not to be used in any proceedings without the valuer's consent, as the opinion may change if the valuer is later required to give evidence in formal proceedings.
- Where the lender decides to institute formal proceedings the valuer must be instructed to act as an expert witness and will follow the RICS mandatory standard, *Surveyors acting as expert witnesses* (2008).

UK appendix 12
RICS Scotland advice on issuing terms of engagement

1 Introduction

1.1 This appendix reproduces the advice issued by RICS Scotland in January 2006.

1.2 The advice in this appendix does not apply to the provision of services as part of a Home Report in Scotland. In such cases UKVS 3.6 will apply.

1.3 Paragraph 1.1 of the RICS Scotland advice refers to the Rules of Conduct and those standards that were applicable in 2006. As the Rules of Conduct 2007 do not refer to *terms of engagement* and the references in these standards have changed, this paragraph should be read as follows:

> 1.1 This advice should be read in conjunction with the *RICS Valuation – Professional Standards*. VS 1.4, Terms of engagement, requires the *terms of engagement* to be brought to the client's attention and appropriately documented prior to the issue of the report.

1.4 Similarly, all references to various 'practice statements', now termed *valuation standards*, should be checked against their new numbering and location in this edition of the Red Book.

RICS Scotland advice on issuing terms of engagement (SRF/01/06)

1. Introduction

1.1 This advice should be read in conjunction with the *Royal Institution of Chartered Surveyors (RICS) Appraisal and Valuation Standards* (Fifth edition) (Red Book) Chapter 2 (Agreement of terms of engagement), PS 2.1 – Confirmation of terms of engagement.

RICS Code of Conduct, Rule 8, provides that terms of engagement shall be sent promptly.

1.2 This advice reflects that due to time restrictions sometimes created by the traditional and accepted procedures for buying residential property in Scotland, it is often difficult to issue Terms of Engagement to clients, or those acting for clients, prior to the issuing of a valuation or survey report. The guidance contained in this advice aims to reflect best endeavours on behalf of the Chartered Surveyor, in their firm.

UK appendices

2. Best endeavours

2.1 Where it is possible, and reasonable time permits, these Terms of Engagement shall be issued to clients in accordance with the Red Book PS 2.1 – Confirmation of terms of engagement. Where this is not possible then the Chartered Surveyor, or their firm shall adhere to at least one of the following guiding principles:

2.1.1 A written copy of the standard Terms of Engagement shall be sent to the client, or their representative, within 24 hours of receipt of the instruction.

2.1.2 Where a Chartered Surveyor, or their firm, has a website openly accessible to the public, then their standard Terms of Engagement shall be posted therein and the client, or their representative, shall be directed to view the terms on the website.

2.1.3 Where practicable, the Terms of Engagement shall be emailed to the client, or their representative, within 24 hours of receipt of the instruction.

2.1.4 Where practicable, the Terms of Engagement shall be sent by fax to the client, or their representative, within 24 hours of receipt of the instruction.

2.1.5 It shall be deemed to be good practice for the Chartered Surveyor, or their firm, to furnish their standard Terms of Engagement with referring parties (e.g. local solicitors, lenders, etc., with their valuation commissions once received). A note of receipt of these terms should ideally be sought.

3. This advice is approved by the RICS Appraisal and Valuation Standards Board and RICS Scottish Residential Faculty Board.

UK appendix 13
Valuation of registered social housing providers' stock for secured lending purposes

1 Introduction

1.1 This appendix provides guidance on the additional matters that should be taken into account by valuers undertaking valuations for registered social housing providers' stock for secured lending purposes. Its provisions also apply to valuations of registered social housing providers' interests in property in shared ownership.

1.2 In this appendix references to the 'client' are to the lender, which will normally issue its valuation instructions. However, the provisions apply equally if an registered social housing provider requests a valuation for secured lending.

2 Identifying the property

2.1 The valuer first needs to agree with the client whether the stock is to be valued as a single portfolio or in lots, which could be individual dwellings. If the stock is not to be valued as a single portfolio, the client must be made aware that the aggregate of the valuations provided may differ from the price that could be achieved if some or all of the properties were sold as a portfolio, or if a large number were placed on the market concurrently for sale individually (see also GN 3, Valuations of portfolios and groups of properties).

2.2 Particular care is necessary to establish the nature of the housing provider's interest(s) to be valued. Restrictions and encumbrances (for example, Section 106 agreements, right to buy and nomination rights) are common. Planning consents may include restrictions upon occupation or its tenure. Obviously the valuation must reflect the terms of any shared ownership leases.

3 Extent of inspection

3.1 Where the stock to be valued comprises a large number of similar properties, or a number of estates or blocks, each of which comprising similar properties, the valuer must agree with the client whether every property will be inspected or, as is more usual, whether sample *inspections* should be completed. In such case, the valuer will assume that these are representative of those properties that have not been inspected. The extent of each sample *inspection* (for example, internal and external, external only or front elevation only) must also be agreed.

3.2 Where the *inspection* will be of a sample only, the extent of the sampling and the method of its selection must be agreed with the client. If the valuer subsequently considers that the extent of the *inspection* is not adequate for the purpose of the service, the client must be advised accordingly and further instructions agreed before reporting.

4 Basis of value

4.1 *Market value* will be subject to existing tenancies. Unless the client specifies to the contrary, a *special assumption* should not be made that dwellings vacant at the *valuation date* have been re-let to tenants in the registered social housing provider's target group. Instead, they should be valued with vacant possession.

4.2 A valuation on the basis of *market value* should reflect any intention that the valuer considers a prospective purchaser would have to raise the rents. If the valuer expects to make this *assumption*, the potential impact of this on the value of the security should be drawn to the client's attention.

4.3 Existing use value for social housing (EUV–SH) is defined in UKVS 1.13, Valuations for registered social housing providers. Its use is appropriate in secured lending valuations, as it assumes that the properties will continue to be let as social housing and that any vacant dwellings will be re-let to tenants in the registered social housing providers' target group.

5 Calculations of worth

5.1 The client may also require the valuer to provide a calculation of *worth* on the *assumption* that the lender was in control of the security following default by the borrower. In this case client's potential rights (for example, whether it will be entitled to sell vacant dwellings, or where tenants' rights to buy exist), along with its willingness and ability to raise rents and sell dwellings that become vacant, will be relevant.

5.2 The client may also be interested in receiving, and hence will specify, a return which is to be adopted through the discount rate used in the calculation of *worth*. *Special assumptions* such as this must be stated in the report.

5.3 Where a calculation of *worth* is provided, an opinion of *market value* or EUV-SH should be provided concurrently.

6 Developments

6.1 Where security of a proposed development or a development in the course of construction is being considered for lending purposes, it will normally be appropriate to provide both a valuation of the property in its current condition, and a further valuation on the *special assumption* that the development will be completed in accordance with the plans and specification provided. In establishing the current value the valuer will need to determine what information is available on the anticipated development costs, and the extent to which these may be relied upon by the valuer.

7 Reporting

7.1 The report should contain, in addition to those matters listed in VS 6.1, as many of the following additional matters as appropriate in the circumstances:

- a statement of the average rents being charged for each dwelling and tenancy type, and a comparison of these with the valuer's assessment of the level of rents that could be obtained if the properties were let unfurnished on the open market;
- a statement as to the existence of nomination rights;
- an explanation if there is an exceptionally high number of vacant dwellings;
- an appreciation of the strength of demand for the dwellings, both let at the level of rents charged, or to be charged, by the registered social housing provider and if offered for sale with vacant possession, along with any known factors likely to significantly affect these strengths;
- a statement where the valuation(s) reported has been affected by the existence of an unimplemented planning permission for change of use or other development, or by the prospect of such consent(s) being available, with advice as to the amount(s) of the increase reported as a consequence;
- an opinion as to whether over the period contemplated for the loan, material changes, in real terms, in the necessary level of expenditure are likely to be required;
- the valuer's opinion of the property as a lending security, including implications relating to the ability to realise the security in the event of default, bearing in mind the length (which will be stated) of the term of the loan contemplated by the client, and assuming that the borrower will maintain the property in a reasonable state of repair; and
- a statement as to the valuation method(s) adopted, and an indication of the extent to which the valuer has been able to consider comparable market transactions. The yield, the principal inputs (where a discounted cash flow method is used), *assumption*s and discount rate adopted must be stated.

8 Liaison with lenders

8.1 The British Bankers' Association, the Council of Mortgage Lenders and RICS regard it as important that the lender and the valuer develop a close working relationship in respect of valuation and appraisal, especially in more complex cases, to ensure that the service provided by the valuer reflects the lender's needs and that the lender fully understands the advice which is being given.

UK appendix 14 Affordable rent and market rent

1 Introduction

1.1 This appendix provides background information on the regulatory system in England related to affordable rent and guidance to the valuer on the application of the basis of *market rent* for this type of property. The additional requirements set out in paragraphs 3 to 5 are of mandatory application.

2 Background

2.1 Affordable rent is designed to:

- maximise the delivery of new social housing by making the best possible use of constrained public subsidy and the existing social housing stock; and
- provide an offer which is more diverse for the range of people accessing social housing and an alternative to traditional social rent.

2.2 Affordable rent falls within the definition of social housing in section 68 of the *Housing and Regeneration Act* 2008 (and, in particular, the definition of low cost rental accommodation in section 69 of the Act). Affordable Rent properties will therefore be subject to regulation by the social housing regulator (currently the TSA) where they are provided by a registered provider.

3 Status of the valuer

3.1 The regulations neither specify that the valuer should be professionally qualified, nor require the valuation to be made by a valuer independent from the landlord. However, where the valuer is a *member* of RICS attention is drawn to paragraph 1 of the commentary to VS 1.2. Where the valuer is an employee of, or is in any way associated with, the registered provider, then details of such relationship are to be clearly stated in the report to comply with VS 6.1(i).

4 Basis of value and assumed tenancy terms

4.1 The regulations refer to 'gross market value'. This term is taken to be the same as *market rent* as defined in VS 3.3, having regard to the following assumed tenancy terms:

- The tenancy is assumed to be a 12-month assured shorthold tenancy (AST) on market terms, unfurnished but with appliances, carpets and curtains, with an expected right for the tenant to ‘hold over’ or renew the tenancy.
- The rent is inclusive of any service charges (the *assumption* being, that these are paid by the landlord). If this is not the case the rationale should be explained.
- As long as they do not conflict with the aforementioned *assumptions* the general tenancy terms should reflect those usually applied in the private sector.
- The condition of the property is only taken into account in so far as it impacts the rental value.

5 The property

5.1 The extent of the property being valued should be clearly stated.

5.2 Where the valuation is for a proposed new development, reference to the plans should be clearly stated within the report. The *assumptions* on the quality of specification, and compliance with planning approvals and development control requirements, should also be disclosed.

5.3 Where an existing property is being valued, a summary of the condition of the property should be included within the report to the extent that it impacts the rental value.

5.4 All *assumptions* about the property should be stated.

6 Method of valuation

6.1 The comparison method of valuation evidence is expected to be the most likely approach to be adopted, with evidence obtained from the private rented sector. Where other methods are adopted they are to be specified in the *terms of engagement*, together with confirmation that the client has no objection.

6.2 The method of valuation and justification for its use should be stated within the report.

6.3 Where the landlord owns a large number of properties it is acceptable to provide valuations on a sample, or beacon, basis. In such case the valuer must clearly identify the types of property within each sample or beacon.

7 Analysis of comparable market evidence

7.1 Details of comparable evidence should be included in the report, together with the evidence drawn from these cases.

7.2 Some market information is publicly available, but published and website database information must be used with caution and with the full knowledge of how and from where it is derived. While databases may be useful to providing a general background to values, they may not be sufficiently comprehensive by themselves to provide enough data for an accurate valuation.

7.3 Details of all comparable evidence, including any adjustments made to reflect the differences between the terms of letting and the valuation requirements, should be kept on file and sources of comparables noted in the valuation report.

7.4 The HCA's comment on the difficulty in identifying comparables in certain circumstances is stated in the 2011–15 Affordable Homes Programme – Framework as follows:

> Housing for vulnerable and older people often includes a range of services to support the particular needs of the client group. When setting an Affordable Rent, the gross market rent comparables should be based on similar types and models of service provision.
>
> Where there are insufficient comparables for similar types of provision in the local area, valuers should be requested to identify comparables from other areas, and extrapolate their best view of the gross market rent that would be applicable in the location in which the property is situated.

7.5 Comparables may be more difficult to identify in rural areas, or for specialist supported housing being provided for a particular client group. Where rental evidence of comparable types of property is not available from within the immediate locality, then a wider market area should be used. The valuer will need to use professional knowledge and judgment in order to apply the evidence to the subject property. Comment should be made on similarities and variations in the comparable market and how they affect the valuation. Sometimes evidence may be completely lacking, in which case the valuer may be forced to consider an alternative method of valuation

UK guidance notes

UKGN 1 Land and buildings apportionments for lease classification under IFRS

1 Introduction: the accounting principles

1.1 The purpose of this *guidance note* is to provide assistance to valuers on the various matters that arise from the application of IAS 17, *Leases*.

1.2 This guidance is written with specific reference to UK leasing practice and markets.

1.3 This *guidance note* was originally published as Valuation Information Paper 9 in 2006. Apart from revising the commentary on the classification of the land element of leases that arises from an amendment of IAS 17 in January 2010, there have been no fundamental changes to the original text.

1.4 It is common for items of property, plant and equipment used by a business to be leased rather than purchased outright, as this gives the entity (the term used for the business preparing the *financial statements*) lower entry costs and potentially greater flexibility. Leased assets are generally treated as belonging to the lessor, and therefore do not appear on the balance sheet of the lessee.

1.5 In some cases, however, the rent payable under a lease can be seen simply as payment by instalments for the purchase of the leased asset, including an interest charge. Such a lease is termed as 'finance lease'. In this situation, the underlying asset is classified as belonging to the lessee and appears on the balance sheet of the lessee as an asset, with the corresponding rent outgoings capitalised and shown as a liability (see paragraph 1.6).

1.6 Leases that are more of a temporary arrangement, where the rents can be best seen as a payment for a short-term right to use the asset, are recognised as 'operating leases'. These are accounted for as assets on the balance sheet of the lessor, and the lessee merely presents the periodic rental charge in the profit and loss statement, with future rent liabilities disclosed in the notes to the accounts.

1.7 This *guidance note* does not address in detail the accounting treatment of finance and operating leases. However, under an operating lease the annual rent charge is shown in the profit and loss statement. Under a finance lease, the rent is divided between an interest charge (shown in the profit and loss statement) and a charge for the repayment of the capital. The lessee's accounts will also usually show an annual depreciation charge on the asset.

1.8 *IFRS* requires all leases to be accounted for in accordance with IAS 17, which is not just concerned with land and buildings, but with all leased items such as plant and equipment. The difficulties raised by leases of land and buildings are recognised, and some guidance is given in the standard on how to deal with these asset types.

1.9 Land and buildings are usually traded in the market as a single unit – the land supports the buildings and the buildings cannot be used independently of the land. Leases in the UK are drawn up on this basis, and the valuation process does not differentiate between the two elements. Nevertheless, *IFRS* treats these elements as 'separable' and a separate accounting treatment may be required. This might lead to a requirement for separate valuations of the two elements and, more directly, an apportionment of the rent payable between them.

1.10 A split of rentals is required for two reasons. First, it will help determine the classification of the lease (as it relates to each element) as either a finance lease or an operating lease. Where it has been classified as a finance lease, the split of rentals will be used to calculate the amounts to be included in various parts of the *financial statements*.

1.11 It is the responsibility of company directors to determine lease classification in consultation with their accounting advisers. The directors may ask valuers for advice ranging from advising on elements of the classification routines described in this *guidance note*, to undertaking a full detailed quantitative test for lease classification, including the calculation of the amounts to be included in the *financial statements*. Valuers are advised only to provide these services if they have an adequate understanding of the accounting concepts involved.

1.12 As illustrated in Table 1, the classification of a lease for an asset (which would either be the land or the buildings in the case of *real estate*) can have a significant impact on what is presented in the *financial statements*.

2 Accounting guidance

2.1 IAS 17 requires all leases to be classified as either a finance lease or an operating lease, depending on the substance of the transaction, and not by its legal form. A finance lease is defined as 'a lease that transfers substantially all the risks and rewards incidental to ownership of the leased asset to the lessee' (IAS 17, paragraph 4). An operating lease is a lease 'other than a finance lease'.

2.2 When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance lease or an operating lease by applying the tests outlined in paragraphs 2.6 and 2.7.

Table 1: Lease classification

Party	Operating lease	Finance lease
Lessor *financial statements*	• The asset will be held on the balance sheet as (usually) an *investment property*.	• A financial asset is recognised on the balance sheet as representing the right to receive lease payments and the entity's interest in the residual value of the property.
	• Rental income is recognised in the income statement over the lease term, and depreciation may be charged against the asset.	• Rental payments are allocated between the repayment of the financial asset and interest income (which is recognised in the income statement).
Lessee *financial statements*	• The asset is not recognised on the balance sheet.	• The asset is recognised on the balance sheet initially at an amount equal to the lower of its *fair value* or the present value of the minimum lease payments.
		• A liability to make future payments, equal to the lower of the *fair value* of the asset or the present value of the minimum lease payments, is recognised on the balance sheet.
	• Lease payments paid are recognised in the income statement over the lease term.	• The asset will be depreciated.
		• Interest expense is recognised in the income statement.

2.3 In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life. Consequently, most leases of land are normally classified as operating leases, unless the practical effect of the lease is to transfer the risks and rewards. This would apply if, for example, the lease is longer than 99 years or the lessee is expected to acquire title to the land (because it can be bought at a favourable price). In addition, if the land value is insignificant, there is no need to account for the land and buildings assets separately and the classification of the buildings will be paramount.

2.4 Therefore, under IAS 17 unless title to the land is expected to pass to the lessee, the lessee is not considered to receive 'substantially all the risks and rewards of ownership' of the land. This is a clear instruction within the standard, despite the fact that substantially all the value of the land might pass to the lessee at the inception of a long lease.

2.5 The classification of the buildings element is often less straightforward. However, in many cases it is possible to determine that the lease of the building is an operating lease at a qualitative level without performing detailed calculations. The underlying test is not financial (IAS 17 does not state any threshold apportionments of value), but depends on the transfer of risks and rewards having regard to the substance of the transaction, rather than the form of the lease contract.

2.6 IAS 17, paragraphs 10 and 11, provide examples of situations that 'would normally' indicate that a lease is a finance lease. These are (in the order as they appear in the standard):

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, for it to be reasonably certain at the inception of the lease that the option will be exercised;

(c) the lease term is for the major part of the asset's economic life 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.

2.7 In addition, the following circumstances are described as situations that 'could also' indicate a finance lease:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the *fair value* of the residual accrual to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than *market rent*.

2.8 Paragraph 12 of IAS 17 states that the examples and indicators in paragraphs 10 and 11 (see paragraphs 2.6 and 2.7) are not always conclusive. If it is clear from other features of the lease that it does not transfer substantially all the risks and rewards incidental to ownership, the lease is classified as an operating lease.

2.9 Most of these tests are primarily factual and objective, and should not be difficult to apply. The exceptions are 2.6(c) and (d).

2.10 With regard to 2.6(c), there is no definition of what is meant by 'the major part of the asset's economic life'. Some auditors interpret this to mean a lease term that is at least 75% of the asset's remaining economic life at the inception of the lease, but the standard offers no further guidance. Building lives are a matter of judgment, so this test is unlikely to be conclusive in isolation. An appropriate test might be to ask whether the building would be redeveloped or re-let today if it currently was at the age and in the condition predicted for the end of the lease term. If a refurbishment might be envisaged (perhaps retaining the structure and frame, but rebuilding the walls, roof and services), then the estimate of the residual value should take account ofwhich elements would be retained.

2.11 Under 2.6(d), there is similarly no definition of what is meant by 'substantially all' of the *fair value*. The company directors and their accounting advisers will need to interpret this test in the context of the advice provided to them by the valuer. In due course a certain percentage might become established practice. Certainly, if the value of the lease interest in the buildings comes close to 90% of the freehold value or more, then the lease would likely be classified as a finance lease, unless there is persuasive evidence to the contrary.

2.12 If the qualitative tests (excluding 2.6(d), which is quantitative) indicate an operating lease and a preliminary (non-detailed) consideration of 2.6(d) does not suggest otherwise, then no further analysis is required. If the qualitative tests are not conclusive, then separate valuations of the land and buildings under the lease, as well as an apportionment of the rent, will be required. They will be necessary in order to carry out the test under 2.6(d) and to determine the figures to be included in the *financial statements*. The remainder of this *guidance note* will focus on this subject matter.

3 Definitions

3.1 Certain terms are used in IAS 17 for which definitions are not provided. Phrases that may seem familiar to valuers may have different meanings than expected. The following expressions (defined in IAS 17, paragraph 4, and reproduced in quotes) are used with the meanings provided in the following paragraphs. Valuers should refer to IAS 17 for the full list of definitions.

3.2 ***Fair value*** is 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'. In the context of IAS 17, the *fair value* of the leased asset or interest will normally be its *market value* as defined in VS 3.2.

3.3 **Asset** normally refers to the property out of which the lease is created. In valuation terms, this would be the freehold in the land or the buildings. IAS also uses the term **leased asset** (though it is not defined).

3.4 A **lease** is an 'agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time'. It is the substance of the agreement that is important, not its legal form. An agreement can be a lease in accounting terms that would, however, not be considered a lease under UK law.

3.5 The **inception of the lease** is the 'earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease'. This would usually be the date when the heads of terms are agreed or the date of the lease. The inception of the lease and the commencement of the lease term refer to the original lessor and lessee's situation, not that of the current parties if the lease has been assigned. There may be practical difficulties in ascertaining some dates that are many years after the event, but the date of the lease and the stated commencement date are usually sufficient for lease analysis.

3.6 The **commencement of the lease term** is the 'date from which the lessee is entitled to exercise its right to use the leased asset'.

3.7 The **lease term** is the 'non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option'.

3.8 **Contingent rent** is the 'portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. future changes in market rents, percentage of future sales, amount of future use, future price indices, future market rates of interest)'.

3.9 **Minimum lease payments** are 'the payments over the lease term that the lessee is or can be required to make, excluding contingent rents, costs for services and taxes to be paid by and reimbursed to the lessor together with:

1 for a lessee, any amounts guaranteed by the lessee or any party related to the lessee (for example, another group company); or
2 for a lessor, any amounts guaranteed to the lessor by:
   (a) the lessee;
   (b) a party related to the lessee; or
   (c) a *third party* unrelated to the lessor that is financially capable of discharging the obligations under the guarantee'.

In addition, if the lessee has an option to purchase the asset at a price that makes it reasonably certain at the inception of the lease that the option will be exercised, then the minimum lease payments will be the rent payable up to the date when the option can be exercised, plus the option payment. The 'minimum lease payments' include any premium paid as consideration for the granting of the lease.

3.10 **Residual value** is the term used in *IFRS* for the value the asset will have at the end of its useful life. **Useful life** is the period over which the entity currently holding the asset expects to use it, which can be contrasted with economic life (see paragraph 3.11). For valuations undertaken in the context of IAS 17, residual value is considered to be the discounted reversion value of the leased asset – that is, the estimated value of the leased asset at the end of the lease term discounted back to the inception of the lease. (The terms 'residual value' and 'reversion value' are virtually synonymous in the context of IAS 17. Where this *guidance note* refers to a specific concept within IAS 17, the term 'residual value' is used. Where the discussion is on more general valuation issues, the term 'reversion' is used.)

3.11 **Economic life** is (for land and buildings) the period over which an asset is expected to be economically usable by one or more users. This is not necessarily the same as the physical life, as it can take into account when a building is likely to be redeveloped due to changing economic circumstances, or because of technical obsolescence.

3.12 The **interest rate implicit in the lease** is 'the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the *fair value* of the leased asset and (ii) any initial direct costs of the lessor'. Residual value here refers to the leased asset, which is usually the buildings element of the freehold reversion value. The *fair value* of the leased asset would normally mean its *market value*.

3.13 The **lessee's incremental borrowing rate of interest** is 'the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, with a similar security, the funds necessary to purchase the asset'.

3.14 The terms **land** and **buildings** are not defined in IAS 17. These are familiar terms to valuers, but when used in an accounting context should not be interpreted too literally. IAS 17 assumes that all the features and qualities of a parcel of *real property* that contribute to its value can be grouped under two categories: 'land' and 'buildings'. Further, there is the implicit *assumption* that the sum of the values of these categories equals the value of the parcel of *real property*. Value might be affected by many features, such as location, architectural merit, lease structure, covenant and sunk finance costs.

3.15 It is possible to construct arguments that value relies on matters other than 'land' and 'buildings', and that the sum of the parts does not necessarily add up to the whole, but they are not relevant to this discussion. IAS 17 instructs valuers to apportion the value of a leased asset into two parts, labelled 'land' and 'buildings', and therefore by definition the two combined will equate to the whole.

3.16 The 'land' category is best defined as those elements that contribute to the value of *real property* and do not depreciate or reduce in a systematic way over time or usage. 'Buildings' is best defined as everything else. 'Land' therefore has an indefinite value, while 'buildings' needs to be accounted for as a wasting asset. In practice, 'buildings' will include, for example, the physical structures on the land, plus the sunk finance costs, developer's profit and perhaps the lease value, all of which will depreciate to zero if the land is cleared of all built structures. 'Land' will include the location factors, as well as the physical ability and the legal right to use and construct improvements upon the site.

4 The process of lease classification

4.1 Land and buildings are considered separately for lease classification. Financial calculations are only required to assist in the classification process for borderline leases. Subsequently, these calculations are used for producing the various figures required for reporting purposes if the lease of either element is determined to be a finance lease.

4.2 The lessor and lessee do not have to classify the lease in the same way. For example, if the lessor had the benefit of a guaranteed residual value from a party unrelated to the lessee, then this would affect the lessor's lease classification, but not the lessee's.

4.3 In terms of *IFRS*, the value of an asset comprising land and buildings that have been leased has four elements:

- the value within the lease of the buildings;
- the value within the lease of the land;
- the residual value of the buildings; and
- the residual value of the land.

4.4 Although most UK leases are drawn up on the *assumption* that the buildings will be yielded up to the landlord at the end of the term in good repair and ready for re-letting, the reality is that some buildings are redeveloped rather then re-let. In financial terms, the lessor may not be concerned with the value of the buildings (as opposed to the value of the land as a development site) at the end of the term when agreeing to grant a lease. If the reversionary value of the buildings is not important at the inception of the lease, many accountants will consider that the buildings have been 'bought' by the lessee. This would create a finance lease, whatever the form of the lease and covenants.

4.5 Where there are rent reviews during the non-cancellable term and these rent reviews are expected to take effect, it might be perceived that the benefits of an increase in the value of the asset during the term still accrues to the lessor, indicating an operating lease. However, if the rent reviews are upwards only and the initial rent is set at a high enough figure and lasts for a long enough term, such that these rent payments alone could 'pay for' the buildings regardless of the contingent element, this would indicate a finance lease.

4.6 The valuer may be asked to carry out classification appraisals on long lease terms without unusual review provisions, where the economic life test might be passed and the effects of declaring a finance lease need to be considered.

4.7 The following information is needed from the valuer by those who prepare accounts regarding leases of land and buildings for classification under the test in paragraph 2.6(d) to determine the asset and liability figures to be shown in the accounts:

- the freehold value of the asset that has been leased, split between the buildings and the land;
- the value contained within the lease, again split between the buildings and the land;
- the allocation of the minimum lease payments under the lease between the buildings and the land; and
- the calculation of the interest rate implicit in the lease.

Table 2

Process	Description	Land element	Buildings element	Total	Commentary
1. Assess the freehold value of the land and buildings				2,500,000	Carry out a valuation of the investment *See section 5*
2. Apportion the freehold value between the value within the lease and the residual (reversion) value	Lease value Residual value Total			1,843,000 657,000 250,000	Deduct the present value of the freehold reversionary interest *See section 6*
3. Apportion the freehold value between the land and buildings		550,000	1,950,000	2,500,000	Deduct land value or buildings (*DRC*) value *See section 7*
4. Apportion the value of the buildings element between the residual value and the value within the lease	Within lease Residual value Total		1,640,000 310,000 1,950,000		Estimate the buildings residual value using expected depreciation, or from the current value of older buildings *See section 8*
5. Apportion the values under the lease		203,000	1,640,000	1,843,000	Deduct the value of the buildings within the lease
6. Apportion the minimum lease payments between the land and buildings (Alternative approach) Sinking fund		19,300 32,700	155,700 116,000 + 26,300	175,000 175,000	Apportionment in the ratio of step 5 values *See section 10* Apportion in the ratio of step 3 values, but allowing for the depreciating nature of the buildings
7. Calculate the interest rate implicit in the lease	Freehold value Residual value Minimum lease payments Implicit interest rate		1,950,000 310,000 155,700 6.99%		Work out the discount rate that, when applied to both the lease payments and the residual value, gives the present value of the leased asset *See section 11*

4.8 Table 2 illustrates the main steps the valuer will need to take. The figures are drawn from Example 1 (see section 13). Although this is not a finance lease, it is used to illustrate the method and how the calculations would be carried out as if it was a finance lease.

5 The value of the freehold interest

5.1 The value of the freehold interest is the *market value* of the property (land and buildings combined) as an investment, determined in the normal manner in accordance with VS 3.2.

5.2 Most leases will have been agreed as arm’s length transactions, and therefore the *market value* of the asset at the inception of the lease can be readily determined.

If a premium has been paid for a lease, this is to be included as part of the minimum lease payments. However, the valuer may consider that the *investment value* arising out of the lease is not the same as the *market value* (i.e. *fair value*) of the leased asset. If so, the valuer is advised to assess the true *fair value* of the asset so that the difference between the created *investment value*, or actual sale price, and the underlying *fair value* can be accounted for separately in the accounts. This might occur when, for example, there is a clear case of a *special purchaser* or through a sale and leaseback transaction which is known to be at a non-market rent.

5.3 This is borne out by the particular rules that apply to sale and leasebacks (IAS 17, paragraphs 58 to 66). Clearly these allow for the possibility that the money paid by the investor/lessee under a sale and leaseback may be in excess of the normal *market value* of the leased asset. In these cases, where there is a clear indication that a non-market price has been reached as a result of a sale and leaseback, the valuer will have to carry out the test outlined previously in paragraph 2.6(d). For this test, the valuer compares the sale and leaseback lease payments with the true *market value* of the asset, assuming a normal lease (having regard to the market at the time) and a *market rent*. When defining the difference between the sale and leaseback price and the true *market value*, the valuer might consider the following factors:

- **Yield:** sale and leasebacks may be arranged across a number of properties at the same time, giving the investor greater security by spreading the property risk. The yield may also be determined by the financial strength of the vendor/lessee. Either of these factors might alter the price paid above or below the true underlying asset value, especially if the price paid is an apportionment of a larger transaction. The valuer should apply a market yield having regard to the normal covenant expected for properties of a similar nature.
- **Rent:** the rent paid under a sale and leaseback transaction might be related to affordability rather than current *market rents*. The *market rent* is to be used when estimating the true *market value* of the asset.
- **Lease terms:** if the lease term is unusually long, or other covenants have been written into the lease that would not be considered normal in the marketplace and that have affected the price paid, then the price paid may need adjustment to reflect ‘normal’ lease terms in the prevailing market. For example, there might be a rent escalator provision linked to a financial index as opposed to *market rents*.
- **Lease incentives:** the *investment value* of a property at the inception of the lease might be affected by a rent-free period or other incentives that have been granted to the lessor. Such provisions would not usually apply to a sale and leaseback transaction, meaning the price paid might be raised.

5.4 The valuer needs to be sure that any atypical lease terms that have been identified have affected the price paid. Otherwise, there is no need to use an alternative market value in the test outlined in paragraph 2.6(d). While the ‘true’ *market value* is required for lease classification, once the lease is classified this value is only used again if the lease is an operating lease. If a finance lease results, then the asset is not deemed to have changed hands and any excess amount of the sale proceeds over the carrying amount of the asset is deferred and amortised over the period of the lease (IAS 17, paragraph 59). Under an operating lease, any amounts above or below *fair value* (as opposed to carrying amount) have to be identified because these are treated separately in the accounts.

6 Residual value

6.1 The residual value of the property (the land and buildings combined) for the purposes of lease classification can be estimated using the freehold value of the property in the condition anticipated at the end of the lease term, but in the market prevalent at the inception of the lease, and then deferring this over the term certain of the lease. This will be the shorter of the lease term or the period to the first break (unless it is reasonably certain the break will not be exercised).

6.2 The suggested means of doing this is to apply the single rate years purchase (YP) for the lease term at the valuation yield to the minimum lease payments (usually the current rent payable), and deduct this from the freehold value. Mathematically what is left will be the part of the freehold value that is not dependent on the contractual rents payable under the lease.

6.3 Care is required if the current buildings are known to be a sub-optimum use of the land, so that the land reversion is inflated by the expectation of redevelopment. The valuer should make sure all of this element of value is included in the residual, thus diminishing the value within the lease. These circumstances are unlikely at the inception of the lease and, in any event, suggest the buildings will be held under a finance lease (see Example 8 in section 13).

6.4 Normally this residual value is split between the land and buildings elements at this stage, as shown earlier in Table 2 (see paragraph 4.8). The lessor of a finance lease of buildings will show in its balance sheet a financial asset equal to the net investment in the lease (the discounted value of the lease payments plus the unguaranteed residual value). The land and buildings components of the residual value will therefore appear as different assets, and the valuer must distinguish between them accordingly. This apportionment is also required in order to calculate the interest rate implicit in the lease for the buildings element.

6.5 This apportionment could be done in one of two ways. The first is to estimate the remaining economic life of the buildings at the end of the lease term, and then apply this as a ratio to the current *depreciated replacement cost* (*DRC*). This is a simple and robust method that can be easily understood by the reader of the valuer's report. An alternative is to estimate what the building might be *worth* if it was already at the age and in the condition expected at the end of the lease, but using the market conditions as at the lease inception date. For example, if the lease of a new property was for 40 years, the value of a comparable 40-year-old building today and the redevelopment value should be considered. Any margin between those two elements would become the residual value of the buildings.

7 Apportioning the values between land and buildings

7.1 All calculations are carried out as at the inception of the lease, as defined previously in section 3.

7.2 The apportionment can be done by finding the value of the land and treating the remaining value as attributable to the buildings, or vice versa.

7.3 If the buildings are valued as the remainder after deducting the known value or a development appraisal (see paragraph 7.4) of the land, this presents few problems for the valuer. Frequently, however, evidence of land values is not available, but the situation varies depending on local market practice and conditions.

7.4 If a development appraisal of the land is carried out using the existing development, in effect the calculation is the same as using the *DRC* of the buildings (see paragraphs 7.6 to 7.9). If the freehold value would be affected by a different development in highest and best use, this development value could be used provided it is treated only as part of the residual value (see paragraph 6.3). Again, the same result might be obtained more easily by taking the current development cost of the buildings and depreciating it heavily to reflect the expected redevelopment at the end of the lease term.

7.5 If the buildings have to be valued, this is usually done based upon their *DRC*, which is not the same as the fire insurance reinstatement cost. Instead, the value required represents the remaining utility value of the buildings, having regard to their age and condition at inception of the lease and current construction techniques, not simply their reinstatement cost. However, the initial stage of the process is similar.

7.6 The valuer first estimates the gross rebuilding cost of the buildings. As the valuer is concerned with value and utility rather than reinstatement, the costs should be for a modern equivalent structure of the same utility, rather than the reproduction costs. The value should take into account factors that add to the prestige and attractiveness of the building and therefore its value, but should not necessarily seek to reproduce every feature in a like-for-like manner.

7.7 Professional and carrying (finance) costs should be added to the building costs and any non-recoverable tax. This is because these costs would have to be incurred when constructing the buildings, and the value of these costs is lost once the building reaches the end of its economic life. They therefore attach to, and depreciate with, the buildings. Costs that need to be considered include:

- professional fees;
- developer's profit (see paragraph 7.8);
- interest charges;
- VAT; and
- acquisition costs.

7.8 The developer's profit is judgmental. It is believed that this item should be allowed for if, under the normal scheme of procurement for the asset, this cost would be incurred in the market at the inception of the lease. For example, if the asset is the supermarket unit in a shopping centre, it is not possible to construct this unit except as part of a larger scheme. This would involve a developer who would need a return. In contrast, an owner-occupied and self-constructed building on leased land might not involve any *third-party* developer. However, even in this situation there may have been internal costs that should be correctly capitalised to arrive at the true cost of procuring the building.

7.9 The gross building costs then need to be depreciated having regard to the situation and condition of the buildings at the inception of the lease. This should also reflect the difference between the modern equivalent building that has been costed and the remaining utility of the existing structures. A new building might not require any depreciation, while older buildings are usually depreciated having regard to their original estimated economic life, adjusted for maintenance and repairs, compared with their estimated remaining economic life.

8 Land and buildings residual values

8.1 This is the part of the process that is most likely to cause difficulties for valuers and their clients.

8.2 It might be assumed that if a direct valuation of the land is used, the same value could be used as the end of lease value and discounted to the inception of the lease. In practice, this is unlikely to produce the right figure because the yield rates used in valuations are growth implicit, and most of that growth will apply to the land, not the buildings. Therefore, at the end of the lease the land will have a value that reflects the then optimum development of the site, involving issues such as technological development, changing tenant requirements and revised planning restrictions. It is impossible to predict these changes, and so mathematically there is a good reason to adopt a lower discount rate for the land element if the current land value is used to calculate the residual value of the land at lease expiry, as compared with the buildings. Implicitly, the discount rate on the land would be lower than the valuation yield for the whole property. The difficulty is that there is unlikely to be any objective basis by which this revised discount rate can be calculated.

8.3 It is therefore simpler to estimate the residual value of the buildings by applying a depreciation adjustment to the value of the buildings at the inception of the lease, than to estimate the land residual value. While it might not be clear how long the economic life of the buildings might be, at least a reasoned estimate can be made, thus making the adopted figure more transparent and reliable.

8.4 The building's residual value (in current market prices, as required by IAS 17) can be estimated using a straight-line deprecation over the expected economic life, and applying a depreciation factor proportionately to the relative durations of the lease term and the economic life. Alternatively, if the current value of an older building is known, the amount of depreciation can be calculated if it is assumed that all of the fall in value as the building ages should be attributed to the buildings.

8.5 In section 13, Examples 2 and 3 show how these calculations might be carried out.

9 Minimum lease payments

9.1 Minimum lease payments include only those rent payments that can be quantified absolutely at the inception of the lease, as well as any premiums or capital sums payable as part of the agreement.

9.2 Any increase in the rent payable following a review to market rental value is a contingent element and not included in the minimum lease payments. If the rent cannot reduce on review, then the initial rent is included until the end of the lease term or earlier expected date of determination. If there is an upward or downward review, then the entire rent after the review date is treated as contingent and is not included in the minimum lease payments. In practice, a lease with regular upward or downward rent reviews cannot be a finance lease because the lessor retains the risk of rental value changes. Minimum lease payments would not extend beyond a break clause unless it was reasonably certain the break would not be exercised.

10 Apportioning the minimum lease payments

10.1 IAS 17 states that 'the minimum lease payments are allocated between the land and the buildings elements in proportion to the relative *fair values* of the leasehold interests in the land element and the buildings element' (paragraph 16). The allocation of the minimum lease payments, simply by reference to the relative *fair values* of the land and buildings, would not reflect the fact that land often has an indefinite economic life and therefore would be expected to maintain its value beyond the lease term.

10.2 In contrast, the future economic benefits of a building are likely to be used up, at least to some extent, over the lease term. Therefore, the lease payments relating to the building could be reasonably expected to be set at a level that would enable the lessor not only to make a return on initial investment, but also to recoup the value of the building used up over the term of the lease. IAS 17 confirms that the allocation of the minimum lease payments should be weighted to reflect their role in compensating the lessor, and not mechanically by reference to the relative *fair values* of the land and buildings (see IAS 17, 'Basis for Conclusions', BC 9 to BC 11).

10.3 The simplest way of achieving this weighted allocation of the minimum lease payments is to apportion the rent. This should not be apportioned by reference to the freehold relativity of the land and buildings values, but by the ratio of the values within the lease. As the net present value of the buildings residual value has been reduced by applying a depreciation factor before discounting it, the result is that the buildings element in the lease has been increased, as compared with the proportion of the freehold value attributed to the buildings. Therefore, applying the leasehold value apportionment to the rent produces a realistic weighting to reflect the depreciating nature of the buildings.

10.4 Alternatively, the rent could be apportioned simply by reference to the ratio of the freehold values of the land and buildings, and then adding a sinking fund element to the buildings allocation that would explicitly allow for the wasting nature of the leased buildings. The term used would be to the expected lease termination date (either the full term or an earlier break date, if this is expected to be exercised). The sinking fund would be calculated to replace that element of the buildings value used up during the lease term. This would be the difference between the buildings freehold value at the inception of the lease and the undiscounted residual (reversion) value at the end of the term.

11 Discount rate (interest rate implicit in the lease)

11.1 The implicit interest rate can be calculated using discounted cash flow (DCF) techniques or by a formula in spreadsheet applications. The discount rate needs to be applied to both the minimum lease payments allocated to the buildings and the buildings residual value, such that the net present value of both elements equals the freehold value of the buildings at the inception of the lease.

11.2 IAS 17, paragraph 16, implies that the interest rate implicit in the lease (or the lessee's incremental borrowing rate) can be applied to the allocated minimum lease payments to test whether the net present value equates to 'substantially all' of the *fair value* of the leased asset. These calculations reveal a certain circularity in the lease classification process because for leases of land and buildings (unless the lessee's incremental borrowing rate is used), the interest rate will depend on the prior calculation of the residual value.

11.3 For high land value locations, such as a high street, the minimum lease payments could possibly equate to the freehold value of the buildings over relatively short terms, if a high enough proportion of the payments are allocated to the buildings (see Example 5 in section 13). In these situations, it is worth considering the payments apportioned to the land element to decide whether they, in fact, give a realistic return on the land element. If the land return is similar to the buildings return (see Examples 4 and 6 in section 13), then it is more likely the buildings should be classified as held under a finance lease.

11.4 Once all the aforementioned values have been obtained, the company will decide on the lease classification and, if a finance lease is determined, on the allocation of the rent between the interest charge (in the profit and loss account) and the payment for the leased asset.

12 Listed buildings

12.1 UK planning law dictates that certain buildings are protected from development or substantial alteration through having a historic or architectural significance. There is a presumption in law that these buildings will be maintained and will effectively have an indefinite economic life. However, there are circumstances under which redevelopment is permitted.

12.2 Certain listed buildings (those of the greatest importance) can be treated as if they will never be redeveloped, and therefore a lease of such buildings, or part of them, will qualify as an operating lease. This applies for the same reason that the land element is usually an operating lease: the lease term is a temporary arrangement when compared with the economic life of the building.

12.3 Even when the listed building is considered not to be of particular importance, such that at least a partial redevelopment might be envisaged at some time in the future, it would be appropriate to assume a long remaining economic life at the inception of the lease that is at least the length of a new modern building. Only longer lease terms would pass the economic life test in paragraph 2.6(c).

12.4 When calculating the construction cost of listed buildings, the valuer should take into account the features of the building giving rise to its listed status and presume these features and the materials used would have to be identical to the existing structure. It would not be appropriate to cost a modern equivalent building with the same utility. The depreciation factor applied will need careful consideration, and guidance can be found in GN 6, Depreciated replacement cost method of valuation for financial reporting.

12.5 Listed buildings whose the features give rise to their listed status are relatively unimportant in relation to the building as a whole (for example, the façade or certain rooms within the structure) are often redeveloped around these features. In these cases, it may not be appropriate to make significant changes to the lease classification considerations because the building is listed, especially if development work has already been carried out on the structure.

13 Examples

13.1 The following examples are intended to illustrate how the calculations might be performed and to address difficulties that might arise. All calculations for these examples are given together at the end of this *guidance note*.

13.2 Example 1

13.2.1 This is a provincial office building that is newly constructed and let under a 20-year upwards only, full repairing and insuring (FRI) lease. It was leased at £175,000 per annum with no rent-free period. The rent has been treated as the expected market rental value, and therefore the freehold value is calculated at £2.5 million using a standard YP approach. The buildings have an estimated rebuilding cost of £1,950,000, which includes fees and profit. While there is little doubt that this is not a finance lease under the economic life test, this example serves to illustrate the judgments that the valuer will be required to make.

13.2.2 In this example it is assumed that there are no readily available comparables that give a direct land value for the analysis, so the *DRC* of the buildings has been used to apportion the value between the land and buildings.

13.2.3 The building costs include fees, unrecoverable VAT and the developer's profit. It is considered normal in the particular location for this property for developers or property companies to carry out developments and then sell them into the market. Although a company could self-develop a property, it is most unlikely for them to do this unless they have a particular property expertise. In that event, it might be appropriate to consider capitalising internal costs such as managers' time, so the final figure might not be very different.

13.2.4 The residual value of the buildings at the end of the lease term has been estimated using simple straight-line depreciation.

13.2.5 The results show that even though the lease term is only for 20 years, 84% of the present value of the buildings element is included in the value of the lease. Using undiscounted values this figure falls to 40%, reflecting the 30 years of continued economic life after expiry of the lease term anticipated at the inception of the lease.

13.2.6 The rent has then been apportioned in the same ratio as the land and buildings values under the lease, with 89% of the rent allocated to the buildings. When compared with the freehold values, this gives a return of 8% on the freehold value of the buildings, but only 3.5% on the land. The discrepancy and relatively low returns again suggest this is an operating lease.

13.2.7 The interest rate implicit in the lease has been calculated exactly the same as the property yield (7%). This is as expected, because the calculations have all been predicated on the yield and no external adjustments (such as applying a known land value) have been made.

13.2.8 The alternative calculation shows the effect of using the freehold relativities for the rent apportionment, and then applying a sinking fund to recover the buildings value consumed over the term of the lease (£770,000). The calculations do not give quite the same answer, as the freehold analysis inevitably applies a higher land value and the calculation is sensitive to the sinking fund accrual rate. The discrepancy between the two approaches diminishes for longer lease terms (see Examples 4 and 6).

13.3 Example 2

13.3.1 This example is the same as Example 1, but with the residual value taken from market evidence of the value of older buildings. The difference between the value of the new property and the 20-year-old property is £830,000. For the sake of simplicity, it is assumed that this entire diminution applies to the buildings. Therefore if the cost of construction today is £1,950,000 (including fees, profit and interest), then the value of the 20-year-old building will be £1,120,000 at today's prices. The rest of the calculation is much the same as for Example 1.

13.4 Example 3

13.4.1 Again, this is very similar to Example 1 but with a known land value applied to calculate the buildings value at the inception of the lease. Therefore, there is no need to calculate the building costs, but the residual value of the land and buildings is still most easily calculated by applying a depreciation factor to the buildings value. The alternative is to use the estimated land value at the end of the lease term and discount this. However, this calculation is difficult because investments in land are purchased in the expectation of capital value growth in the land over the lease term. Therefore, either a rate of growth has to be assumed in the land value over the lease term, or the discount rate has to be reduced to reflect this. This leads to subjective adjustments that are best avoided.

13.5 Example 4

13.5.1 This is the same as Example 1, but with a much longer lease term. The rental return on the lease values is much higher than in Example 1 (especially on the land) and much closer to the implied return on the freehold values, but the interest rate implicit in the lease has not changed.

13.5.2 This example might be considered to create a finance lease on the buildings element because of the length of the lease term. However, if the lessee's increment borrowing rate is applied and is higher than 7%, then the allocated minimum lease payments would not equate to 'substantially all' of the *fair value* of the buildings.

13.6 Example 5

13.6.1 This property is a high street shop, where the buildings cost is relatively low compared to the value of the freehold land and buildings. The relative returns on the land and buildings are similar to Example 4, despite the lease term being only 20 years. Mathematically, therefore, the value test in paragraph 2.6(d) will be 'passed' much earlier than for properties with a lower relative land value, leading to the possibility of a finance lease with shorter lease terms.

13.7 Example 6

13.7.1 This is the same as Example 5, but with a longer lease term. The implicit interest rate is again unchanged, but the return on the land and buildings elements has converged, as with Example 4.

13.8 Example 7

13.8.1 This is a detached restaurant in an edge-of-town retail and leisure park. It is a simple single-storey structure that can be built cheaply, but uncertainty over future rental movements means that the lessee has agreed to a compounded fixed rent escalator of 3.5% per annum.

13.8.2 As this is a fixed rent increase, these additional payments form part of the minimum lease payments for classification analysis. This has two notable effects: first, the interest rate implicit in the lease is much higher than in the earlier examples, which is a strong indication that the buildings lease could be classified as a finance lease. Secondly, the interest charges are implicitly higher than the rent payable for the early years of occupation.

13.8.3 This is an example of an atypical lease structure, which means the lessee does assume the risk of variations in the value of the leased asset. The rent does not change if the value of the property changes over the lease term. Therefore, provided the lease term is long enough, a finance lease is indicated for the buildings.

13.9 Example 8

13.9.1 This example is for an older industrial property already midway through its expected economic life and let for 20 years at £50,000. The rebuilding cost is similar to the current value of the building, but after allowing for depreciation at 50%, there is still a significant value on the land.

13.9.2 The remaining estimated economic life of the building at the inception of the lease is equal to the lease term, even though it is only for 20 years. The values and implicit interest rates also suggest a finance lease has been created for the buildings. While this might appear illogical for an FRI lease, the original lessor and lessee are anticipating (at inception of the lease) that the buildings will be redeveloped at the end of the lease term. Even though this might not happen, it would be reasonable to assume the lessor is not relying upon the buildings element having a significant residual value.

Example 1: DRC on buildings cost, using expected life of buildings

Description	Detached office building in provincial town		
Tenure	Lease date	21-Jan-00	*inception of the lease*
	Term commencement	21-Oct-99	
	Term	20.00	years
	Lease expiry date	21-Oct-19	
	Rent review date(s)	21-Oct-04	and every 5 years
	Basis of rent review	Market Rent	
	Rent passing	£175,000	
	Effective term	19.75	years
Valuation	Rent passing	175,000	
	Yield	7.00%	
	Years purchase	14.29	
		2,500,000	(rounded)

Usually at this stage, purchaser's costs would be deducted to arrive at a 'price' in exchange.
However, as 'fair value' includes these costs, this step can be omitted.

Residual Value	Freehold Value	2,500,000	
	Value within the Lease	(1,843,000)	The PV of £175,000 pa for 19.75 years, at 7%
	The residual value	657,000	for both land and buildings

Depreciated Replacement Cost of Building (used when no land values are available)

Gross internal area		1,050.00	
Effective value construction cost		1,200.00	£/m²
Building cost		1,260,000	
Add fees	12.50%	158,000	
Developer's profit	20.00%	284,000	
Acquisition fees	2.00%	34,000	
Capitalised interest	7.5% for 6 months	65,000	
Non-recoverable VAT		151,900	
Total Building cost (rounded)		1,950,000	
Depreciation		0.00%	assuming new building
Effective value of buildings		1,950,000	

Calculation of Buildings Residual Value (using interest rate implicit in the lease)

Depreciated Replacement Cost		
Current construction cost (as above)	1,950,000	
Remaining economic life	49.75	years, being 50 years from completion
Less lease term	(19.75)	
Remaining life at end of lease	30.00	
Buildings residual value (straight line approach)	1,180,000	being £1,950,000 x (30/49.75)
Present value multiplier at IR implicit in lease	0.2632	rounded 6.9932% for 19.75 years
Present value of buildings residual value, say	310,000	
Value under the lease	1,640,000	being £1,950,000 less £310,000
residual value as % of total	*15.90%*	*using net present value*
	60.51%	*using undiscounted figures*

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	1,640,000	88.99%	155,700	7.98%
Land element	203,000	11.01%	19,300	3.51%
	1,843,000		175,000	

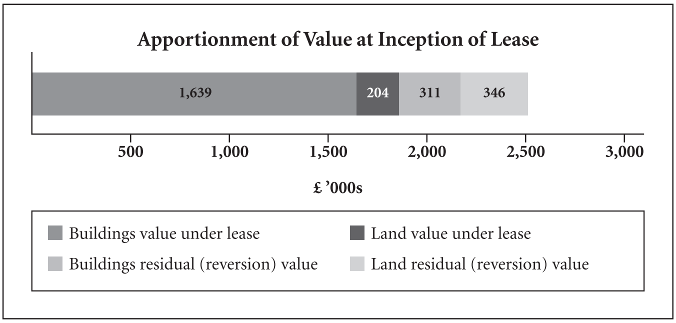
Implicit interest rate (buildings lease) **6.9990%**

UK guidance notes

Example 1: DRC on buildings cost, using expected life of buildings *(continued)*

Breakdown of Net Present Values

Buildings value under lease	1,640,000
Land value under lease	203,000
Buildings residual (reversion) value	310,000
Land residual (reversion) value	347,000
	2,500,000



Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	1,950,000	
Undiscounted buildings value at end of term	(1,180,000)	
Buildings value consumed during term	770,000	39.49%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	26,300	

	Fair Value of Leasehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	1,950,000	136,500	116,000	7.30%
Buildings sinking fund			26,300	
Land element	550,000	38,500	32,700	5.95%
	2,500,000	175,000	175,000	
Implicit interest rate (buildings lease)			**6.2270%**	

Table of Components

	Total	Land	Buildings
Value of Whole Leased Asset (including costs)	2,500,000	550,000	1,950,000
LESS Residual Value	(657,000)	(347,000)	(310,000)
Value of the Lease Elements	1,843,000	203,000	1,640,000
Rent allocation, using values within the lease	175,000	19,400	155,700
Interest Rate Implicit in the Buildings Lease			7.00%
Rental allocation, using FH values with sinking fund	175,000	32,700	116,000
Buildings sinking fund			26,300
			142,300
Interest Rate Implicit in the Buildings Lease			6.23%

Example 2: DRC on buildings cost, using evidence of value for older buildings

Description	Detached office building in provincial town			
Tenure	As per example 1			
Valuation	As per example 1	2,500,000		
Residual Value	As per example 1	657,000		

Value of Old Asset Today

Market rent	125,000	
Yield	7.50%	
	13.33	
	1,670,000	(rounded)
Diminution in Value	830,000	(assumed to be buildings)

Depreciated Replacement Cost of Building

As per Example 1	1,950,000	
LESS diminution in value of 20 year old building	(830,000)	
Effective value of building at end of lease	1,120,000	
Depreciation	42.56%	
Implied straight line life	46.99	years

Calculation of Buildings Residual Value (using interest rate implicit in the lease)

Depreciated Replacement Cost		
Current construction cost (as above)	1,950,000	
LESS diminution in value	(830,000)	
Buildings residual value	1,120,000	
PV multiplier at IR implicit in lease	0.2631	6.9933% for 19.75 years
Present value of buildings residual value	295,000	
Value under the lease	1,655,000	being £1,950,000 less £295,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	1,655,000	89.80%	157,100	8.06%
Land element	188,000	10.20%	17,900	3.25%
	1,843,000		175,000	

Implicit interest rate (buildings lease) **6.9934%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value consumed during term	830,000	42.56%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	28,400	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	1,950,000	136,500	114,300	7.32%
Buildings sinking fund			28,400	
Land element	550,000	38,500	32,300	5.87%
	2,500,000	175,000	175,000	

Implicit interest rate (buildings lease) **6.1553%**

Example 3: Using current land values

Description	Detached office building in provincial town		
Tenure	As per example 1		
Valuation	As per example 1	2,500,000	
Residual Value	As per example 1	657,000	
Land and Building Values			
	Land area	0.04	hectares
	Price	13,750,000	per hectare
		550,000	value of land within freehold
		1,950,000	value of buildings within freehold

Having derived the buildings element in the freehold value, the calculations proceed as per example 1 – Calculation of Buildings Residual Value

Example 4: Long lease with upwards only rent reviews

Description	Detached office building in provincial town		
Tenure	As per example 1		
	Rent passing	£175,000	
	but with an effective term of	44.75	years
Valuation	As per example 1	2,500,000	
Residual Value	Freehold Value	2,500,000	
	Value within the Lease	(2,379,000)	The PV of £175,000 pa for 44.75 years, at 7%
	The residual value	121,000	for both land and buildings

Depreciated Replacement Cost of Building (as before)

Effective value of buildings	1,950,000	as per example 1

Calculation of Buildings Residual Value

Current buildings value	1,950,000	
Remaining economic life	49.75	years, being 50 years from completion
Less lease term	(44.75)	
Remaining life at end of lease	5.00	
Buildings residual value (straight line approach)	200,000	being £1,950,000 x (5/49.75), rounded
PV multiplier at IR implicit in lease	0.0485	6.998% for 44.75 years
Present value of buildings residual value	10,000	
Value under the lease	1,940,000	being £1,950,000 less £10,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	1,940,000	81.55%	142,700	7.32%
Land element	439,000	18.45%	32,300	5.87%
	2,379,000		175,000	

Implicit interest rate (buildings lease) **6.9981%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	1,950,000	
Undiscounted buildings value at end of term	(200,000)	
Buildings value consumed during term	1,750,000	89.74%
Accumulation rate	4.00%	
Effective Term	44.75	
Sinking Fund (rounded)	14,600	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	1,950,000	136,500	125,100	7.16%
Buildings sinking fund			14,600	
Land element	550,000	38,500	35,300	6.42%
	2,500,000	175,000	175,000	

Implicit interest rate (buildings lease) **6.8277%**

UK guidance notes

Example 5: Retail unit on institutional lease

Description	High street shop with upper parts in provincial town			
Tenure	As per example 1, except			
	Rent passing	£100,000		
	Effective term still	19.75	years	
Valuation	Rent passing	100,000		
	Yield	6.00%		
	Years purchase	16.67		
		1,670,000	(rounded)	
Residual Value	Freehold Value	1,670,000		
	Value within the Lease	(1,139,000)	The PV of £100,000 pa for 19.75 years, at 6%	
	The residual value	531,000	for both land and buildings	

Depreciated Replacement Cost of Building

Gross internal area		400.00	
Effective value construction cost		1,000	£/m²
Building cost		400,000	
Add fees	12.50%	50,000	
Developer's profit	20.00%	90,000	
Acquisition fees	2.00%	11,000	
Capitalised interest	7.5% for 6 months	21,000	
Non-recoverable VAT		48,213	
Total Building cost (rounded)		620,000	
Depreciation		0.00%	assuming new building
Effective value of buildings		620,000	

Calculation of Buildings Residual Value

Current buildings value	620,000	
Remaining economic life, say	49.75	years, being 50 years from completion
Less lease term	(19.75)	
Remaining life at end of lease	30.00	
Buildings residual value	370,000	being £620,000 x (30/49.75), rounded.
PV multiplier at IR implicit value	0.3158	6.0106% for 19.75 years
Present value of buildings residual value	117,000	
Value under the lease	503,000	being £620,000 less £117,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	503,000	44.16%	44,200	7.13%
Land element	636,000	55.84%	55,800	5.31%
	1,139,000		100,000	

Implicit interest rate (buildings lease) **6.0106%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	620,000	
Undiscounted buildings value at end of term	(370,000)	
Buildings value consumed during term	250,000	40.32%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	8,500	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	620,000	37,126	34,000	6.85%
Buildings sinking fund			8,500	
Land element	1,050,000	62,874	57,500	5.48%
	1,670,000	100,000	100,000	

Implicit interest rate (buildings lease) **5.6990%**

UK guidance notes

Example 6: Retail unit on long lease

Description High street shop with upper parts in provincial town

Tenure	As per example 5		
	Rent passing	£100,000	
	but with and effective term of	44.75	years
Valuation	As per example 5	1,670,000	
Residual Value	Freehold Value	1,670,000	
	Value within the Lease	(1,544,000)	The PV of £100,000 pa for 44.75 years, at 6%,
	The residual value	126,000	rounded for both land and buildings

Depreciated Replacement Cost of Building

As per example 5	620,000	

Calculation of Buildings Residual Value

Current buildings value	620,000	
Remaining economic life	49.75	years
Less lease term	(44.75)	
Remaining life at end lease	5.00	
Buildings residual value	60,000	being £620,000 x (5/49.75),
PV multiplier at IR implicit in lease	0.0736	rounded 6.0047% for 44.75 years
Present value of buildings residual value	4,000	
Value under the lease	616,000	being £620,000 less £4,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	616,000	39.90%	39,900	6.44%
Land element	928,000	60.10%	60,100	5.72%
	1,544,000		100,000	

Implicit interest rate (buildings lease) **6.0048%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	620,000	
Undiscounted buildings value at end of term	(60,000)	
Buildings value consumed during term	560,000	90.32%
Accumulation rate	4.00%	
Effective Term	44.75	
Sinking Fund (rounded)	4,700	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	620,000	37,126	35,400	6.47%
Buildings sinking fund			4,700	
Land element	1,050,000	62,874	59,900	5.70%
	1,670,000	100,000	100,000	

Implicit interest rate (buildings lease) **6.0416%**

Example 7: Long lease with fixed uplifts

Description	Detached single storey unit in retail park		
Tenure	Lease date	21-Jan-00	inception of the lease
	Term commencement	21-Oct-99	
	Term	35.00	years
	Lease expiry date	21-Oct-34	
	Rent review date(s)	21-Oct-04	and every 5 years
	Basis of rent review	3.5% per annum	compounded
	Rent passing	£100,000	
	Effective term	34.75	years
Valuation	Rent passing	100,000	
	Yield	6.00%	
	Years purchase	16.67	
		1,670,000	(rounded)
Residual Value	Freehold Value	1,670,000	
	Value within the Lease	(1,447,000)	The PV of £100,000 pa for 34.75 years, at 6%
	The residual value	223,000	for both land and buildings

Average Contractual Rent (minimum lease payments)

Period	Rent	PV at 8.3321%	NPV
0.75	75,000	0.94	70,631
1.75	100,000	0.87	86,931
2.75	100,000	0.80	80,245
3.75	100,000	0.74	74,073
4.75	100,000	0.68	68,376
5.75	115,927	0.63	73,170
6.75	115.927	0.58	67,542
7.75	115,927	0.54	62,384
8.75	115,927	0.50	57,552
9.75	115,927	0.46	53,126
10.75	134,392	0.42	56,850
11.75	134,392	0.39	52,478
12.75	134,392	0.36	48,442
13.75	134,392	0.33	44,716
14.75	134,392	0.31	41,277
15.75	155,797	0.28	44,171
16.75	155,797	0.26	40,774
17.75	155,797	0.24	37,638
18.75	155,797	0.22	34,743
19.75	155,797	0.21	32,071
20.75	180,611	0.19	34,319
21.75	180,611	0.18	31,680
22.75	180,611	0.16	29,243
23.75	180,611	0.15	26,994
24.75	180,611	0.14	24,918
25.75	209,378	0.13	26,665
26.75	209,378	0.12	24,614
27.75	209,378	0.11	22,721
28.75	209,378	0.10	20,973
29.75	209,378	0.09	19,360
30.75	242,726	0.09	20,718
31.75	242,726	0.08	19,124
32.75	242,726	0.07	17,653
33.75	242,726	0.07	16,295
34.75	242,726	0.06	15,042
Average		0.3286	42,213
Implied rental equivalent			**128,469**

Example 7: Long lease with fixed uplifts *(continued)*

Depreciated Replacement Cost of Building (used when no land values are available)

Gross internal area		750.00	
Effective value construction cost		800.00	£/m²
Building cost		600,000	
Add fees	12.50%	75,000	
Developer's profit	20.00%	135,000	
Acquisition fees	2.00%	16,000	
Capitalised interest	7.5% for 6 months	31,000	
Non-recoverable VAT		72,275	
Total building cost (rounded)		930,000	
Depreciation		0.00%	assuming a new building
Effective value of building		930,000	

Calculation of Buildings Residual Value (using interest rate implicit in the lease)

Depreciated Replacement Cost		
Current construction cost (as above)	930,000	
Remaining economic life	40.00	years
Less lease term	(34.75)	
Remaining life at end of lease	5.25	
Buildings residual value (straight line approach)	120,000	being £930,000 x (5.25/40),
Present value multiplier at IR implicit in lease	0.0620	rounded 8.332% for 34.75 years
Present value of buildings residual value, say	7,000	
Value under the lease	923,000	being £930,000 less £7,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	923,000	63.79%	81,947	8.81%
Land element	524,000	36.21%	46,522	6.29%
	1,447,000		128,469	

Implicit interest rate (buildings lease) **8.3321%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	930,000	
Undiscounted buildings value at end of term	(120,000)	
Buildings value consumed during term	810,000	87.10%
Accumulation rate	4.00%	
Effective Term	34.75	
Sinking Fund (rounded)	11,100	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	930,000	71,543	65,400	8.23%
Buildings sinking fund			11,100	
Land element	740,000	56,926	51,969	7.02%
	1,670,000	128,469	128,469	

Implicit interest rate (buildings lease) **7.6711%**

UK guidance notes

Example 8: Old industrial building

Description	Ageing single storey industrial unit			
Tenure	Lease terms as per example 1			
	Rent passing	£50,000		
	Effective term	19.75	years	
Valuation	Rent passing	50,000		
	Yield	8.00%		
	Years purchase	12.50		
		630,000	(rounded)	
Value from above		630,000		
	Value within the Lease	(488,000)	The PV of £50,000 pa for 19.75 years, at 8%	
	The residual value	142,000	for both land and buildings	

Depreciated Replacement Cost of Buildings

Gross internal area		1,000.00	
Effective value construction cost		350.00	£/m^2
Building cost		350,000	
Add fees	12.50%	44,000	
Developer's profit	20.00%	79,000	
Acquisition fees	2.00%	9,000	
Capitalised interest	7.5% for 6 months	18,000	
Non-recoverable VAT		42,175	
Total building cost (rounded)		540,000	
Depreciation		50.00%	
Effective value of building		270,000	

Calculation of Buildings Residual Value

Current buildings value	270,000	
Remaining economic life	25.00	years, being 50 years from completion
Less lease term	(19.75)	
Remaining life at end of lease	5.25	
Buildings residual value	60,000	being £270,000 x (5.25/25),
PV multiplier at IR implicit in lease	0.2188	rounded 7.9985% for 19.75 years
Present value of buildings residual value	13,000	
Value under the lease	257,000	being £270,000 less £13,000

	Fair Value of Leasehold Assets	Percentage Split	Rent Allocation	Income Rate of Return on FH Value
Buildings element	257,000	52.66%	26,300	9.74%
Land element	231,000	47.34%	23,700	6.58%
	488,000		50,000	

Implicit interest rate (buildings lease) **7.9986%**

Alternative Approach – using freehold apportionment, but adjusted by a buildings sinking fund

Buildings value at start of term	270,000	
Undiscounted buildings value at end of term	(60,000)	
Buildings value consumed during term	210,000	77.78%
Accumulation rate	4.00%	
Effective Term	19.75	
Sinking Fund (rounded)	7,200	

	Fair Value of Freehold Assets	Direct Rent Allocation	Include Sinking Fund	Income Rate of Return on FH Value
Buildings element	270,000	21,429	18,300	6.78%
Buildings sinking fund			7,200	
Land element	360,000	28,571	24,500	6.81%
	630,000	50,000	50,000	

Implicit interest rate (buildings lease) **7.6313%**

UKGN 2 EU directives and regulations relevant to valuation

1. This *guidance note* provides brief information on the various EU directives and regulations that have an impact on valuation.

2. Valuers providing valuations for specific purposes within the EU will normally refer to the regulatory requirements that apply in the relevant country. Those local rules must reflect the framework set out by the directives or regulations. Although it may not be necessary to refer to them directly, valuers should be aware of their relevance and impact. National association *valuation standards* (see VS 1.3), where they have been provided, will set out the relevant local regulatory requirements.

An ‘EU directive’ is a legislative act which member states are required to transpose into national legislation. A directive normally states the desired outcome, but leaves member states with a certain amount of leeway as to the exact rules to be adopted. When adopted, directives give member states a timetable for the implementation of the intended outcome.

An ‘EU regulation’ is directly enforceable in the member states and therefore does not need to be transposed.

3. The four directives in Table 1 are those that provided the original framework for regulation of the *financial statements* of specified entities. Since their introduction they have been amended and revised, and Table 2 lists some of those directives where they affect the valuation requirements. The list of directives in Table 2 is not comprehensive. Table 3 contains brief details of miscellaneous directives and regulations that have an impact on the valuation process.

4. The text of the directives may be obtained from the following web address: eur-lex.europa.eu/RECH_naturel.do. This link is to the search page of the English version of the directives, but links are also provided to all other language translations throughout the EU. These legislative texts are also available from the RICS EU Public Affairs team at +32 (0)2 289 25 34 or publicaffairsbrussels@rics.org.

Table 1: The four main financial directives

Directive 78/660/EEC	**Fourth* Council Directive on the annual accounts of certain types of companies** Sets out the basic requirements for recognition of assets in company accounts of public companies (excluding banks, other financial institutions and insurance companies). Originally provided that valuations should be based on the principle of purchase price or production cost. National law variations to be disclosed (section 7 of the Directive – articles 31 to 42). Method applied (cost/revaluation/replacement) to be noted in accounts.

UK guidance notes

Directive 83/349/EEC	**Seventh* Council Directive on consolidated accounts** Originally, under article 29, valuations were to be provided in accordance with Directive 78/660/EEC.
Directive 86/635/EEC	**On the annual accounts and consolidated accounts of banks and other financial institutions** Effectively applies 78/660/EEC to asset valuations of banks and financial institutions (section 7 – articles 35 to 39).
Directive 91/674/EEC	**On the annual accounts and consolidated accounts of insurance undertakings** Effectively applies 78/660/EEC to asset valuations of insurance companies but allows current value to be on the basis of *market value* on the *valuation date*. Revaluations to be at not more than five year intervals. (Section 7 – Articles 45 to 62.) 'Market value' is defined in this directive as: ... the price at which land and buildings could be sold under private contract between a willing seller and an arm's length buyer on the *valuation date*, it being assumed that the property is publicly exposed to the market, that market conditions permit orderly disposal and that a normal period, having regard to the nature of the property, is available for the negotiation of the sale. Although this definition differs in detail, it is considered that a valuation at *market value* as defined in VS 3.2 will give the same result.

* Fourth and Seventh refer to the fact that these directives are the fourth and seventh directives based on Article 54(3)(g) of the Treaty Establishing the European Community ('Treaty of Rome'), which is under the chapter 'Right of establishment'. Article 54(3)(g) reads:

> 3. The Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular: … (g) by co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and other, are required by Member States of companies or firms within the meaning of the second paragraph of Art. 58 with a view to making such safeguards equivalent throughout the Community.

Table 2: Amendment of the directives in Table 1

Directive 90/604/EEC	**Amending Directives 78/660/EEC and 83/349/EEC as concerns the exemptions for small and medium-sized companies and the publication of accounts in ecus** Increasing certain monetary thresholds to simplify administrative procedures for small and medium-sized enterprises.

Directive 90/605/EEC	**Amending Directives 78/660/EEC and 83/349/EEC with regard to the scope of those directives** Extension of company types to comply with these directives.
Commission Recommendation 2000/408/EC	**Concerning disclosure of information on financial instruments and other items complementing the disclosure required according to Council Directive 86/635/EEC** Banks and financial institutions are to disclose information according to the annex.
Directive 2001/65/EC	**Amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC with regard to the valuation rules for the annual and consolidated accounts of certain types of companies, as well as of banks and other financial institutions** Allows all valuations under the amended directives to be at *fair value*.
Regulation (EC) 2909/2000	**On the accounting management of the non-financial fixed assets** Provides that for accounting purposes: 'The market value of an asset shall be the price which a buyer would be prepared to pay for it, having due regard to its condition and location and on the assumption that it could continue to be used.'
Regulation (EC) No. 1606/2002	**On the application of international accounting standards** Provides that from 2005 all consolidated accounts of listed companies shall be prepared in accordance with 'international accounting standards', meaning IAS, *IFRS* and Standing Interpretations – Committee-*International Financial Reporting* Interpretations Committee (SIC-IFRIC) interpretations.
Regulation (EC) No. 1725/2003	**Adopting certain accounting standards in accordance with Regulation (EC) No. 1606/2002** Expands the regulation referred to by adopting the *IFRS* and interpretations.
Directive 2003/51/EC	**Amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings** Removes inconsistencies between the four mentioned directives and IAS, and amends them. Allows *fair value* as a *basis of value*.

Directive 2006/43/EC Amended by Directive 2008/30/EC	**On statutory audits of annual accounts and consolidated accounts, amending Directives 78/660/EEC and 83/349/EEC and repealing Directive 84/253/EEC** Establishes rules concerning the statutory audit of annual and consolidated accounts.
Directive 2006/46/EC	**Amending directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC** Technical, non-valuation amendments.

Table 3: Miscellaneous directives and regulations

Directive 2006/123	**On services in the internal market** The directive provides that member states shall respect the right of providers to provide services, which include valuation services, in a member state other than that in which they are established. The member state in which the service is provided shall ensure free access to, and free exercise of, a service activity within its territory. Rules on the limited extent to which the provision of services may be restricted are set out in the directive.
Directive 2006/48/EC Amended by Directives • 2007/18/EC • 2007/44/EC • 2007/64/EC • 2008/24/EC	**Relating to the taking up and pursuit of the business of credit institutions (recast)** The directive is described as 'the essential instrument for the achievement of the internal market from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions'. • introduces the Basel II provisions; • incorporates the IVS definition of *market value*; and • sets out the monitoring requirements and the definition of 'independent valuer … means a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the valuation process'. This recasts Directive 2000/12/EC on this topic.
Directive 2006/49/EC Amended by Directive 2007/23/EC	**On the capital adequacy of investment firms and credit institutions** Links back to the monitoring requirements of 2006/48 but with slight variation. This recasts Directive 93/6/EC on this topic.

Commission Communication 97/C 209/03	**Commission Communication on State Aid Elements in sales of land and buildings by public authorities** This communication gives guidance on the procedure to handle sales of publically owned land in a way that automatically precludes the existence of State Aid. In broad terms, a sale by auction is recommended but if that is not the route taken an independent valuation has to be provided to establish the *market value* of the land. The definition of *market value* is the same as set out in Directive 91/674/EEC as noted in Table 1.

UKGN 3 Valuations for capital gains tax, inheritance tax and stamp duty land tax

1 Introduction

1.1 Valuations for capital gains tax (CGT), inheritance tax (IHT) and stamp duty land tax (SDLT) purposes are based on a statutory definition of 'market value', which is similar to the definition used in these standards. However, the statutory definition has been the subject of interpretation by the Upper Tribunal (Lands Chamber) and higher courts. *Members* should be aware of the differences between the definitions, so that HM Revenue and Customs (HMRC) will not be able to challenge their valuations as being made on an incorrect basis.

1.2 This *guidance note* deals solely with the statutory basis of 'market value' for CGT (including corporation tax on capital gains), IHT and SDLT, and does not cover valuations which may be required for income tax or corporation tax (such as capital allowances). The valuation approach in this *guidance note* is the one that would likely be adopted by HMRC for VAT purposes.

1.3 CGT, IHT and SDLT are complex taxes and *members* should take care to understand the background to the event triggering a potential tax liability before proceeding.

1.4 Further information is available on the HMRC website (www.hmrc.gov.uk), which gives access to the HMRC's internal guidance manuals, and the Valuation Office Agency (VOA) website (www.voa.gov.uk), which gives access to the instructions to district valuers.

1.5 Valuations, which will include apportionments in appropriate cases, for tax purposes are based upon the concept of a hypothetical sale for which a statutory definition is required. The statutory definition and interpretation of market value for tax purposes is not exactly the same as the definition of *market value* used in these standards. While the differences are not always significant, difficulties arise frequently enough to warrant some basic introduction for general practitioners who may encounter such issues only on rare occasions.

1.6 This *guidance note* is based upon interpretations arising from cases that have been determined by the Upper Tribunal (Lands Chamber) or higher courts on appeals made by taxpayers against tax assessments based on the value of property. It is recognised that there may be circumstances where the client wishes to challenge an aspect of the tax calculation, including the interpretation of the statutory basis or the method of valuation. If the valuer is instructed to give valuations on specified *assumptions* which differ from those in this *guidance note*, the procedures in VS 2.1 and VS 2.2 must be followed.

2 Background

2.1 CGT, IHT and SDLT are included in self-assessment procedures where the taxpayer is responsible for calculating the appropriate amount of tax based on the valuations provided by the valuer.

2.2 In the case of individual taxpayers, partnerships and trusts, any CGT calculation will be included in the tax return for the tax year in which the transaction requiring the tax application took place.

2.3 Large companies, on the other hand, pay their corporation tax on any capital gains in advance, by quarterly instalments based on a prediction of their results for that tax year. A large company is one that does not fall in the category of a small or medium sized enterprise (SME) as defined by the European Commission. Its definition of an SME is an enterprise that employs fewer than 250 persons and has either a turnover less than €50 million or a balance sheet total less than €43 million.

2.4 Special provisions apply for groups of companies. Any large company taxpayer with a significant property portfolio is faced with the problem that property transactions may generate large gains or losses which can distort a tax charge. The exact amount of those gains or losses may be dependent on the valuation provided.

2.5 In IHT cases the personal representatives are required to submit an IHT account that identifies all ‘appropriate’ property and its value.

2.6 The valuations used by taxpayers in their tax computations are subject to examination by district valuers on behalf of the HMRC. It is therefore imperative that any valuation used in those tax calculations has been calculated on the statutory basis using best practice.

2.7 If, following discussion with a district valuers, a different valuation or apportionment is agreed or determined and results in a materially different tax bill, a taxpayer could be faced with a claim for interest and, in some cases, additional penalties. Where the taxpayer has paid too much tax, the HMRC may pay interest, although the taxpayer is still worse off because the interest rates are less favourable than commercial rates.

2.8 It is therefore of great importance, when preparing a valuation for taxation purposes, to apply the statutory rules appropriately and have a proper understanding of the basis of market value for taxation purposes.

3 Basis of value

3.1 Definitions for the basis of valuation for CGT can be found in section 272, *Taxation of Chargeable Gains Act* 1992, for IHT in section 160, *Inheritance Tax Act* 1984, and for SDLT in section 118, *Finance Act* 2003.

3.2 These definitions are written in similar terms and broadly define market value as:

> The price which the property might reasonably be expected to fetch if sold in the open market at that time, but that price must not be assumed to be reduced on the grounds that the whole property is to be placed on the market at one and the same time.

3.3 The current statutory definitions for CGT, IHT and SDLT are similar to those used in earlier tax acts. Over the years, case law has established that, in arriving at market value, the following *assumptions* must be made:

- the sale is a hypothetical sale;
- the vendor is a hypothetical, prudent and willing party to the transaction;
- the purchaser is a hypothetical, prudent and willing party to the transaction (unless considered a *special purchaser*);
- for the purposes of the hypothetical sale, the vendor would divide the property to be valued into whatever natural lots that would achieve the best overall price;
- all preliminary arrangements necessary for the sale to take place have been carried out prior to the *valuation date*;
- the property is offered for sale on the open market by whichever method of sale will achieve the best price;
- there is adequate publicity or advertisement before the sale takes place so that it is brought to the attention of all likely purchasers; and
- the valuation should reflect the bid of any *special purchaser* in the market (provided that purchaser is willing and able to purchase).

3.4 Clients will often request a valuation for 'probate purposes', when they actually need a valuation for IHT purposes. When confirming instructions and in the report, the valuer must make it clear that although the valuation is required as part of the procedure for obtaining a 'grant of probate', the *basis of value* will be in accordance with the statutory definition. Valuers should therefore avoid using the term 'probate value'.

4 Analysis of the definition

4.1 The definition of *open market value* for the *basis of value* for CGT or for tax purposes may be broken up into elements that have been defined in case law.

'The price …'

4.2 In *Duke of Buccleuch v IRC* (1967 1AC 506) the price that the property might reasonably be expected to fetch was defined as the gross sale price for the property without deducting any selling costs.

4.3 Furthermore, in *Ellesmere v IRC* (1918 2KB 735) the price was held to mean the best possible price that would be obtainable in the open market, if the property was sold in such a manner (and subject to such conditions) as might reasonably be calculated to obtain for the vendor the best price for the property.

4.4 However, it should not be assumed that the best price is automatically the highest possible price that could be achieved. What is required, in valuation terms, is an estimate of the price that could be realised under the reasonably competitive conditions of an open market on a particular date.

'… the property …'

4.5 In *Duke of Buccleuch v IRC* it was held that the reference to 'the property' was not a reference to the whole estate being valued, but meant any part of the estate that was proper to treat as a unit for valuation purposes. Similarly, in *Ellesmere v IRC*, it was held that the market price was a price based on the separate values of the various parts. It was also indicated that the price must be estimated on the basis that the properties were sold in whatever lot(s) would realise the best price.

4.6 In *IRC v Gray (Executor of Lady Fox decd.)* (1994) it was held that the property must be valued as it actually existed, even if in reality a vendor would most likely have made some changes or improvements before putting it on the market. Although this case referred to variations in the way that the property was held by the parties (rather than physical works), it identified the general principle of valuing the property as it stands at the *valuation date*.

4.7 As a consequence, in preparing any taxation valuation, it is important to have proper regard to the most viable lotting of the property (or properties) to be valued, in order to maximise the overall price. This is effectively a notional marketing exercise, commonly referred to as 'prudent lotting'.

'… if sold …'

4.8 The statutory definition of market value is concerned with a hypothetical sale, not an actual one. As originally held in *IRC v Crossman* (1937 AC 26), and confirmed unanimously in *Duke of Buccleuch v IRC* and in *Lynall v IRC* (1972 AC 680), in arriving at the value it is irrelevant to consider what would have been the circumstances attending an actual sale.

4.9 The price that the property would have actually realised in the open market, or the potential impossibility of putting the property on the market at the *valuation date*, is also irrelevant. In other words, it does not have to be assumed that the property actually had to be sold, as a hypothetical market must be assumed, as at the *valuation date*.

4.10 In *IRC v Gray (Executor of Lady Fox decd.)* it was said that the property must be assumed to have been capable of sale in the open market, even if it was in fact inherently unassignable or held subject to restrictions on sale. The relevant question is what a purchaser would have paid to enjoy whatever rights were attached to the property at the relevant date, assuming a hypothetical sale.

'… in the open market …'

4.11 In *Lynall v IRC* it was held that the property must be valued on the basis of a hypothetical sale between a hypothetical willing vendor (not the actual owner of the property in question) and a hypothetical willing purchaser. The hypothesis used was that potentially no one was excluded from buying (the hypothetical purchaser thus potentially including even the actual owner).

4.12 The statutory definition refers to 'the open market' and not 'an open market'. This has been interpreted to mean a real market made up of real people. In *Lynall v IRC* the open market was regarded as a blend of reality and hypothesis. It was held that the conditions under which the hypothetical sale is deemed to take place should be built upon a foundation of reality as far as possible. However, it was deemed even more important not to defeat the intentions of the statute by an undue concern for reality in what is essentially a hypothetical situation.

4.13 Case law has added additional refinements to the components of the open market and, in particular, to those parties assumed to be active in it. In *Lynall v IRC* it was held that the statute implied that there had been adequate publicity or advertisement before the sale, and that steps had been taken (before the sale) to enable a variety of persons, institutions or financial groups to consider what offers they would be prepared to make.

4.14 However, in *IRC v Gray (Executor of Lady Fox decd.)* it was said that it could not be emphasised too strongly that although the sale is hypothetical, there is nothing hypothetical about the open market in which it is supposed to have taken place. The hypothetical sale envisaged (in order to ascertain the market value for taxation purposes) presupposes a willing vendor and a willing purchaser.

'… at that time …'

4.15 This is defined by statute for the purposes of the valuation exercise in question (for example, in a CGT case it might be 31 March 1982). The *assumption* regarding the definition of the date is that all the preliminary arrangements have been made prior to the *valuation date* so that a hypothetical sale can take place at the statutory point in time. The objective is to ascertain the value of the asset at the prescribed time (and not at any other time), and this can only be achieved by assuming that all preliminary arrangements have been made beforehand.

5 Further interpretation

5.1 As part of the consideration of the definition of market value for tax purposes, the courts have also given guidance on other terms which, although not appearing in the statutory definition, are used in the interpretation.

5.2 A **willing vendor** or **willing seller** is one who is prepared to sell, provided that a fair price is obtained. It does not mean a vendor who is prepared to sell at any price and on any terms. In short, the hypothetical vendor is assumed to be a reasonable and prudent person.

5.3 A **willing purchaser** presupposes that the open market includes everyone who has the will and the money to buy. It has been said that the buyer, like the vendor or seller in paragraph 5.2, must be a person of reasonable prudence.

5.4 A ***special purchaser*** is one who has a particular interest in acquiring a property. The case of *IRC v Clay* (1914 3KB 466) effectively established that where there is a known purchaser in the market who is willing to buy at a considerably higher price than anyone else, then the value of the asset for tax purposes is represented by the higher price the *special purchaser* is willing to pay, or by a close approximation to this.

5.5 In *Walton v IRC* (1995 STC 68) it was held that it was a question of fact – to be decided by evidence – whether or not there were any *special purchasers* in the market and what price they would be prepared to pay.

6 Methods of valuation

6.1 Methods of valuation are not predetermined by statute or by case law. Transaction evidence may reflect the application of a variety of valuation methods, but that does not affect the comparability of the price realised in each case. In practical terms, property assets are valued or appraised by whichever 'method' is most appropriate. Special classes and categories of asset will be valued in different ways because of how 'the market' values them. A presumption of the Lynall case is that the vendor, when advertising the property, will make such information available to purchasers of that type of asset as they would expect to receive, or to be able to access, that information in a normal market transaction.

7 Special cases

7.1 Special situations, such as the valuation for taxation purposes of interests in land that are rarely (undivided shares) or never (unassignable agricultural tenancies) sold in the real world, or apportionments for part-disposal calculations, are beyond the scope of this guidance. Those involved in such matters should study the relevant HMRC and VOA manuals and other guidance. Further help may be obtained from the RICS Valuation Professional Group (valuation@rics.org).

8 Case references

8.1 The following is a list of relevant cases referred to in this *guidance note*:

Duke of Buccleuch v IRC (1967 1AC 506)

Ellesmere v IRC (1918 2KB 735)

IRC v Clay (1914 3KB 466)

IRC v Crossman (1937 AC 26)

IRC v Gray (Executor of Lady Fox decd.) (1994)

Lynall v IRC (1972 AC 680) (This case was heard in a range of courts between 1969 and 1972); see also *Attorney-General v Jameson* (1905 IRR 218)

Walton v IRC (1995 STC 68).

UKGN 4 Inspections and material considerations

1 Introduction

1.1 The commentary to VS 5.1 notes that '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'.

1.2 Unless expressly stated to the contrary in the *terms of engagement*, valuers have an obligation to investigate, consider and report on any material feature that affects a property or its surroundings that could have an impact on value.

1.3 Although there are many issues that can affect the value of a property interest, the degree to which these matters may be addressed by the valuer will often depend upon the purpose of the valuation and the extent of enquiries that would normally be associated with such a valuation. It is acceptable for the valuer to agree with the client in the *terms of engagement* (see Appendix 2, paragraph 2.1(l)) that either no investigation of these matters will be undertaken, or that specific *assumptions* can be made.

1.4 The topics referred to, and the information sources provided, are for guidance only. They should not be regarded as a comprehensive list of all matters that may need to be investigated or reflected in every situation.

1.5 While many information sources are property specific, others are not and only give general information relating to a wider area. The valuer will need to take care in considering the potential impact on the specific property and, where appropriate, make clear the limitations of the information relied upon in the report.

1.6 Under UK legislation, a risk assessment is to be undertaken by a designated competent person who will identify the appropriate action to be taken to counter a potential property hazard. Valuers are not expected to be competent to assess these risks, but are recommended to familiarise themselves with those matters that commonly affect value in the sector or locality in which they practise. Where these are likely to be a factor, valuers will need to discuss with clients whether the matters identified should be subject to an investigation by appropriate specialists, or whether the value is to be reported on the basis of a specific *assumption* about the level of risk.

1.7 In most cases the risk arising from a particular hazard reflects a combination of the physical features of the property and the manner in which the property is utilised by the occupier. Care is to be taken to distinguish between any work that may be required because of the specific way in which a particular occupier utilises a property, and work that would have to be undertaken by any potential buyer in the market.

1.8 Where expert reports have been obtained, the valuer is to consider their effect on the valuation. It is important that the valuer does not offer any explanation or interpretation of such reports in the absence of any personal expertise in the subject.

2 Contamination and environmental matters

2.1 Contamination, or pollution, of land and buildings can be caused by a wide variety of activities both current and historic, and it is not confined to areas that have been used for heavy industrial purposes. It is unlikely that valuers will have the knowledge or expertise to advise on the extent of any contamination present, or any appropriate remedial works.

2.2 Similarly, the impact of environmental matters, particularly mining and flooding risk, will need consideration. Valuers are expected to be aware as to how these issues may impact the property interest

2.3 The RICS *guidance note*, *Contamination, the environment and sustainability: their implications for chartered surveyors* (2010), contains detailed guidance on various issues related to environmental and sustainability. The use of the relevant property checklist provided in the *guidance note* is strongly recommended.

3 Hazardous or deleterious materials

3.1 It is estimated that asbestos, in some form, is present in 1.5 million buildings in the UK, as its use was common until the mid-1980s.

3.2 The *Control of Asbestos Regulations* 2006 requires non-domestic property to have management plans in place. In any building where asbestos is present, the cost of maintenance, alteration and repair can be significantly increased because of the need to take appropriate precautions under the regulations, and this can impact value. It is therefore recommended that all valuers develop an awareness of the types of buildings and construction likely to contain asbestos.

3.3 Depending on the purpose of the valuation, the valuer may have to alert the client of the need to identify or discover:

- the dutyholder;
- the asbestos register; and
- if any management plan is in place, following any specialist asbestos survey.

Valuers are not qualified to interpret or validate the content of any asbestos register, or asbestos management plan, unless they have been specially trained, for example, accredited by National Individual Asbestos Certification Scheme (NIACS).

3.4 The RICS *guidance note*, *Asbestos and its implications for surveyors and their clients* (2011), has been especially prepared for non-specialist surveyors. Its purpose is to assist them in identifying potential problems and knowing when to recommend the appointment of an expert.

3.5 There may be various materials used in the construction of buildings that may be deleterious, for instance, high alumina concrete and calcium chloride cement and, in Devon and Cornwall, mundic. The identification of these requires specialist knowledge, but for more information *members* are referred to the following RICS *guidance notes* (all available on www.rics.org):

- *Building surveys and technical due diligence of commercial property* (2010)
- *Building surveys of residential property* (2004)
- *The 'mundic' problem: Recommended sampling, examination and classification procedure for suspect concrete building materials in Cornwall and parts of Devon* (1997).

4 Disability discrimination

4.1 The *Equality Act* 2010, which came into effect 1 October 2010, largely replaced the *Disability Discrimination Act* 2005 as well as consolidated numerous other anti-discriminatory laws. With regard to disability, the Act imposes a duty on employers and businesses offering a service to the public to make reasonable changes to practices and procedures to enable disabled people to do their jobs. In addition, they must remove or alter any feature that makes it impossible, or unreasonably difficult, for a disabled person to make use of the services provided.

4.2 Disability has a wide definition; valuers should be aware of the potential liability on building owners or occupiers to comply with the Act and its possible impact on the value of the property interest. However, it is important to note that the duty of compliance rests with the occupier. Although physical changes to a property may enable a particular occupier to comply with the Act, so may changes in the way it conducts its business. For further information, the Department for Work and Pensions provides extensive advice on the application of the legislation (visit www.dwp.gov.uk).

5 Fire safety law

5.1 The *Regulatory Reform (Fire Safety) Order* 2005 (SI 2005/1541) requires the 'responsible person' to make a suitable and sufficient assessment of the risks, and to identify the fire precautions required to comply with the Order. The Order applies to all non-domestic property.

5.2 Such fire precautions may include adaptation of the building and installation of fire safety equipment, but in all cases they must include: signage, fire safety action plans, staff training, identifying dutyholders and routine maintenance/monitoring via signed and dated checklists.

5.3 For further information the RICS publication, *The New Fire Safety Legislation 2006: A Practical Guide* (2007), has been prepared for construction and property management professionals outlining their duties under fire safety legislation. Detailed information on the regulations and fire safety in general is available from www.fire.org.uk.

6 Energy Performance Certificates

6.1 In England and Wales the government has implemented the European Energy Performance of Buildings Directive requiring Energy Performance Certificates (EPC) to be made available for all properties, residential and commercial, when bought sold or rented.

6.2 For commercial properties the duty was introduced progressively from 6 April 2008, according to the floor area of the building. From 1 October 2008 an EPC must be made available by the 'relevant person' whenever a non-domestic building is constructed, sold or rented out, subject to certain exemptions. EPCs are valid for ten years.

6.3 The valuer should be aware that the 'relevant person' (such as a prospective landlord or a tenant making an assignment of, or subletting, a non-domestic building) is responsible to make an EPC available free of charge to the prospective buyer, tenant or assignee. Landlords are required to cooperate in providing an EPC if their tenant decides to assign or sublet the premises that are subject to common heating or air conditioning services. More information can be found on the CLG website at www.communities.gov.uk.

6.4 In Scotland the Scottish government via Scottish Building Standards (SBS) Agency is responsible for the implementation of the directive. Generally, all public buildings over 1000m^2 will need to display an EPC, even if they are not being sold or leased. The implementation date for non-domestic EPCs in Scotland when leased or sold was 4 January 2009.

6.5 Domestic (residential) properties that are marketed for sale in Scotland after 1 December 2008 are required to provide an energy report as part of the Home Report (this will generate an EPC). All rented dwellings are also required to have an EPC from 4 January 2009 when they change occupants, although existing tenancies are not affected. An EPC will be valid for ten years. More information can be found on the Scottish government website at www.sbsa.gov.uk.

UKGN 5 Local authority disposal of land for less than best consideration

1 Introduction

1.1 This *guidance note* applies only to local authorities in England and Wales.

1.2 Local authorities have wide land disposal powers under sections 123 and 127 of the *Local Government Act* 1972 and section 233 of the *Town and Country Planning Act* 1990. However, they are required to seek specific consent from the secretary of state where the consideration is less than the best that can reasonably be obtained.

1.3 In England, the *Local Government Act 1972: General Disposal Consent (England)* 2003 removes the requirement for authorities to seek specific consent from the secretary of state for any disposal of land where the difference between the unrestricted value of the interest to be disposed of and the consideration accepted (the 'undervalue') is £2 million or less.

1.4 The detailed valuation requirements are set out in the Technical Appendix to the Consent, which specifically incorporates this *guidance note* and the definition of *market value* in VS 3.2.

1.5 In Wales, the *Local Government Act 1972: General Disposal Consent (Wales)* 2003 removes the requirement for authorities to seek specific consent from the National Assembly for Wales for any disposal of land where the difference between the unrestricted value of the interest to be disposed of and the consideration accepted (the 'undervalue') is £2 million or less.

1.6 The circular accompanying the 2003 Consent provides that the valuer shall have regard to the guidance on local authority disposals of land at an undervalue in these standards.

1.7 The local authority decides whether any proposed disposal requires specific consent, as the secretary of state and the National Assembly for Wales have no statutory powers to advise in any particular case. The valuer may be asked to provide a valuation so that the local authority may consider whether or not an application for consent is necessary, or to support a submission for a specific consent. For either request, valuation must be provided in England following the advice in the Technical Appendix and in Wales following the advice in paragraph 4 of the circular.

1.8 In Scotland, the consent regime is provided by section 74 of the *Local Government (Scotland) Act* 1973. However, this section was amended with section 11 of the *Local Government in Scotland Act* 2003, so that the current ministerial consent regime can be replaced by regulations issued by Scottish ministers. No regulations have yet been made.

2 Basis of value

2.1 The consent requires the valuer to provide the following figures (details of which are given in the proceeding paragraphs):

- unrestricted value;
- restricted value; and
- the value of voluntary conditions.

2.2 Unrestricted value

2.2.1 This is the best price that is reasonably obtainable for the property. It is the *market value* of the land, as defined in VS 3.2, except that it should take into account any additional amount that is, or might reasonably be expected to be, available from a purchaser with a special interest. It should also ignore the reduction in value caused by any voluntary condition imposed by the local authority.

2.2.2 In general terms, unrestricted value is intended to be the amount that would be received for disposal of the property where the principal aim is to maximise the value of the receipt. Apart from the inclusion of bids from a purchaser with a special interest, it is defined in the same way as *market value*. For example, the valuer must take account of any uses that might be permitted by the local planning authority if these were reflected by the market, and not only a use (or uses) intended by the parties to the proposed disposal.

2.2.3 The valuer should assume that the freehold disposal is made, or the lease is granted, on terms which are intended to maximise the consideration. For example, where unrestricted value is based on the hypothetical grant of a lease, at a rack rent or ground rent, with or without a premium, the valuer should assume that the lease would contain those covenants normally included in such a lease by a prudent landlord. The valuer should also assume that the lease would not include unusual or onerous covenants that would reduce the consideration, unless these had to be included as a matter of law.

2.3 Restricted value

2.3.1 This is the *market value* of the property having regard to the terms of the proposed transaction. It is defined in the same way as unrestricted value, except that it should take into account the effect on value of any voluntary condition.

2.3.2 Where the local authority has invited tenders and is comparing bids, the restricted value is normally the amount offered by the local authority's preferred transferee. Otherwise it is normally the proposed purchase price.

2.4 The value of any voluntary conditions

2.4.1 Sales may be subject to voluntary conditions. These are any term or condition of the proposed transaction that the local authority chooses to impose. Voluntary conditions do not include any term or condition that the local authority is obliged to impose, for example, as a matter of statute or a condition that runs with the land. They also do not include any term or condition relating to a matter which is a discretionary, rather than a statutory, duty of the local authority.

2.4.2 Their value is the total of the capital values of voluntary conditions imposed by the local authority as terms of the disposal, or under agreements linked to the disposal, that produce a direct or indirect benefit to the local authority which can be assessed in monetary terms. It is not the reduction in value (if any) caused by the imposition of voluntary conditions, and any adverse effect these may have on value must not be included in this figure.

2.4.3 The proposed disposal, or an agreement linked with it, may give rise to non-property benefits to the local authority. For example, these might include operational savings, or income generated as a result of the transaction where the local authority has an associated statutory duty. The monetary value of these benefits to the local authority should be included in the value of voluntary conditions in the valuer's report.

2.4.4 The valuer will often be able to assess the value of a voluntary condition of disposal to the local authority. However, there may be times where a question arises about the status, in law, of such value (whether or not it is capable of forming part of the consideration). In such cases, the local authority may need to seek legal advice as to whether the value of the voluntary condition is such that it may form part, or all, of the consideration the local authority proposes to accept. Conversely, there may also be cases where a term or condition of disposal is, in law, capable of forming part or all of the proposed consideration, but it has no quantifiable value to the local authority, or its value is nil.

2.4.5 Where the valuer is not qualified to assess the value of any benefits (for example, of share options) the report should make clear the extent to which the valuer accepts liability for the figures. Where the valuer does not accept full responsibility, the report should make clear who was responsible for assessment of the remainder, and copies of any valuations or advice received from accountants or other professional advisers should be annexed.

3 Leasehold disposals

3.1 The valuer is required to assess the unrestricted value in capital terms. The unrestricted value should be assessed by valuing the authority's interest after the lease had been granted, plus any premium payable for its grant. In other words, it will be the value of the right to receive the rent and any other payments under the lease, plus the value of the reversion when the lease expires.

4 Options

4.1 Where a disposal involves the grant of an option, the valuer must consider both the payment for the option and the consideration which might be received, were it to be exercised, as either, neither or both may involve a discount. Paragraphs 19 to 21 of the 2003 Consent provide more detailed guidance on the treatment of options.

5 Discount

5.1 The discount is the amount by which the value of the actual consideration is less than that of the best consideration reasonably obtainable. It is given by the formula:

unrestricted value – (restricted value + value of conditions).

Otherwise, where the value of the consideration for the disposal differs from the restricted value, it is given by this formula:

unrestricted value – (value of consideration + value of conditions).

5.2 The secretary of state must be aware of cases where the proposed consideration is more or less than the value of the interest to be disposed of, subject to the proposed voluntary conditions, so that this can be taken into account when reaching the decision. Accordingly, where the value of the consideration differs from the restricted value, both figures must be given.

6 Purpose of the valuation

6.1 Along with stating the purpose of the valuation, the valuer must provide a summary of the proposed transaction, noting the key terms and any restrictions to be imposed by the local authority. Where the local authority proposes to grant a lease, a copy of the draft lease should be attached to the report. Where this is impracticable, a copy of any heads of terms agreed or a summary of the key terms of the proposed lease should be provided.

7 Assumptions as to planning

7.1 Where there is no detailed scheme, the valuer should make reasonable *assumptions* about the form of the development. This should include a note of the existing use(s), current planning consents and use(s) likely to be permitted with regard to the development plan. Where the unrestricted value has been based on an assumed planning use other than that for which the property has been sold, a detailed explanation of the planning *assumptions* made is required.

8 Tenure

8.1 The tenure must include a note identifying the local authority's tenure and giving details of the purpose(s) for which the land is held (which is normally for the purposes of the power under which it was acquired, or taken on lease, unless it has since been formally appropriated). It must also include a summary of the details of any leases, or encumbrances such as easements, to which the land is subject.

9 Valuations

9.1 The unrestricted and restricted values, together with the value of conditions, should be given. Where any of these is nil this should be expressly stated.

9.2 Where the value of a scheme is less than the development cost (that is, there is 'negative development value'), the advice in paragraph 23 of the 2003 Consent should be followed.

9.3 Where the value of land may be affected by the availability of grants, the advice in paragraph 24 of the 2003 Consent should be followed.

9.4 The *valuation date* should not be more than six months before the submission of the application to the secretary of state.

10 Description

10.1 The report must include a written description of the site and buildings, the location and surroundings. A plan, to which the secretary of state will refer if giving consent and which is sufficiently accurate to identify the land, is also to be provided.

11 Existence of a special purchaser

11.1 The effect on value of the existence of a purchaser with a special interest should be described.

12 The report

12.1 The report must be signed by a 'qualified valuer' (a *member* of RICS).

UKGN 6 Analysis of commercial lease transactions

1 Introduction

1.1 The analysis of comparable transactions and the effect of the value of incentives is only one part of the process of considering the value of a specific property. There is no single correct approach to analysis and, as identified in the examples in the appendix to this *guidance note*, no 'right' answer. Methods may vary depending on the circumstances of individual cases and market practices in different areas and sectors. Changing markets may mean that the approach adopted previously may not be appropriate several years later.

1.2 It is just as important that valuers use their experience of the market and understanding of the differing practices in differing markets when approaching comparable transactions. Through this, they should consider the circumstances of these types of transaction, understand the transaction being analysed and identify the true incentive before adopting a mathematical approach.

1.3 One essential element of any valuation of commercial property is the consideration of its rental value. Although the use of rental value may be different for rent reviews, advising on new lettings or the starting point of a capital valuation (whether for *financial statements*, investment or loan purposes), the underlying principles discussed in this *guidance note* are the same.

1.4 The valuer may be required to establish the *market rent* of the subject property. The assessment of that figure will be informed by the results of the analysis of comparable transactions. *Market rent* is defined in VS 3.3.

1.5 In the case of a rent review, the rent review clause usually contains its own definition, which takes precedence over the *market rent* definition in VS 3.3. In the case of lease renewals under the *Landlord and Tenant Act* 1954, the Act and case law will also take precedence over this definition.

1.6 Any property transaction is a result of negotiations between the parties, but in the field of commercial letting in particular, there can be a combination of factors that may influence either party. In addition, there are varying degrees by which those factors can, individually or collectively, drive the transaction.

1.7 If all lettings in a market were on identical terms, comparing the rents agreed to establish the rent for any property would be straightforward. In practice, letting terms vary considerably, even for similar properties. An essential part of the valuation process is to identify the effect that different terms may have had on the rent that was agreed, and use this when making comparisons between different lettings.

1.8 The purpose of this *guidance note* is to assist valuers in establishing rental value. Evidence of new lettings will generally carry more weight than rents agreed or determined on review. However, new lettings frequently include rent-free periods or other forms of incentive. This *guidance note* explores some of the factors that the valuer may need to consider when assessing the impact of such incentives on the rent agreed and its analysis.

1.9 Openness, transparency and a willingness to share information are of benefit to the market as a whole and are to be encouraged. However, it is recognised that due to commercial sensitivities, lettings of commercial property can be subject to confidentiality clauses, meaning that the available information may be limited. As *assumptions* may have to be made, it is very important that the valuer is closely involved with, and aware of, the workings of the particular market.

1.10 The following terms are used in this *guidance note*:

- **Incentive**: this term embraces any form of incentive, inducement or concession made by either party. The most common examples are capital payments and rent-free periods (subject to paragraph 4.1.3 for fitting-out periods).
- **Headline rent**: this is the actual contracted periodic rental payment under the lease that becomes payable after all the initial incentives or concessions in the letting have ended. It is sometimes referred to as the 'face rent'.
- **Net effective rent**: this is the rent that would be agreed between the parties for a letting of the premises on the relevant terms and conditions, but without incentives forming part of the transaction. In some circumstances, such as where a large premium has been paid to secure the property and part of it is considered to be a rental equivalent, the net effective rent could be higher than the headline rent. The net effective rent is sometimes referred to as the 'equivalent rent'.

2 Motivation of the parties

2.1 The terms upon which prospective landlords and tenants will enter into a commercial lease are influenced by the general and local state of the market at the time that the terms are negotiated.

2.2 The parties may also be influenced by their respective individual objectives, economic circumstances, accounting practices or tax positions even though these are not directly related to the value of the property.

2.3 The motivations for parties offering or accepting incentives will differ with each transaction. A tenant accepting an incentive may have different motivations from the landlord offering them. Moreover, the two parties to a transaction may put different interpretations on their agreement.

2.4 Aside from market conditions and the negotiating strength of the parties, the reasons for, and influences upon, the agreement of incentives include, among others, the following:

- Investor landlords generally seek to hold the property for a combination of rental income and capital growth. They will seek to maintain or achieve a given level of rent and/or length of lease to secure an income stream from a good tenant covenant for a period that will maximise capital value.

- They may be given to facilitate funding, possibly at a more favourable funding rate. The achievement of higher headline rents may be an important factor.
- If the lessor is itself a tenant, its motivation may be different from an investor landlord as it will normally be aiming to mitigate or eliminate its continuing liabilities rather than maximising capital value.
- The taxation, grant and capital allowance positions of the parties may be factors.
- The strength or weakness of the tenant's covenant may be a consideration.
- The actual terms, frequency and nature of rent reviews and the *assumptions* to be made on future rent reviews may have an impact.
- They may ease cash flow for either party. For the tenant, a rent-free period, coupled with a higher subsequent rent, is effectively an unsecured borrowing from the landlord.

3 Impact of the length of the lease and break clauses

3.1 In certain markets the amount of an incentive is directly proportionate to the length of tenant commitment, with larger incentives being payable if the tenant commits to a longer lease. There may also be variations in the preferences of landlords and tenants as to the length of leases.

3.2 Break clauses may have a critical impact on any valuation, depending on whether there is a reasonable possibility that they will be exercised and the terms on which they are capable of being exercised. Break clauses may have a bearing upon any write-off period, and it will normally also be appropriate to reflect their existence in the yield adopted. The likelihood of the break being exercised (whether by landlord or tenant) should be considered.

3.3 It is not necessarily correct to assume that all tenants might be expected to operate a break clause (especially if there is a penalty for its operation). Exercising the break might cause the need to write off fitting-out costs over a shorter period than initially envisaged, which may in turn have to be reflected in an adjustment to the tenant's accounts. The effect of the notice period and the tenant's need to secure alternative premises may also be factors. If alternative premises are secured first, there could be an element of double overheads. Landlord's break clauses, on the other hand, are unlikely to be operated if the rent passing still exceeds the net effective rent, unless other pressures dictate.

3.4 The existence and extent of any penalties payable by either party if a break clause is operated (or extra incentives for the tenant if it is not) will need to be considered, as the valuation is likely to be influenced by these factors.

4 Types of incentives

4.1 Rent-free periods

4.1.1 A rent-free period may occur at the beginning of the lease or at any time during the currency of the lease term. Occasionally, the tenant is required to pay rent for an initial period as evidence of its commitment to the lease, with the free period commencing at some future date.

4.1.2 Rent-free periods may reflect:

- the time required to fit out the property to suit the tenant's needs;
- agreement by the tenant to carry out repairs, or improve the property, which may benefit the landlord;
- commitment from the tenant to pay a higher rent so the landlord maintains rental levels as high as possible; or
- acceptance of specific liabilities or restrictions under the lease.

4.1.3 The principle of granting a rent-free period to reflect the time required for fitting out the property to suit the tenant's reasonable needs is common practice in many markets, therefore it may not normally be regarded as an incentive. It represents a balance between the landlord's need to secure an income from as early a date as possible and the tenant's need not to have a rent liability until the property can be occupied.

4.1.4 What is considered a reasonable length of time for the fitting out will vary according to the extent of the works, the size of the property in question and local market practice. Where specialist fitting out is involved, the time taken may go beyond a normal fitting-out period and an element may not be considered to be part of the reasonable fitting-out period.

4.1.5 In some circumstances, usually by the grant of a licence or following an agreement for a lease, the fitting-out period may begin before the formal commencement of the lease.

4.1.6 Assistance by the landlord with the costs of fitting out (in contrast to the rent-free period to reflect the time taken for the works) may take the form of capital payments to the tenant, or the provision of physical works by the landlord.

4.1.7 When fitting-out works or improvements are carried out as a condition of the grant of the lease, they are effectively a premium payable by the tenant. It is necessary to establish whether such improvements can be reflected in the rent at review.

4.2 Premiums and other capital payments

4.2.1 The consideration of premiums requires care because they rarely show a consistent pattern. A premium could be made up from several elements, which are necessary to establish so that only those elements that are appropriate to be reflected in an adjustment are identified. The timing of payments also needs to be considered, particularly where they are close to new lettings, reviews or renewals.

4.2.2 A payment by the landlord to the tenant is not necessarily an incentive as it may relate to other issues, such as taking on repairing obligations.

4.2.3 A payment by the landlord for the cost of works that improve the property in a way that enhances its rental value may not be an incentive, but merely a change in the nature of the property being let. Premiums can also be cash payments to the tenants at the commencement of (or at any time throughout) the lease term, or they can be payments in kind, such as subsidies or equipment, or tenants' removal/relocation costs.

4.2.4 A premium paid by the incoming tenant to the landlord, or an existing tenant on an assignment of a lease, may reflect the fact that the passing rent is below the current net effective rent. The value of improvements, *goodwill*, a need to be in a particular location or building or the assignee being a *special purchaser* may also be considered in this premium. In addition, the premium may account for special modification of the lease terms tailored for that tenant's particular trading circumstances, or even the benefit of restrictive covenants on other tenants in a development.

4.2.5 The assessment of the true capital cost of these benefits to both landlords and tenants can be problematic, and there may be differing interpretations which include the following:

- The landlord may argue that the whole of the premium represents capitalised profit rent, or it is common in prime locations to find new lettings significantly above reviews or lease renewals.
- The tenant may argue that: treating premiums as capitalised profit rent may result in high figures which cannot be justified by other market evidence; its payment of a premium is solely to obtain occupation that is not related to rental value; or an occupier may be prepared to pay a premium, but would not pay an equivalent amount as rent because of its particular accounting practices.

The validity of these arguments requires careful consideration to establish what proportion (if any) of the premium should be considered to be paid in lieu of rent.

4.3 Stepped rents, rent capping and fixed rent on reviews

4.3.1 Stepped rents and fixed rents are common in sale and leaseback transactions, and in these circumstances they are not an incentive but a reflection of the price of the capital raised by the lessee. However, in an open market letting, these features can be used as incentives and may influence the headline rent.

4.3.2 The period over which rents may be stepped is usually, but not always, within the period to the first rent review. Rents may be capped to a maximum or minimum level, or a range, and may also be linked to factors not directly property related.

4.4 Lease surrenders or take-backs

4.4.1 The landlord may agree to accept the tenant's ongoing liabilities, either partially or in their entirety, in respect of the previous or other premises of the tenant.

4.4.2 The calculation of the benefits to a tenant may consider not only the projected void costs in any existing leases surrendered or assigned, but also the costs of disposal (including legal and agency fees, and any necessary incentives) and any accrued dilapidations or other liabilities.

4.4.3 The landlord may be influenced by its ability or wish to redevelop or refurbish the premises taken back.

4.4.4 Another example might be *marriage value* (or *synergistic value*) accruing to the landlord by taking back the premises. This might influence the valuer to make an upwards adjustment of the rent, rather than discounting it.

4.5 Other incentives

4.5.1 The parties may agree to incentives which may reflect circumstances particular to the letting. These could include concessions in the lease covenants and service charge caps.

4.5.2 The assessment of these incentives may not be straightforward due to the difficulty in obtaining full details of the amounts involved and assessing the real benefits to the tenant.

5 Analysing the transaction

5.1 The purpose of the analysis is to establish the net effective rent having regard to the package of incentives incorporated into the specific transaction.

5.2 There are two primary methods of analysis in common use:

(a) devalue each comparable to a net effective rent and then apply all of them to arrive at one net effective rent for the subject premises, after making appropriate adjustments for differences (for example, in lease length) that might cause the appropriate scale of the incentives, and hence the net effective rent, to differ; or

(b) use the comparable evidence to find the market package (that is, headline rent and incentives) that would be likely to be agreed in the marketplace for the subject premises, and then adjust that transaction to reflect the assumed lease terms. Having arrived at the market package applicable to the subject premises, the net effective rent is then calculated broadly in accordance with one of the methods described in this *guidance note*.

5.3 The treatment of the incentive does not necessarily depend upon its nature. However, the way in which the payment is made and the manner in which the tenant chooses to spend it may have relevance, for example, in terms of accounting or tax implications.

5.4 The valuer may need to decide if the net effective rent is to be calculated including or excluding a rent-free period during which the fitting out works took place. For lease renewals, the legislation (in England and Wales, the *Landlord and Tenant Act* 1954) and associated case law will be relevant in all cases, although the Act is silent on fitting out *assumptions* in its definition of rental value.

5.5 In the case of rent reviews, the lease wording should be checked carefully. There are two possible approaches. The first is to assume that under the hypothetical 'net effective rent deal', the tenant would receive a rent-free period equal to the fitting-out period only. An alternative approach is to assume that the fit-out took place before the start of the lease term.

5.6 As an example, a hypothetical deal has a total rent-free allowance of two years and an assumed fit-out period of six months. In the first approach, the comparison would be between a headline rent deal with two years rent-free and a net effective rent deal with six months rent-free. In the second approach, the comparison would be between a headline rent deal with 18 months rent-free and a net effective rent deal with no rent-free period. It is common for rent review clauses to specify the second approach, which is also the basis adopted in the examples in the appendix to this *guidance note*. However, the calculations could be easily adapted to reflect the first approach.

5.7 The time over which the incentive should be analysed is a much debated point. It will be recognised that the landlord will usually contend for the longest period, such as the full term of the lease, and the tenant for the shortest period, such as the first review. The valuer's decision has to be a judgment between these conflicting claims, having regard to the overall effect of all the incentives, anticipated rental growth, knowledge of the market, motivations of the parties and what, in reality, might be achieved in an open market letting on the hypothetical terms. Tenants will commonly seek to minimise the anticipated rental payments, and the occupier landlord will seek to mitigate the liability. Investor landlords will commonly seek to maximise capital value.

5.8 Devaluation may be calculated on a simple straight-line apportionment, or by using discounting through a discounted cash flow (DCF) or all-risks yield approach. Most landlords and tenants will be aware of the time value of money and discounting may be the likely approach, unless a clear local market practice to the contrary can be established.

5.9 It is arguable that the tax and accounting implications of the incentives, from both the landlord and tenant's point of view, should be taken into account in the analysis. However, for simplicity the effect of taxation and accounting principles has not been reflected in the examples given in this *guidance note*.

6 Methods of analysis

6.1 There are various approaches to the analysis which include, but not exclusively, the four methods outlined in this section. Where data is to be analysed and aggregated for the purpose of constructing market indices, it is important that a consistent approach is taken.

6.2 The choice of method adopted and *assumptions* behind the analysis undertaken is a matter for the valuer in the light of all of the circumstances regarding the problem to be assessed.

6.3 The appendix includes examples to illustrate the various methods.

Method 1: rent and value apportionment not assuming time value of cash flows (straight-line method)

6.4 This is a commonly used general approach that does not take the time value of money into account. However, where the value of the incentive is low in relation to the total rent passing, or where the period over which the inducement is devalued is short, the error caused by ignoring the timing of the rental payments is likely to be considerably less than the range of uncertainty in the assessment of other elements of the transaction.

Method 2: rent and value apportionment assuming time value of cash flow utilising a discount rate or all-risks yield

6.5 This method has the advantage of reflecting the time value of money. However, if an all-risks yield is used, it suffers from the criticism of traditional investment valuation approaches, namely that the use of equivalent yields and current values does not identify the true differences between fixed and variable prospective cash flows from property leases.

6.6 An alternative approach that is often adopted is to devalue the incentive using a discount rate reflecting the borrowing rate (for example, swap rate) plus a margin.

Method 3: comparison by reference to the effect on investment value

6.7 This method would only be applicable to investor landlords. It would not apply to occupier landlords subletting surplus premises.

6.8 The capital value–based analysis presents the problem of the arbitrary nature of the adjustments to all-risks yields. Logically, the initial or equivalent yield applied to an investment let at the net effective rent should be significantly lower than that let at a headline rent, which will probably be ex-growth for a significant period, perhaps even for the entire duration of the lease.

6.9 An investment let at headline rent may initially be over-rented. However, there will often be market evidence of yields for similar properties let on similar terms. These yields will already reflect the market's perception of the additional risk attaching to the over-rented element. Therefore, it will not be necessary to adopt a valuation method that treats this separately.

Method 4: DCF approach which assesses the write-off period by examining the duration of the incentives' effect upon future cash flows

6.10 A DCF approach has the advantages that all the *assumptions* are explicitly stated, and the different prospective cash flows from the net effective and headline rents are fully set out. It is the most logical and therefore defensible approach. However, it is not an approach that is often used in the market when leases are negotiated, except in more valuable and sophisticated transactions. Use of a sophisticated method to analyse a transaction that was agreed overall may be a useful tool for determining the actual performance of an investment in the hands of the owner. However, it may not give an accurate picture of what would happen in an actual market transaction.

Appendix to UKGN 6: Examples of the analysis of incentives

This appendix illustrates and compares the results of analysing a transaction using the methods outlined in section 6. They do not recommend or endorse any particular approach. To illustrate the principles, the examples are highly simplified and thus cannot be used as a model approach to the analysis of a specific lease.

Discount rates

In all of the examples, the following discount rates have been assumed:

- **Equivalent yield**: 6.0% (the investment capitalisation rate)
- **Borrowing rate**: 7.0% (swap rate for the relevant period plus an appropriate margin)
- **Target internal rate of return (IRR)**: 8.0% (investors' typical target IRR, or 'equated yield', for an investment in the property).

Cash flow in advance

In methods 2 and 4, where a DCF concept is adopted, the calculations are presented using a DCF shortcut approach employing years purchase (YP) and present value factors. The YP factors are on a quarterly-in-advance basis on the *assumption* that it is the reality of the rental cash flows. In Example 2 (method 4), the calculation is also set out as an explicit cash flow to demonstrate the equivalence of the methods.

Disregard of the fit-out period

Paragraphs 5.5 and 5.6 of this *guidance note* describe alternative approaches to the disregard of the fit out period. The examples in this appendix all assume that the fit out took place before the start of the lease term. The alternative would be to assume that under the hypothetical deal, the tenant receives a fit-out rent-free period beginning at the start of the lease term. Under this alternative approach, Example 1 (method 1), for instance, would be calculated as £100,000 × 4 years/4.75 years (= £84,211). For this formula, 100,000 × 4 years represents the income received during the first 5 years under the headline rent deal, and 4.75 years represents the income duration where the tenant receives a rent-free period equal to the fit-out period only. All other calculations in the other examples could be similarly adapted.

Example 1

Lease term	5 years
Rent-free period	1 year, including 3-month fitting out period
Headline rent	£100,000 per annum

Method 1: Straight line

Headline rent	£100,000
For 4.25 years (being 5 years less 9 months incentive rent-free)	× 4.25
Value of headline rent	£425,000
Spread over the full 5-year term (assuming no fit out rent-free)	Divide by 5
Net effective rent	**£85,000 p.a.**

Method 2: Calculation reflecting time value of cash flow utilising a money discount rate

Headline rent	£100,000
YP 4.25 years in 0.75 years at 7%	3.54057
Present value of headline rent	£354,057
Divided by YP 5 years at 7%	4.27806
Net effective rent	**£82,761 p.a.**

Method 3: Comparison by reference to effect on investment value

This is not likely to apply to a five-year lease, so the approach will be introduced in Example 2.

Method 4: DCF – calculation reflecting time value of cash flow utilising equated yields and explicit rental growth rates

In the case of a five year term, this would be the same as method 2 since there is no rental growth during the term.

Comparison of results

Method 1 *Straight line*	**Method 2** *Discounted*	**Method 3** *Asset value*	**Method 4** *DCF with growth*
£85,000	£82,761	—	—

Example 2

Lease term	15 years with 5 yearly reviews
Rent-free period	2 years including 3 month fitting out period
Headline rent	£100,000 per annum

For each of the methods illustrated, the calculations show the effect of reflecting the rent-free period (a) to the first review; (b) over a period of ten years; or (c) for the full term of the lease.

Method 1: Straight line

(a) To first review only

Headline rent	£100,000
For 5 years less 21 months incentive rent-free	× 3.25
Value of headline rent	£325,000
Spread over 5 years (assuming no fit out rent-free)	Divide by 5
Net effective rent	**£65,000 p.a.**

(b) Over 10 years

Headline rent	£100,000
For 10 years less 21 months	× 8.25
Value of headline rent	£825,000
Spread over 10 years	Divide by 10
Net effective rent	**£82,500 p.a.**

(c) To end of lease

Headline rent	£100,000
For 10 years less 21 months	× 13.25
Value of headline rent	£1,325,000
Spread over 15 years	Divide by 15
Net effective rent	**£88,333 p.a.**

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Method 2: Calculation reflecting time value of cash flow utilising borrowing rate or target IRR ('equated yield')

(a) To first review only

Headline rent	£100,000
YP 3.25 years in 1.75 years at 7%	2.61370
Present value of headline rent	£261,370
Divide by YP 5 years at 7%	4.27806
Net effective rent	**£61,095 p.a.**

(b) Over 10 years

Headline rent	£100,000
YP 8.25 years in 1.75 years at 7%	5.66390
Present value of headline rent	£566,390
Divide by YP 10 years at 7%	7.32826
Net effective rent	**£77,288 p.a.**

(c) To end of lease

Headline rent	£100,000
YP 13.25 years in 1.75 years at 7%	7.83865
Present value of headline rent	£783,865
Divide by YP 15 years at 7%	9.50302
Net effective rent	**£82,486 p.a.**

In calculations (b) and (c), there is an issue as to appropriate discount rates to be adopted. The existing headline rent is unlikely to grow for some time, so it should be discounted at the 7% borrowing rate, or possibly at the 8% target IRR (equated yield) to reflect property risk. The effective rent will grow and should therefore be discounted at the 6% all-risks yield rate, or maybe even at a lower rate if the 6% applies to an investment let at the headline rent. These difficulties illustrate the drawbacks of this approach, which are addressed by method 4.

The above calculations could be set out as an explicit cash flow. An example of this presentation is given under method 4. The calculation under method 2 would be identical, except that the cash flow for the hypothetical lease would have no rental uplift at year five.

Method 3: Comparison by reference to effect on investment value

The YPs used in this method are annually-in-arrears YPs, since this is intended to represent investment market custom and the 6% cap rate is assumed to be a traditional annually-in-arrears investment yield.

Headline rent	£100,000	
YP in perpetuity at 6% deferred 1.75 years	15.0509	
		£1,505,090
Net effective rent	*x*	
YP perpetuity at 6%	16.6667	
		16.6667*x*
To make these values equal: 1,505,090 = 16.6667*x* Therefore: *x* = 1,505,090/16.6667		
Net effective rent		**£90,306 p.a.**

This reflects the position only from the landlord's viewpoint, but is a valid approach since it is often the maximisation of capital value that drives the rental package sought by a landlord, which is usually looking to maximise the headline rent by granting significant incentives.

There are, however, issues in respect of its application. Since the investment let at the headline rent could be said to be over-rented (in comparison with the net effective rent value), it is arguable that a higher capitalisation yield should be applied. Applying a 6.5% all-risks yield to the capitalisation of the headline rent (and 6% to the net effective rent) reduces the net effective rent to £82,675 p.a.

It is almost certain that a lower capitalisation yield would apply to the hypothetical investment let at the net effective rent, which has considerably greater growth potential than the headline rent. It will often be difficult to obtain market evidence to support the selection of that yield. Sales of similar properties that have recently had their rent reviewed (to the current effective rent) would provide useful evidence. However, there may be a shortage of such evidence in market conditions where there are significant incentives resulting with most reviews being settled at nil increase (under an upward-only review clause).

Method 4: DCF – calculation reflecting time value of cash flow utilising equated yields (IRRs) and explicit rental growth rates

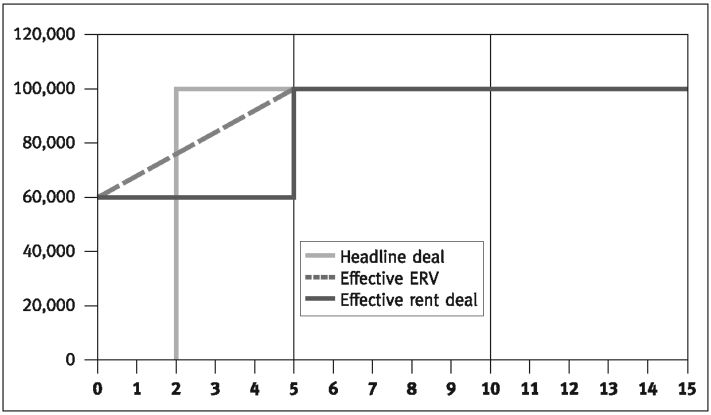
(a) To first review only

Headline rent	£100,000
YP 3.25 years in 1.75 years at 8%	2.53735
Present value of headline rent	£253,735
Divide by YP 5 years at 7%	4.19043
Net effective rent	**£60,551 p.a.**

UK guidance notes

Figure 1

	Effective rent	
	Growth	*£psf*
2005		£28.76
2006	11.0%	£31.93
2007	11.0%	£35.44
2008	11.0%	£39.34
2009	11.0%	£43.66
2010	11.0%	£48.47
2011	0.0%	£48.47
2012	0.0%	£48.47
2013	0.0%	£48.47
2014	0.0%	£48.47
2015	0.0%	£48.47
2016	0.0%	£48.47
2017	0.0%	£48.47
2018	0.0%	£48.47
2019	0.0%	£48.47
2020	0.0%	£48.47



In Figure 1, the light grey line represents the headline rent deal with 1.75 years rent-free (it being assumed that the fit-out was carried out prior to the grant of the lease, so that the fit-out element of the rent-free period is disregarded). The dark grey line represents the effective rent that would have applied if no rent-free had been granted. The method consists of determining the level of net effective rent that makes the areas under the two lines equal (in net present value terms). The dotted line represents the implied growth in net effective rent, starting from the calculated figure and rising, in this case, to equal or exceed the initial headline rent by the time of the first rent review.

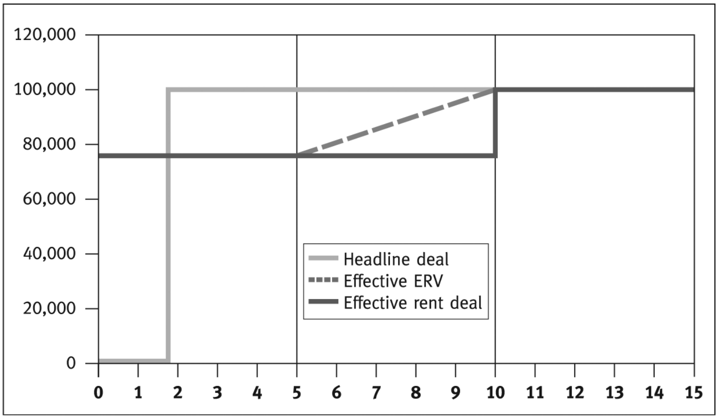
Calculating the net effective rent by comparing cash flows over five years implies that the rent beyond year five has been unaffected by the incentive. However, if the effect of the incentive has been to raise the headline rent to a level above the rent, which would have been established on review at year five, the rent for the second five-year period will also be affected.

Note that the headline rent illustrated here would apply to an open market letting with incentives. It is not the rent reserved by the lease that is the subject of the rent review, which may be materially different and is not relevant to the calculation of the net effective rent. (The effective rents shown in all the charts are calculated using an 8% discount rate, as against the 7% used in the illustration of method 2.)

(b) Over 10 or 15 years, without growth

Figure 2

Effective rent		
	Growth	*£psf*
2005		£36.35
2006	0.0%	£36.35
2007	0.0%	£36.35
2008	0.0%	£36.35
2009	0.0%	£36.35
2010	0.0%	£36.35
2011	6.0%	£38.53
2012	6.0%	£40.84
2013	6.0%	£43.29
2014	6.0%	£45.89
2015	6.0%	£48.64
2016	0.0%	£48.64
2017	0.0%	£48.64
2018	0.0%	£48.64
2019	0.0%	£48.64
2020	0.0%	£48.64

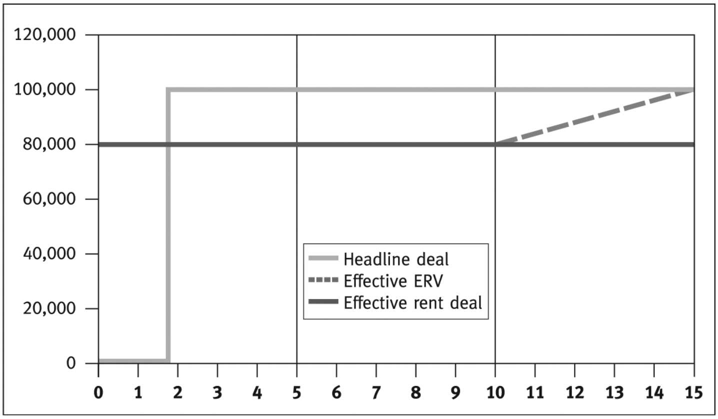


On the other hand, if the incentive is devalued over 10 years (or the length of the lease), this implies that, in the absence of the incentive, the net effective rent level calculated will apply for the whole 10 (or 15) year period. This may not be correct since the rent may well increase at year five (or 10), and this should be considered.

(c) To end of lease, with growth

Figure 3

Effective rent		
	Growth	*£psf*
2005		£38.76
2006	0.0%	£38.76
2007	0.0%	£38.76
2008	0.0%	£38.76
2009	0.0%	£38.76
2010	0.0%	£38.76
2011	0.0%	£38.76
2012	0.0%	£38.76
2013	0.0%	£38.76
2014	0.0%	£38.76
2015	0.0%	£38.76
2016	4.0%	£40.31
2017	4.0%	£41.92
2018	4.0%	£43.60
2019	4.0%	£45.34
2020	4.0%	£47.16

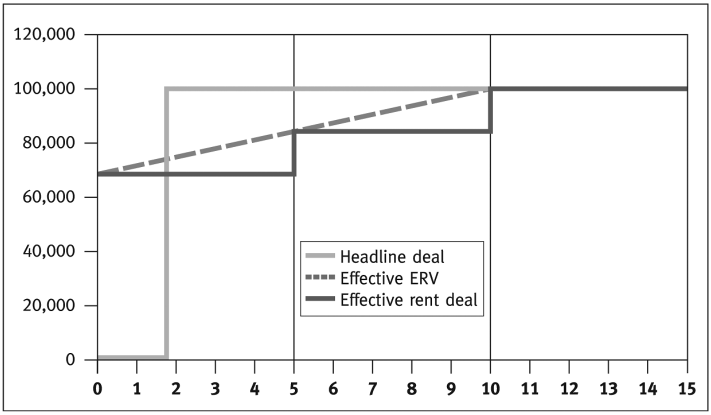


A logical approach, which avoids these pitfalls, is therefore to compare the cash flows arising from the actual deal with those that would arise from a letting at an effective rent, including subsequent rent increases anticipated at review. Assessing the write-off period has therefore nothing to do with opposing philosophies of landlord or tenant; it is a financial calculation according to the circumstances. The larger the package of incentives, the more likely it is that their effect will last beyond the first review.

It is assumed in the following calculation that the effective rent will increase at 3.5% per annum. At that rate of growth, the headline rent would be overtaken at year 10.

Figure 4

Effective rent		
	Growth	*£psf*
2005		£34.46
2006	3.5%	£35.66
2007	3.5%	£36.91
2008	3.5%	£38.20
2009	3.5%	£39.54
2010	3.5%	£40.92
2011	3.5%	£42.36
2012	3.5%	£43.84
2013	3.5%	£45.37
2014	3.5%	£46.96
2015	3.5%	£48.60
2016	0.0%	£48.60
2017	0.0%	£48.60
2018	0.0%	£48.60
2019	0.0%	£48.60
2020	0.0%	£48.60



In practice, it may be more meaningful to estimate the rental level at year five (and year 10 if necessary) by:

(a) forecasting the likely change in headline rent (reflecting normal and/or anticipated cyclical rental change); and

(b) applying the discount between headline and net effective rent, which the valuer believes might apply in the anticipated market conditions at that time.

However, based on a 3.5% compound growth rate in net effective rent, the calculation would be as given in Table 1.

Table 1

Headline rent	£100,000
YP 8.25 years in 1.75 years at 8%	5.38929
Present value of first 10 years of headline rent	£538,929
Net effective rent	x
YP 5 years at 8%	4.19043
Present value of first 5 years at net effective rent	4.19043x
Rental at review in 5 years: $x \times 1.035^5$	1.18769x
YP 5 years in 5 years at 8%	2.85193
Present value of second 5 years at net effective rent	3.38720x
Value of first 10 years of net effective rent	7.57763x
If the value of packages are equal	£538,929 = 7.57763x
Net effective rent	**£71,121**

If the circumstances are such that the incentives will have an effect on the rent beyond year 10, the calculation above will be extended to 15 years, and the appropriate estimated rental values will be adopted at each rent review. Clearly, the effective rent that will apply at years five and 10 is a matter of conjecture. In reality, a willing tenant considering the merits of a net effective rent deal, as an alternative to the actual headline-plus-incentive deal, would weigh up – explicitly or implicitly – what the future rent liability might be in each of the two circumstances. Other factors, such as accounting treatment and short-term availability of cash for fitting out, may also be relevant.

The previous calculation can alternatively be presented as an explicit cash flow over 10 years, as illustrated in Table 2. The method involves finding the net effective rent that makes the net present values of the two cash flows equal.

Table 2

Present value		Headline rent		Net effective rent	
Years	8%	Cash flow	Present value	Cash flow	Present value
0.00	1.00000	0	0	17,780	17,780
0.25	0.98094	0	0	17,780	17,441
0.50	0.96225	0	0	17,780	17,109
0.75	0.94391	0	0	17,780	16,783
1.00	0.92593	0	0	17,780	16,463
1.25	0.90828	0	0	17,780	16,149
1.50	0.89097	0	0	17,780	15,842
1.75	0.87399	25,000	21,850	17,780	15,540
2.00	0.85734	25,000	21,433	17,780	15,244
2.25	0.84100	25,000	21,025	17,780	14,953
2.50	0.82497	25,000	20,624	17,780	14,668
2.75	0.80925	25,000	20,231	17,780	14,389
3.00	0.79383	25,000	19,846	17,780	14,115
3.25	0.77870	25,000	19,468	17,780	13,846
3.50	0.76387	25,000	19,097	17,780	13,582
3.75	0.74931	25,000	18,733	17,780	13,323
4.00	0.73503	25,000	18,376	17,780	13,069
4.25	0.72102	25,000	18,026	17,780	12,820
4.50	0.70728	25,000	17,682	17,780	12,576
4.75	0.69380	25,000	17,345	17,780	12,336
5.00	0.68058	25,000	17,015	**21,117***	14,372
5.25	0.66761	25,000	16,690	21,117	14,098
5.50	0.65489	25,000	16,372	21,117	13,830
5.75	0.64241	25,000	16,060	21,117	13,566
6.00	0.63017	25,000	15,754	21,117	13,308

* Equals top figure × 1.035^5

UK guidance notes

Table 2 *(continued)*

Present value		Headline rent		Net effective rent	
Years	8%	Cash flow	Present value	Cash flow	Present value
6.25	0.61816	25,000	15,454	21,117	13,054
6.50	0.60638	25,000	15,160	21,117	12,805
6.75	0.59483	25,000	14,871	21,117	12,561
7.00	0.58349	25,000	14,587	21,117	12,322
7.25	0.57237	25,000	14,309	21,117	12,087
7.50	0.56146	25,000	14,037	21,117	11,857
7.75	0.55076	25,000	13,769	21,117	11,631
8.00	0.54027	25,000	13,507	21,117	11,409
8.25	0.52997	25,000	13,249	21,117	11,192
8.50	0.51987	25,000	12,997	21,117	10,978
8.75	0.50997	25,000	12,749	21,117	10,769
9.00	0.50025	25,000	12,506	21,117	10,564
9.25	0.49072	25,000	12,268	21,117	10,363
9.50	0.48136	25,000	12,034	21,117	10,165
9.75	0.47219	25,000	11,805	21,117	9,971
			538,929		538,929
	Difference	**0**	**Effective rent 17,780 × 4 = 71,121 p.a.**		

It has been suggested that different discount rates should be applied to reflect the differing security of parts of the cash flows, i.e. that contractual rents are more secure than those dependent on future market conditions. The headline rent is a secure minimum rent and should attract a lower discount rate. The net effective cash flow is more risky.

Alternative approaches have been proposed, such as the rental increment above the initial contractual (minimum) rent could be discounted at a higher rate. Alternatively, the rent for each five-year period could be discounted at a low risk rate (to reflect the security of the rent once it has been established), and each five-year 'package' discounted back to the present at a rate to reflect market risk. Such approaches will produce a higher net effective rent than calculated for method 4 and closer to that obtained by method 2 (to second review).

On the other hand, the higher the rate of rental growth that is assumed, the closer will be the resultant net effective rent to the five year calculation of (a).

Table 3: Comparison of results of methods 1 to 4

	Method 1 *Straight-line*	**Method 2** *Discounted*	**Method 3** *Asset value*	**Method 4** *DCF with growth*
To first review	£65,000	£61,095	£82,675 *(dependent on the cap rates applied to the headline-rented and effective-rented investments)*	£60,551
To second review	£82,500	£77,288		£71,121 *(or higher if differential risk is reflected, but lower if faster rental growth is assumed)*
Length of the lease	£88,333	£82,486		

Incentives other than rent-free

For simplicity of presentation, all of the examples in this appendix have assumed that a rent-free period is the only incentive that has been granted.

The methodology in each case can be very simply adjusted to reflect other incentives. For instance, if there was a capital contribution of £50,000 (or other incentives to a value of £50,000) then Example 2, method 2 (b), would become what is shown in Table 4.

Table 4

Headline rent	£100,000
YP 8.25 years in 1.75 years at 7%	5.66390
Present value of headline rent	£566,390
Less capital contribution	£50,000
Present value of the headline, plus incentive deal	£516,390
Divide by YP 10 years at 7%	7.32826
Net effective rent	**£70,466 p.a.**

UK guidance notes

UKGN 7 Valuations for charities

1 Introduction

1.1 There are various statutory provisions that apply to charities. These include:

- *Companies Act* 1985 and 2006;
- *Charities Act* 1993 and 2006;
- *Trusts of Land and Appointment of Trustees Act* 1996; and
- *Trustee Act* 2000.

1.2 In addition, the Charity Commission publishes various booklets giving advice on specific topics that are available on its website (www.charity-commission.gov.uk/publications). Booklets CC33, *Acquiring Land*, and CC28, *Sales, leases, transfers or mortgages*, together with their operational guidance, are particularly useful. Where charities are producing *financial statements*, they will follow the Charity Commission's statement of recommended practice (SORP), which broadly follows FRS 15 (see UKVS 1.1).

1.3 This guidance, which is based on CC28 and CC33, provides further information for valuers who are requested to provide valuations for acquisitions and disposals by charities. *Members* who require more information about the powers of trustees or any other matters related to charities should seek advice from the charity's own professional advisers.

2 Acquisitions

2.1 Where trustees propose to acquire land, there is no requirement for them to obtain professional advice, unless such a requirement is in the trust deed. However, the Charity Commission strongly recommends that they obtain a report from a 'qualified surveyor' (as defined in CC33 and given in following paragraph) who is acting solely for the trustees. Where the proposed transaction requires the trustees to obtain an order of the Charity Commission before acquiring land (for example, acquiring land other than freehold land, buying land from one of the trustees or where there is no power to acquire land), it is anticipated that the Commission will expect such an application to be accompanied by a surveyor's report.

2.2 A 'qualified surveyor' is defined in CC33 as 'a fellow or professional associate of the Royal Institution of Chartered Surveyors (RICS)'. Pending any review of this publication, the reference with regard to RICS may be read as referring to any '*member*' of RICS, as defined in the Rules of Conduct.

2.3 When considering the purchase of land, the trustees must take all reasonable steps to ensure that, among other matters:

- the property is suitable for its intended use and, in particular, is not subject to any legal or planning restrictions or conditions that might conflict with that use, or with which it may be difficult for the trustees to comply;
- any necessary planning permission is obtained;
- the price or rent is fair compared with similar properties on the market; and
- when acquiring a lease, they understand the obligations to which they will be subject under the lease and ensure that the terms of the lease are fair and reasonable.

Basis of value

2.4 Although there is no *basis of value* specified in the guidance, the presumption is that it will be *market value* or *market rent*.

2.5 There may be circumstances where a charity is in a special position – for instance, where it has the benefit of certain tax exemptions or is a *special purchaser* – and therefore may be able to justify paying more than *market value*. Such circumstances, which are assessments of *worth*, are not to be reflected in the valuation but should be referred to in the general advice as to what the trustees should offer to pay or bid at auction.

Matters to be included in the report

2.6 The valuer will comply with the general requirements of VS 6.1, Minimum content of valuation reports, having regard to the commission's recommendation to include the following:

- a description of the land;
- details of any planning permission needed;
- a valuation of the land;
- advice on the price that the trustees ought to offer to pay, or the maximum bid they ought to make at auction;
- a description of any repairs or alterations the trustees would need to make and their estimated cost;
- a positive recommendation (with reasons) that it is in the interests of the charity to purchase the land; and
- anything else the surveyor thinks is relevant, including a description of any restrictive or other covenants to which the land is subject.

3 Disposals

3.1 Where a charity wishes to dispose of an interest in land exceeding a term of seven years, a report must be obtained from a 'qualified surveyor' (section 36 (3–5) of the *Charities Act* 1993).

3.2 For these purposes, a 'qualified surveyor' is a *member* of RICS. The *member* must also be reasonably believed by the trustees of the charity to have ability in, and experience of, the valuation of land of the particular kind and in the particular area in question.

Matters to be included in the report

3.3 The report must include a range of information laid down in the *Charities (Qualified Surveyors Report) Regulations* 1992 (SI 1992/2980), as summarised in the following paragraphs.

3.4 A description of the relevant land and its location, by reference to a plan if convenient, is to include:

- the measurements of the relevant land;
- its current use;
- the number of buildings (if any) included in the relevant land;
- the measurements of any such buildings; and
- the number of rooms in any such buildings and their measurements.

3.5 Details of whether the relevant land, or any part of it, is leased by or from the charity trustees should be included and, if it is, so should provide:

- the length of the lease and the period of this which is outstanding;
- the rent payable under the lease;
- any service charge payable;
- the provisions in the lease for any review of the rent payable under it, or any service charge payable;
- the liability under the lease for repairs and dilapidations; and
- any other provision in the lease that, in the opinion of the surveyor, affects the value of the relevant land.

3.6 The report should contain information on whether the relevant land is subject to the burden, or enjoys the benefit, of any easement or restrictive covenant. In addition, it should inform if the land is subject to any annual or other periodic sum charged on, or issuing out of, the land, except rent reserved by a lease or tenancy.

3.7 Information on any buildings included with the relevant land and whether they are in good repair should be commented on. If not, the surveyor' advice should be given:

- on whether or not it would be in the best interests of the charity for repairs to be carried out prior to the proposed disposition;
- on what those repairs, if any, should be; and
- the estimated cost of those repairs.

3.8 Advice should be given on whether it would be in the best interests of the charity to alter any buildings included in the relevant land prior to disposition (because, for example, adaptations to the buildings for their current use will not command the best market price on the proposed disposition). An estimate of the outlay required for any alterations should be suggested.

3.9 Advice should be given as to the manner of disposing of the relevant land so that the terms on which it is disposed of are the best that can reasonably be obtained for the charity, including:

- where appropriate, a recommendation that the land should be divided for the purposes of the disposition;
- the period for, and the manner in which, the proposed disposition should be advertised (unless the surveyor's advice is that it would not be in the interests of the charity to advertise the proposed disposition);
- where advised that it would not be in the best interests of the charity to advertise the proposed disposition, the reasons for that advice (for example, that the proposed disposition is the renewal of a lease to someone who enjoys statutory protection, or belief that a *special purchaser* will pay considerably more than the market price for it); and
- any view the surveyor may have on the desirability or otherwise of delaying the proposed disposition and, if it is reasonable to believe that such delay is desirable, what the period of that delay should be.

3.10 The report should include the surveyor's opinion of:

- the current value of the relevant land, taking account of its current state of repair and current circumstances (such as the presence of a tenant who enjoys statutory protection) or, where the proposed disposition is a lease, the rent which could be obtained in its current state;
- the value of the relevant land, or what the rent under the proposed disposition would be if advice under paragraph 3.7 has been given and followed, or where an opinion expressed under paragraph 3.8 has been acted upon – or if both such advice and opinions had been acted upon;
- the increase in the value of the relevant land or rent if a recommendation made under paragraph 3.9 had been followed;
- the amount by which the price that could be obtained by not advertising exceeds the price that could be obtained if the proposed disposition were advertised (where the advice is that it would not be in the best interests of the charity to advertise the proposed disposition because it is believed a higher price can be obtained by not doing so); or
- where a delay is advised in the proposed disposition under paragraph 3.9, the amount by which the surveyor believes the price that could be obtained due to such a delay exceeds the price that could be obtained without it.

3.11 In cases where it is relevant, and the surveyor feels competent to do so, advice should be given on whether VAT can be charged on the proposed disposition, and the effect it would have on the valuations given in paragraph 3.10. In cases where either the surveyor does not feel able to give such advice, or believes that such advice is not relevant, a statement should be made to that effect.

3.12 The surveyor may be of the opinion that the proposed disposition is not in the best interests of the charity because it does not make the best use of the relevant land. If this is the case, the reasons for this opinion, together with advice on the type of disposition which would constitute the best use of the land are to be given. For example, this would include any relevant advice on the prospect of buying out a sitting tenant, or of succeeding in an application for a change in the use of the land under the laws relating to town and country planning or similar.

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)

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International Valuation Standards

2011

IVSC

International Valuation Standards Council

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Contents

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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.

Principal Changes

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

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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**

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
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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

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

Contents	Paragraphs

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

Contents | **Paragraphs**

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

Contents **Paragraphs**

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

Contents | **Paragraphs**

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

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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

Contents | **Paragraphs**

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)

This edition of *RICS Valuation – Professional Standards* (the 'Red Book') updates the standards to make them fully compliant with the *International Valuation Standards* (IVS) 2011. To assist users the whole of IVS 2011 is reproduced as an annex.

The Red Book is issued by the RICS Valuation Professional Group as part of its ongoing commitment to promote and support high standards in valuation delivery. It is mandatory for RICS members undertaking valuation services, but will also be a useful reference work for valuation users and other stakeholders.