INTERNATIONAL VALUATION STANDARDS COUNCIL

IVSC Investment Property Project

PROPOSED AMENDMENTS TO IVS 230 AND IVS 300

EXPOSURE DRAFT

Comments on this Exposure Draft are invited before 30 April 2014. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to:

commentletters@ivsc.org

or by post to IVSC, 1 King Street, LONDON EC2V 8AU, United Kingdom.

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Introduction to Exposure Draft

In December 2012 the IVSC Standards Board issued a Discussion Paper on Investment Property, which examined various options for improving the way in which the standards relate to this class of real property. Views were sought on how various issues that had been raised with the Board concerning investment property should best be dealt with in the standards

After analysis of the comments made by respondents on various issues raised in the Discussion Paper, the IVSC Standards Board tentatively agreed that the additional requirements for valuing investment property that had been identified as needing consideration would best be dealt with by making amendments to the existing IVS 200 *Real Property Interests* and by including a section of investment property in IVS 300 *Valuations for Financial Reporting*.

This draft shows the changes and additional material that are proposed in both of the above standards. The Discussion Paper also discussed replacing the current IVS 233 *Investment Property under Construction* with more broadly based guidance for valuing property under construction generally. That is the subject of a separate Exposure Draft, *Development Property.*

Proposed deletions from the existing standards are shown struck through in red and proposed new material is shown in underlined blue text.

Questions for Respondents

The IVSC Standards Board invites responses to the following questions. Not all questions need to be answered but to assist analysis of responses received please use the question numbers in this paper to indicate to which question your comments relate. Further comments on any aspect of the Exposure Draft are also welcome.

Notes for respondents:

In order for us to analyse and give due weight to your comments please observe the following:

1. Responses should be made in letter format, where appropriate on the organisation's letter heading.
2. Comments should not be submitted on an edited version of the Exposure Draft.
3. Unless anonymity is requested, all comments received may be displayed on the IVSC website.
4. Comments letters should be sent as an email attachment in either MS Word or an **unlocked** PDF format and no larger than 1mb. All documents will be converted to secured PDF files before being placed on the web site.
5. The e mail should be sent to commentletters@ivsc.org with the words "IVS 230 Amendments" included in the subject line.
6. Please be sure to submit comments before 30 April 2014.

Respondents are welcome to comment on any aspect of the proposed changes but the Board is particularly interested in replies to the following questions.

Questions in respect of proposed changes to IVS 230 *Real Property Interests*

It is common in many jurisdictions for investment property to be held in special purpose, single asset companies so that a transfer of the property interest is made by a transfer of the shares in the company that owns the interest. The Board has been made aware of concerns that the distinction between the two is not always made clear in valuations and to inconsistencies in the way such properties are valued. Additional disclosure requirements are proposed in para 2 and para 6 and a supporting commentary is included in paras C31 and C32.

1. **Is the use of special purpose companies to hold property interests common in your experience?**

2. **If you have answered yes to the above, do you consider that the changes described above are adequate to address this issue?**

An amendment is proposed to the list of matters to be considered to limit the information on ground conditions to that known to the valuer and used in the valuation. It has been suggested that the existing reference to any information could be inferred as information that was unknown and unknowable by the valuer.

3. **Do you agree with this proposed change?**

Paragraph C8 has been introduced to include additional guidance on the requirement to identify the interest being valued. This is the Board's proposed response to the problem identified in the Discussion Paper of distinguishing the real property interest from any other assets, in particular intangible assets, which may be associated with a business in occupation but which are either in separate ownership or are capable of being separated from the ownership of the property interest.

4. **Do you agree with the proposed new paragraph C8? If not, please explain why.**

Paragraphs C9 has been introduced because the Board has become aware of some entities commissioning separate valuations of different components in a property and then aggregating these in the mistaken assumption that this represents the value of the whole. Where there is interdependence and complementary contributions to the value of the whole from those different components this may not be a correct assumption.

5. **Do you agree with the proposed new para C9? If not, please explain why.**

A new para C11 has been introduced to alert readers to the need to be aware of the purpose for which the real property is intended to be used. Depending on the purpose for which the valuation is required this can influence the choice of inputs and assumptions.

6. **Do you agree with the proposed new paragraph C11? If not, please explain why.**

Paragraph C20 has been introduced because of concern expressed that some market valuations are based on data from transactions which have not taken place on the same conditions as assumed in the definition of market value (or such other bases of value which may be required). This has particular significance in the case of property interests being transferred through special purpose vehicles (see Q1) but also has more general relevance.

7. Do you agree that the proposed new paragraph C20 adequately addresses this issue?

The proposed paragraph C30 has been included to address a frequent misunderstanding of the statement in the paragraph 35 of the IVS Framework that market value has no regard to the costs or taxes involved in a transaction. Some incorrectly interpret this as meaning that no allowance should be made in the valuation method adopted for transaction costs or taxes that would be incurred by market participants. The disregard of costs and taxes only relates to the reported value, not to its calculation.

8. Do you agree that the proposed paragraph C30 provides the required clarity?

9. Do you consider that an example would be helpful?

Questions in respect of proposed changes to IVS 300 *Valuations for Financial Reporting*

It is proposed to delete the words "the effect of" from the reporting requirements in para 11 on the grounds that the effect of an assumption made during the valuation process is not always known or capable of estimation.

10. Do you agree with this amendment? If not please explain why.

It is proposed to modify Paragraph G5 to provide stronger guidance that a report that complies with the IVSs should contain sufficient information to enable the reporting entity to determine the level in the input hierarchy in IFRS 13, by virtue of the requirements in IVS 103 5(l) and IVS 300 10. It would be an exceptional case for a report that complied with these requirements not to contain sufficient information to determine which level of the hierarchy is applicable.

11. Do you agree with this change?

Paragraphs G18 - G24 have been introduced to provide guidance on the definition, accounting treatment and valuation requirements in IAS 40 at a similar level to the guidance provided for other valuation measurements required in different parts of the IFRSs. The Board does not consider that outside of financial reporting there is any need to have a definition of investment property. As elsewhere in the guidance section of IVS 300, the intention is not to reproduce the accounting standard in detail, but to highlight some key provisions and direct readers to IAS 40.

12. Do agree with this change?

13. Do you consider that the proposed new section includes all matters that a valuer of investment property needs to know in order to produce a valuation suitable for inclusion in financial statements?

IVS 230 Real Property Interests

REQUIREMENTS

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 ownership interests that affect the interest to be valued.
- if the valuation is of a company or other special purpose vehicle that holds the real property interest, this shall be made clear.[1]

[1] See Commentary C31-32

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 known to the valuer and used in the valuation on ground and foundation conditions,
- responsibility for the identification of actual or potential environmental risks,
- legal permissions or restrictions on the use of the property and any buildings.

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. In applying the requirement in IVS 103 5(d) to identify the asset to be valued, if the valuation is of a real property interest that is held in a special purpose company or other special purpose vehicle the report should be explicit as to whether the valuation is of the property interest or the company or vehicle.

7. The report should also include ~~re are no additional requirements for *real property* interests other than inclusion of~~ appropriate references to those matters addressed in the scope of work in accordance with paras 2 to 4 above.

Effective Date

8. To be determined.

COMMENTARY

C1. This Commentary describes the types of *real property* interest and factors that need to be taken into account when identifying the interest to be valued, before examining other factors that are relevant when valuing *real property* interests.

Types of Real Property Interest

C2. Para 2 of this standard requires a description of the *real property* interest to be valued and the identification of any superior or subordinate interests that affect the interest to be valued. 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.

C3. 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.

C4. Although different words and terms are used to describe these types of *real property* interest, 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

C5. 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.

C6. 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.

Identifying the interest

C7. 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. It is important that the description of the *real property* interest provided in the report should be in sufficient detail to provide clarity as to the physical assets to which the rights relate.

C8. Care is required where non-physical, ie *intangible assets*, are associated with the real estate or a business operated from it. Some *intangible assets* may have an impact on the cash flows generated by the holder of the *real property* interest, and therefore it will be necessary to clarify whether or not these assets are included in the valuation of that interest. Examples of *intangible assets* frequently associated with a *real property* interest include brand names associated with hotels or shopping malls. For further information on the valuation of intangible assets see IVS 210 *Intangible Assets* and Technical Information Paper 3 *The Valuation of Intangible Assets*.

C9. It is important to note that 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.

C10. 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.

Purpose for which held

C11. An interest in *real property* may be held for the physical benefit that ownership provides (owner occupation), for the benefit of any income or capital appreciation that it provides (investment) or a combination of both. For certain valuation purposes classification as either owner-occupied property or investment property may have an impact on the valuation approach required or on the matters that need to be addressed in the report. An example is valuation for financial reporting where different reporting requirements and valuation information are often required for owner-occupied and investment property, see IVS 300 *Valuations for Financial Reporting*. In addition to describing the real property interest to be valued, it is therefore often appropriate to also describe the purpose for which it is held by the current owner or prospective owner.

Rent

C12. 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*.

C13. *Market rent* is the estimated amount for which an interest in real property should 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.

C14. 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.

C15. 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

C16. The three principal valuation approaches described in the IVS *Framework* can all be applicable for the valuation of a *real property* interest.

Market Approach

C17. 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.

C18. 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.

C19. 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*.

C20. It is also important to establish that the transaction being used to provide comparable data is on the same terms as the *basis of value* required, eg that if *market value* is required that the transaction was on the same terms as the definition.

Income Approach

C21. 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".

C22. 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.

C23. 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.

C24. 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 their 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.

C25. 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 determined from other methods such as building ~~built~~ up from a typical "risk free" return adjusted for the additional risks and opportunities specific to the particular *real property* interest.

C26. 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.[2]

Cost Approach

C27. This approach is generally applied to the valuation of *real property* interests through the depreciated replacement cost method.[3] 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.

[2] Additional guidance is contained in TIP 1 *Discounted Cash Flow* – published by IVSC IBSN 978-0-9569313-4-4
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[3] Additional guidance is contained TIP 2 *The Cost Approach for Tangible Assets* published by IVSC IBSN 978-0-9569313-1-3.

C28. 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.

C29. 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.

Transaction Costs

C30. The IVS Framework para 36 states that *market value* is the estimated exchange price without regard to the seller's costs of sale or the buyer's cost of purchase and without adjustment for any taxes payable by either party as a direct result of the transaction. This does not mean that the effect of such costs and taxes on market participants and their decision to buy or sell has to be ignored, only that the *market value* reported is the price that would be agreed in the transaction, not the gross cost that would be incurred by the buyer or the net receipt that would be received by the seller. The transaction costs for *real property* can be significant. They do affect the pricing decisions of market participants and should be reflected when analysing market data and in the valuation methods adopted.

Special Purpose Companies

C31. In some jurisdictions high taxes on real property transfers have led to many larger real property interests being held in special purpose companies or other legal vehicles, and transfers take place of the shares in the company or vehicle rather than of the property because the tax on share transactions is lower.

C32. When either valuing a property interest which is held in a special purpose company or vehicle analysing a transaction involving such an interest caution is required. The value of the company or vehicle may include assets or liabilities other than the property interest that may affect its value or the price that was paid in a transaction. However, subject to the foregoing, if most participants in the market for *real property* of the type being valued hold and transact using special purpose companies or vehicles then the price evidence in the market will be for similar transactions and may therefore be a relevant indicator of the *market value* of the subject interest.

IVS 300 Valuations for Financial Reporting

Amended 2013

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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 (IFRSs): 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.

REQUIREMENTS

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.[4]

   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 about the valuation 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. To be determined

[4] See *A Guide to the Audit Process for Professional Valuers* IBSN 978-0-9569313-9-9 published by the IVSC

IVS 300 Valuations for Financial Reporting

APPLICATION GUIDANCE

This section provides background information on common valuation requirements under IFRSs. IFRSs are published by the International Accounting Standards Board (IASB). The IFRSs 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 IFRS 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.”[5]

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 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

[5] © IFRS Foundation.

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".[6]

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 for a~~A valuation report provided for use in financial statements prepared under IFRSs ~~to~~should 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

[6] © IFRS Foundation.

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.

Investment Property

G18. IAS 40 defines Investment Property as 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.

This definition of investment property includes property that is being constructed or developed for future use as investment property.

G19. Property intended for sale in the ordinary course of business or in the process of construction or development for such sale is not regarded as investment property for the purpose of IAS 40.

G20. Investment property is initially recognised in financial statements at its cost of purchase plus any directly attributable costs. For subsequent recognition the entity may adopt either the fair value model or the cost model for all its investment property. If the fair value model is adopted the fair value of all investment property as at the reporting date is measured in accordance with IFRS 13, see G1-G2 above

G21. Where the fair value model is adopted, the depreciation provisions in IAS 16 and outlined in G12-G17 above do not apply.

G22. If the entity adopts the cost model it shall measure all its investment property in accordance with the cost model in IAS 16. However, if the cost model is adopted for measuring the amount at which the investment property is recognised, the entity is still required to disclose the fair value.

G23. Where the fair value model is adopted there is a presumption that the fair value can be reliably determined on a continuing basis. This presumption may be rebutted in exceptional circumstances, eg because the market for comparable properties is inactive and if methods such as discounted cash flow cannot be used to provide a reliable measurement.[7] In such exceptional circumstances an entity may adopt the cost model for that property. The fact that this is only permissible in exceptional circumstances is reinforced by the general requirement in the standard that where an entity has previously measured an investment property at fair value, it shall continue to measure the property at fair value even if comparable market transactions become less frequent or market prices become less readily available[8]. If the fair value of an investment property under construction cannot be reliably measured it can be measured at cost until either its fair value becomes reliably measurable or construction is completed, whichever is earlier.

G24. TIP # *Development Property* contains information and guidance that is relevant to the valuation of investment property under construction.

Leases

G25. Under IAS 17, leases are classified for inclusion in financial statements as either operating leases or finance leases.[9] Valuations may be required to determine how a lease is classified, and if classified as a *finance lease*, to determine the carrying amount of the asset and liability. These lease types are defined in IAS 17 as follows:

[7] IAS 40 – para 53.

[8] IAS 40 para 55.

[9] 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.

- 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.

G26. 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 G36~~29~~ to G39~~32~~. IAS 17 does not apply to biological assets as defined in IAS 41.

Apart from changes to the paragraph number as a consequence of the proposed changes outlined, no further changes are proposed to the existing IVS 300.