Fair valuation of real estate

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1. Introduction

The International Valuation Standards Committee was founded as The International Assets Valuation Standards Committee (TIAVSC) in 1981 with the following objectives:

- To formulate and publish, in the public interest, valuation Standards for property valuation and to promote their worldwide acceptance; and
- To harmonise Standards among the world's States and to identify and make disclosures of differences in statements and/or applications of Standards as they occur.

In 1994 the Committee changed its name to the International Valuation Standards Committee as it had by then shifted considerably from its earlier remit to focus on harmonising standards solely for financial reporting purposes to a much broader spectrum to cover real estate valuations for all purposes.

The scope of the Committee is continuing to widen as seen from the four broad areas that it now seeks to be involved in, namely (a) real property, (b) personal property, (c) businesses and (d) financial interests, although so far the Committee has not ventured deeply in the last of the said areas.

The current set of Standards, in a publication known as IVS 2003, is in fact the sixth edition of the Standards and it can be obtained from the IVSC at a cost of US$ 25. Orders can be made through the website of the IVSC which is www.ivsc.org. The Standards are also freely available on the website of IVSC for all valuers, users of valuations, and the general public who can either peruse it or download it.

IVS 2003 is in fact the final publication that concludes a special IVSC Standards Project that ran from the year 2000 to 2003. In these years, with the objective of preparing a set of comprehensive and robust Standards to facilitate cross-border transactions involving property as well as contribute to domestic and international financial stability, three publications were concluded, in tandem. Although the project itself is completed, work is still in progress on new Standards as well as revision of old Standards.

The IVSC is managed by a Management Board made up of member States and this Board meets in various places around the globe, twice a year. Under the Management Board is a Standards Board that is charged with Standards setting and this Board is also made of member States but allows for outside contributions such as from regional valuation groupings, prominent valuation associations and "expert groups" who are setup on an ad hoc basis to complete specific projects.

Funding is from subscriptions by member States and organisations ranging from regional valuation groupings, valuation firms and the big accounting firms. Support from the Bank of International Settlements and the International Monetary Fund will not only be welcome but would certainly constitute a worthy cause for the two bodies.

2. Market value

Much of the work of an ordinary valuer revolves around carrying out *market value estimates* for various purposes. Such estimates are needed by most *market economies*.

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It has been no surprise then that almost the first task that the International Valuation Standards Committee (IVSC) set for itself, upon its formation in the early 1980s, was to arrive at an *international consensus* as to the definition of market value.

After much debate, which mostly centred on differing cross-border legislative and judicial considerations, a common definition acceptable to all was arrived at. Today this definition is not only the accepted definition by the global valuation fraternity, but it is also accepted by most regulators and users of valuation, including the courts.

The definition reads: "The estimated amount for which a property should exchange on the date of valuation between a willing buyer and willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion."

Throughout IVS 2003, and in this paper, the terms real estate and property are used interchangeably.

Each element of the definition has its own conceptual framework:

(i) *"The estimated amount …"* refers to a price expressed in terms of money payable for the Property in an arm's length market transaction. *Market Value* is measured as the most probable price reasonably obtainable in the market on the date of valuation 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*.

(ii) *"… the Property should exchange …"* refers to the fact that the value of the *Property* is an estimated amount rather than a predetermined amount or actual sale price. It is the price at which the market expects a transaction that meets all other elements of the *Market Value* definition should be completed on the date of valuation.

(iii) *"… on the date of valuation …"* requires that the estimated *Market 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.

(iv) *"… 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 that the market requires. The present Estate owner is included among those who constitute "the market". A Valuer must not make unrealistic assumptions about market conditions nor assume a level of market value above that which is reasonably obtainable.

(v) *"… 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 Property 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 Property owner are not a part of this consideration because the "willing seller" is a hypothetical owner.

(vi) *"… in an arm's-length transaction …"* is one between parties who do not have a particular or special relationship (for example, 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 *Special Value*. *The Market Value* transaction is presumed to be between unrelated parties, each acting independently.

(vii) *"… after proper marketing …"* means that the Property 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 length of exposure time may vary with market conditions, but must be sufficient to allow the Property to be brought to the attention of an adequate number of potential purchasers. The exposure period occurs prior to the valuation date.

(viii) *"… wherein the parties had each acted knowledgeably and prudently …"* presumes that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the Property, its actual and potential uses, and the state of the market as of the date of valuation. Each is further presumed to act for self-interest with that knowledge, and prudently to seek the best price for their respective positions in the transaction. Prudence is assessed by referring to the state of the market at the date of valuation, not with benefit of hindsight at some later date. It is not necessarily imprudent for a seller to sell property in a market with falling prices at a price that is lower than previous market levels. In such cases, as is true for other purchase and sale situations in markets with changing prices, the prudent buyer or seller will act in accordance with the best market information available at the time.

(ix) *"… and without compulsion …"* establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.

The widespread use of market value in the valuation profession is central and established, and equal in importance to the "fair value" and "mark to market" movements that are now taking place in the accounting and investment circles.

3. Fair value

How then does "market value" differ from "fair value" which is the term used in the title of this paper?

Paragraph 8.1 of the General Valuation Concepts and Principles of IVS 2003 reads:

(i) "The expression ***Market Value*** and the term ***Fair Value*** *as it commonly appears in accounting standards* are generally compatible, if not in every instance exactly equivalent concepts. ***Fair Value***, *an accounting concept*, is defined in International Accounting Standards and other accounting standards as *the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction*. ***Fair Value* is generally used for reporting both *Market* and *Non-Market Values* in financial statements**. Where the *Market Value* of an asset can be established, this value will equate to *Fair Value*. Where the Market Value of an asset cannot be established, its value is arrived at using a surrogate such as Depreciated Replacement Cost (DRC)."

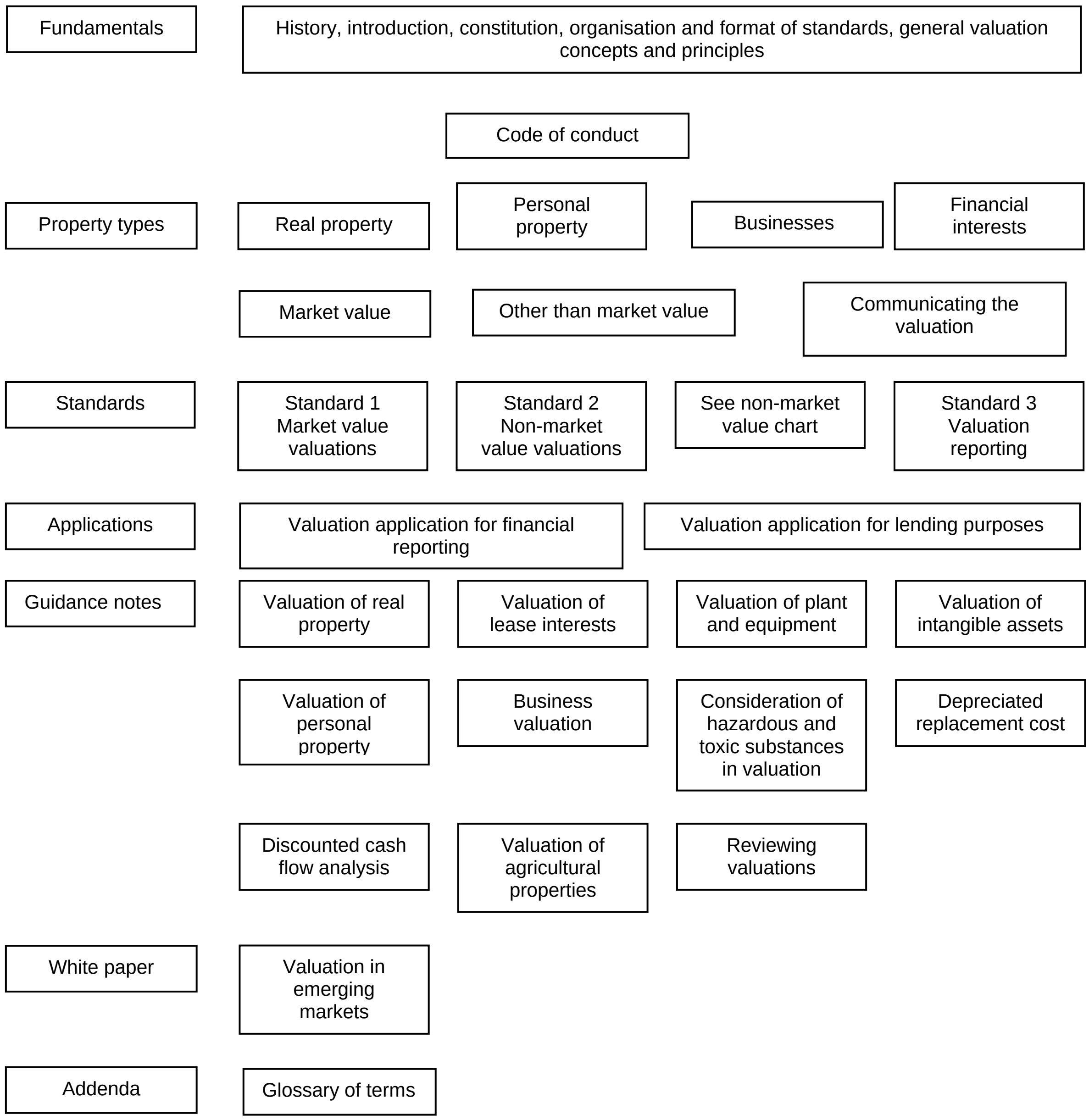
Much of the interplay between the terms "fair value" and "market value" from the standpoint of the IVSC has arisen when valuations for financial reporting are considered. The Standard for Financial Reporting is an Application in IVS 2003's known as International Valuation Application 1 (IVA 1), Valuation for Financial Reporting, the objective of which is to explain the principles that apply to valuations prepared for use in financial statements and related accounts of business entities.

IAS 16 or International Accounting Standards 16 (paragraph 6) as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's-length transaction".

4. The structure of IVS 2003

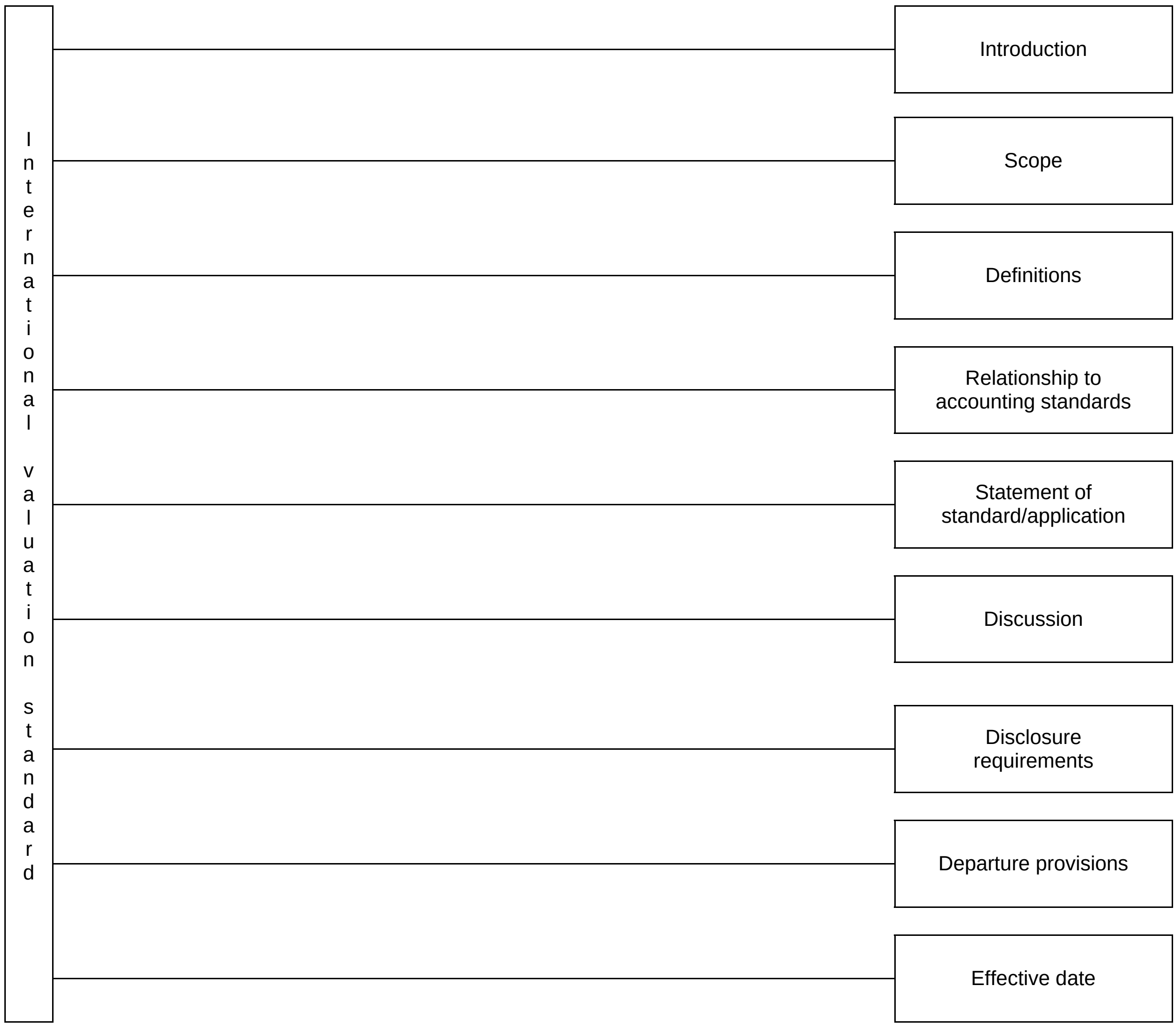
IVS 2003 is structured in the following manner:

Structure of the standards document



5. Format of the standards and applications

Each Standard, Application or Guidance Note in turn is structured as follows:



IVS 2003 begins with some introductory material including the Constitution of the IVSC, followed by two important chapters (General Valuation Concepts and Principles and Code of Conduct) which are of general application and then proceeds to detail out the various Standards, Applications, and Guidance Notes before concluding with a White Paper and a Glossary.

6. General valuation concepts and principles

The first of the important chapters is on General Valuation Concepts and Principles. This chapter defines and distinguishes the concepts of land, real estate, real property and discusses at length some of the important concepts related to valuation such as market value, fair value, highest and best use and other concepts.

7. Code of conduct

The next chapter, the Code of Conduct emphases that valuations should be provided by honest and competent professional Valuers, free of bias and self interest, whose reports are clear, will not mislead and will disclose all matters essential to the proper understanding of the valuation. Valuers are required to always promote and preserve the public trust.

8. Four property types

IVS 2003 identifies four property types, namely, real property, personal property, businesses, and financial interests.

9. The standards

There are three main Standards, the Market Value Basis of Valuation, Valuation Bases Other than Market Value, and Valuation Reporting.

9.1 The market value basis of valuation

The market value basis of valuation is recognised as the most widely required and main basis of valuation for most valuations around the globe. The valuations are required for purposes such as purchasing property, selling property, for accounting purposes (both private and governmental), for securing loans (personal or business), for submission to regulatory authorities and for statutory purposes including taxation.

Market Value is a representation of value in exchange, or the amount a property would bring if offered for sale in the (open) market at the date of valuation under circumstances that meet the requirements of the market value definition.

To determine market value, a Valuer must first determine the highest and best use of the property.

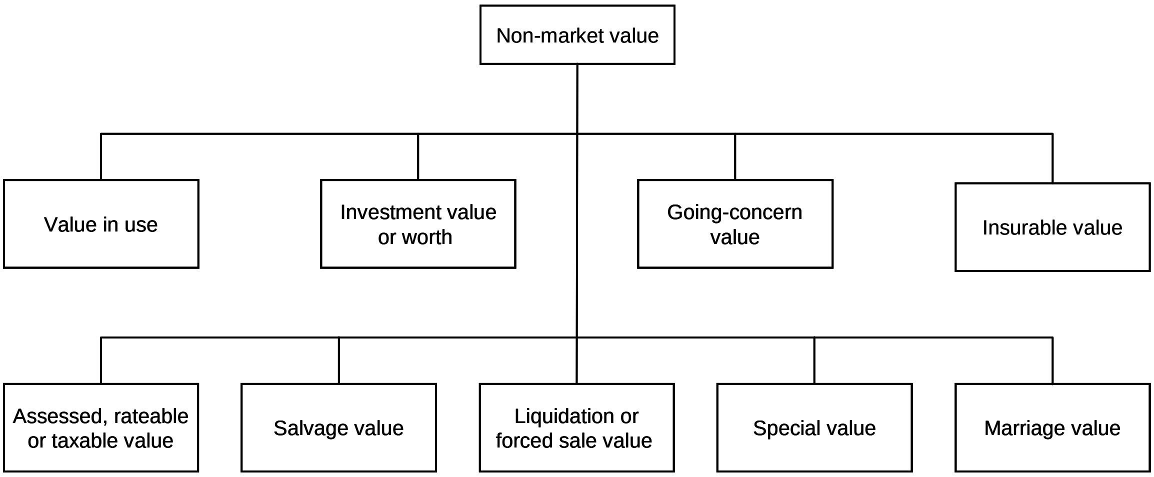
The highest and best use of a property is the most probable use of the property. That use may be for continuation of a property's existing use or for some alternative use.

The most common methods used to estimate market value include the cost approach, sales comparison approach and the income capitalisation approach, including discounted cash flow analysis but fundamental to the determination of market value by these methods is that they are arrived at based on market derived data.

9.2 Valuation bases other than market value

Valuation bases other than market value or non-market based values include non-market based valuations of property use methods that consider the economic utility or function of an asset, other than its ability to be bought and sold by market participants, or the effect of unusual or atypical conditions.

Non-market value components



- Value in Use is a value to a particular user or owner and is not Value in Exchange which is a market value concept.
- Investment Value or Worth is again a value to a particular user using an approach which recognises a specific requirement of the user such as a target discount rate.
- Going-Concern Value is a value ascribed to an established business, not to any of its constituent parts.
- Insurable Value is a value for insurance purposes.
- Assessed, Rateable or Taxable Values are usually values that are determined under specific situations for tax purposes.
- Salvage Value is ordinarily used to express the current price expected for property, that has reached the end of its useful life.
- Liquidation or Forced Sale Value is a value estimated for disposition of property under extraordinary or atypical circumstances.
- Special Value may accrue to a property by reason of a unique location, a temporary situation under exceptional market conditions, or a premium payable by a purchaser having a special interest.
- Marriage Value is additional value created by the possibilities of amalgamating interests or adjoining lands.

The objective of MVS 2, Valuation Bases Other than Market Value, is to identify and explain bases of value other than Market Value and to establish standards for their application and to ***distinguish*** them (bases) from Market Value.

9.3 Valuation reporting

The IVSC considers the reporting of the findings of a Valuer to be of such importance that it has accorded Valuation Reporting a status equal to the two main bases of valuation. An important requirement is the inclusion of a compliance statement that the valuation has been performed in accordance with IVS. Each compliance statement is meant to confirm that:

(i) The statements of fact presented in the report are correct to the best of Valuer's knowledge;

(ii) The analyses and conclusions are limited only by the reported assumptions and conditions;

(iii) The Valuer has no (or if so, a specified) interest in the subject property;

(iv) The Valuer's fee is or is not contingent upon any aspect of the report;

(v) The valuation was performed in accordance with an ethical code and performance standards;

(vi) The Valuer has satisfied professional education requirements;

(vii) The Valuer has experience in the location and category of the property being valued;

(viii) The Valuer has (or has not) made a personal inspection of the property; and

(ix) No one, except those specified, has provided professional assistance in preparing the report.

The importance of the compliance statement to IVS underscores the fact that IVS, unlike national valuation standards, cannot in any way be enforced on Valuers around the globe. Its use is market driven, required ultimately by users who insist on compliance.

10. Applications

The three main Standards are followed by three Applications, for financial reporting, for lending purposes and for public sector financial reporting.

10.1 International Valuation Application 1 (IVA 1) - valuation for financial reporting

The objective of IVA 1, Application for Financial Reporting, is to explain the principles that apply to valuations prepared for use in financial statements and related accounts of business enterprises in both the private and public sectors.

This application addresses the criteria that Valuers must observe in preparing valuations for financial statements and related accounts. It also discusses concepts that must be understood by accountants, regulatory authorities, and other users of valuation services.

IVS 1 is developed with particular regard to the requirements of International Accounting Standards or IAS (now International Financial Reporting Standards or IFRS).

IFAS is one of two main accounting standards in the world today, the other being USGAAP which applies in North America.

At present both IFAS and USGAAP conventions are essentially historic cost conventions in most respects save for the different treatment afforded to assets.

US GAAP (Generally Accepted Accounting Principles) requires that historical cost be the sole basis for the continued recognition of the asset, while IAS allows two options, either historical, known as the benchmark treatment, or revalued amount, known as the allowed alternative treatment.

There is at present a drive towards harmonisation of global accounting standards, the conventions represented by IAS and US GAAP are predominant.

10.2 International Valuation Application 2 (IVA 2) - valuation for lending purposes

(i) IVA 2 deals in performing valuations of property where the results will be used to obtain loans, mortgages, and debentures. Valuers shall normally estimate the Market Value of such assets in accordance with these International Standards.

(ii) Valuers shall have a comprehensive understanding of the requirements of such institutions, and the structure of loan agreement terms and arrangements. Any unusual volatility in the value of the specific property or the market of comparable properties should be mentioned in the valuation report or certificate.

(iii) Related to lending is the Basel Accord, an international agreement on banking solvency. The present solvency ratio is 8% which means, for example, that a bank should allocate US$ 8 of its owned capital to every US$ 100 (on a risk-adjusted basis) it lends.

(iv) The New Bank Accord (due 2005) may give banks greater scope for assessing their risk in their lending.

10.3 International Valuation Application 3 (IVA 3) - valuation of public sector assets for financial reporting

This Application is not incorporated into IVS 2003 as yet as the final draft has only recently been endorsed by the Management Board of IVSC. It will be published shortly as an exposure draft before adoption as an Application.

IVA 3 is about valuation of public sector assets for financial reporting.

Public sector assets are those assets owned by governmental or quasi-governmental entities to provide goods or services to the general public within a given jurisdiction.

The valuation of public sector property may be undertaken for a range of purposes including financial reporting, privatisation planning, loan origination, bond issuance and cost-benefit or economic analyses performed by governments either to determine whether a public sector asset is being used and managed efficiently or to set pricing for monopoly services.

Property in the public sector comprises conventional property types as well as specialised asset types, including heritage and conservation assets, infrastructure assets, public utility plants, recreational assets and public buildings (eg military facilities). As with private sector assets, public sector assts fall into operational and non-operational categories. Non-operational assets include investment and surplus assets.

11. Guidance notes

The valuation Applications are followed by Guidance Notes. However Guidance Notes under the IVS 2003 *are mandatory*, like the main Standards and Application in order for compliance with IVS.

11.1 Guidance note 3 - valuation of plant and equipment

When valued for financial reporting purposes, plant and equipment are valued in the same manner as other assets, applying Market Value and Depreciated Replacement Cost (DRC) concepts in accordance with International Valuation Application 1.

When the purpose of the valuation is other than financial reporting, plant and equipment are valued by applying an appropriate valuation bases and by clearly distinguishing the results from Market Value if a non-Market Value basis is applied.

Non-market valuations include liquidation value, salvage value, insurable value, auction realisable value, reinstatement value and indemnity value.

Plant and equipment may broadly be divided into four categories, namely, machinery and equipment, equipment that includes such items as furniture and fittings, stocks and moulds, factory and industrial buildings that are highly integrated with the enclosed process or equipment they support and structures of a specialised nature and building services that are normally included in valuations of land and building.

11.2 Guidance note 6 - business valuations

Business valuations are commonly sought and performed on the Market Value basis of valuation applying the provisions of International Valuation Standard 1 (IVS 1). Where other bases of valuation are used, with proper explanation and disclosure, the provisions of IVS 2 are applied.

In general the concepts, processes, and methods applied in the valuation of businesses are the same as those for other types of valuations. Certain terms may have different meanings or uses. Those differences become important disclosures wherever they are used.

A description of a business valuation usually includes an identification of the business, business ownership interest, or security to be valued, the effective date of the valuation, the definition of value, the owner of the interest and the purpose and use of the valuation.

11.3 Guidance note no 8 - Depreciated Replacement Cost (DRC)

For purposes of financial reporting, DRC (which is essentially a non-market value) is considered an acceptable method to arrive at a surrogate for the Market Value of *specialised* or *limited market properties* for which the market evidence is unavailable.

DRC is based on an estimate of the Market Value for the Existing Use (MVEU) of the land plus the current gross replacement (or reproduction) costs of improvements less allowances for physical deterioration and all relevant forms of obsolescence (functional or technical and economic or external) and optimisation. DRC may be described either as a valuation methodology or as a basis for value/defined value.

When an asset has been valued by reference to DRC, *adequate profitability* is the test that the directors/manages of the entity should apply to ensure that the entity is able to support the DRC estimate. Where the directors/managers of the entity find the DRC estimate fails to meet the test of *adequate profitability*, the written down estimate represent the asset's *value in use* which then becomes its fair value.

11.4 Guidance notes on discounted cash flow analysis

The Discounted Cash Flow Method of Valuation is an income based method or approach and has a growing following around the world due to its easy use that has come about because of computer spreadsheets and computing power. The method which essentially comprises three major elements, namely the cash inflows, the cash outflows and the discount rate can be applied to most ***complex***, investment properties. Where the Comparison Method falls short in its ability to take into account ***explicitly*** the differences between the comparable sale and the property being valued the discounted cash flow (DCF) triumphs, as it can make explicit in the cash flows, the differences.

Due to the need to address the issues and to ensure the proper use of DCF analyses in valuation, the IVSC set itself the task of coming up with a Standard and setup an Expert Group (a usual approach) to look into the issues and to draw up a Standard.

The Expert Group, in coming up with the Guidance Note that will be in the 6th Edition, made the following distinctions:

- In arriving at *market value*, a DCF valuation must recognise *market derived* inflows, outflows and the discount rate. In practice this will be achieved by a valuer constructing DCF models for known sale comparables and then applying the "market derived" inflows, outflows and discount rate to value the property under consideration. Should the valuer adhere to this he cannot abuse the DCF as the value is based on market derived data. In past valuations there has been some confusion among valuers when they have not been focussed in ensuring that for the estimation of market values, just as in any of the other methods of valuation; they ought to base it on market derived data. In many instances valuers did differ in the construction of inflows and outflows without reference to models of previous known sales and in the determination of discount rates it was not strictly based on market analyses of known sales.
- A DCF valuation to arriving at Market Value on the one hand and a DCF valuation for the determination of a *non-market value* on the other must be distinguished. For example where a valuer is asked to do a valuation based on a certain rate of return specific to the requirements of the client, it is a non-market valuation and he must distinguish this valuation from a market valuation.
- The GN distinguishes between market and non-market valuations done by a valuer and a *value-in-use* (using the DCF) done by Accountants under the International Accounting Standards (IAS). A value-in-use valuation is a non-market estimate based on a strict continuing use of the asset in its existing use whereas a market value estimate (value-in-exchange) done by a valuer will include not only the continued use of the asset in its existing use but its full potential use. Inherent in a market value estimation is the concept of the highest and best use.
- The GN distinguishes between valuations for market and non-market valuations and the use of the DCF for investment analyses purposes where the merits of one property investment or

project with another are assessed. The GN notes that it relates only to *valuation* (market or non-market) and does not relate to *investment analyses*.

- The GN distinguishes between the use of DCF valuations for real property and businesses.
- Perhaps most important of all it requires all data used in the method to be adequately substantiated.

In arriving at its recommendations the Expert Group took particular pains to steer away from being prescriptive, which is an underlying principle upon which the other Standards in IVS have been constructed. This will allow valuers to employ the latest techniques in computing cash flows including the use of various probability techniques, such as the Monte Carlo Simulation technique to establish more accurately the certainty of cash inflows.

In emerging markets, the use of the DCF for valuation is perhaps even more popular and this is because there is usually a lack of sale comparables in sufficient numbers to undertake accurate valuations based on the Comparison Method. With the limited sale comparables however models can be constructed from the limited known sales for application in various similar situations.

The IVSC is acutely aware that for specialised properties such as forests and mineral rights, valuers around the world find that the use of the DCF is the principal means to the determination of value.

Like in the case of all other approaches, more day-to-day use of the DCF method or approach to valuation will usually lead to higher levels of proficiency. Lastly, it is not the method itself that provides an accurate answer; rather it is the knowledge and skill of the person using it that is more important to the level of accuracy desired.

11.5 Guidance notes note no 10 - valuation of agricultural properties

Agricultural properties are valued similarly as other properties with market value being the main basis of valuation.

For Financial Reporting under International Accounting Standards IAS 16 (Property, Plant and Equipment), IAS 40 (Investment Property), and 41 (Agriculture) apply to the valuation of agricultural property. An entity follows IAS 16 or IAS 40, depending on which standard is appropriate in the circumstances. IAS 16 requires that land be measured either at its cost less any accumulated depreciation and accumulated impairment losses or at a revalued amount. IAS 40 requires land that is investment property to be measured at its fair value, or cost less any accumulated depreciation and accumulated impairment losses. IAS 41, which requires that biological assets physically attached to land (eg trees in a plantation forest) be measured at their fair value less estimated point-of-sale costs, separately from the land.

12. Intangible assets (related to business valuations)

Intangible assets are assets that manifest themselves by their economic properties. They do not have physical substance; they grant rights and privileges to their owner and usually generate income for their owner. Intangible assets can be categorised as arising from Rights (supply contracts, distribution contracts, licensing permits), Relationships (assembled workforce, customer relationship, supplier relationship), Grouped intangibles (goodwill), and Intellectual property (brand names, trademarks, copyrights, patents).

The basis is usually market value by the Cost, Income and/or Sale comparison approach. IAS 38 prescribes the accounting treatment.

13. White paper on emerging markets

As an addition to the Standards, Applications and Guidance Notes there is a White Paper in IVS 2003 Commentary. This has come about because one of the three objectives that the IVSC has set for itself is “to provide Standards of valuation that meet the needs of emerging and newly industrialized countries”.

The White Paper on Valuation is twofold:

(i) provide specific guidance to Valuers in emerging markets; and

(ii) contribute to the efforts of international, regional and national development banks and institutions in restructuring and/or strengthening financial systems in emerging markets.

The special economic, legal and institutional characteristics of emerging markets pose particular problems for Valuers working in these markets. Some of these characteristics may also be evident more developed markets, but would tend to be more prevalent in emerging markets and include:

- A poor or inadequate legal framework that does not allow for the efficient functioning of the property market.
- The lack of published information or difficulty in obtaining information regarding transactional as well as other data requisite for proper valuations.
- Greater volatility of property markets.
- Lack of adequately trained professional Valuers.
- Outdated National Valuation Standards.
- External pressure.
- Excessive or insufficient government intervention.
- Growing importance of intangible property.

Broadly, the White paper requires that Valuers carrying out valuations in emerging markets adhere to all the principles and practices that are required for compliance with IVS 2003. Where this is not possible, Valuers should do “the next best thing”.

There is an advisory to bank and other lenders to recognise the characteristics that exist in emerging market and to seek to promote efficient property markets in these States by way of their policy advisories.

14. Conclusions

In very simple terms, IVS 2003 says:

(i) The main basis of valuation of real estate or interests in real estate is market value which also fair value.

(ii) Where not market based, the valuation must be clearly stated and distinguished as a non-market valuation.

(iii) Market value can be arrived at by various “methods” but the inputs must be market derived.

(iv) The Depreciated Replacement Cost when applied to specialised properties or properties with limited markets is a surrogate for market value for financial reporting purposes.

(v) The different types of real properties or interests in real estate may warrant differing emphases and treatment.

(vi) Valuers are required to ensure a high degree of disclosure in their valuation reports.

(vii) The Valuer must be competent and have integrity.

(viii) The valuation report must communicate all facts and the findings in a comprehensive manner. It must not mislead the reader in any way.

Valuation Standards help to promote efficient property markets and property markets underpin market economies around the world. Seen in this context Valuation Standards are important for financial stability.