

RICS Valuation Standards – Global and India

May 2011



RICS

the mark of
property
professionalism
worldwide

IVS Compliant

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Preface

7th Edition, April 2011

The global valuation standards – comparison with 6th edition and reasons for changes

This new edition of the Red Book marks its issue for the first time in Global, UK and India volumes, and incorporates a number of changes and updates to enhance its clarity and ease of use. These include adopting the term ‘valuation standards’ rather than ‘practice statements’ in relation to the key requirements, which continue to be mandatory for members, since the emphasis throughout is on the delivery of valuations to clear and consistent standards.

The standards in VS 1.1 and VS 1.2 have been revised to make a clearer distinction between standards that are mandatory (i.e. the compliance and ethical requirements of VS 1) and those that primarily relate to the valuation process that are not mandatory, if the purpose of the valuation falls within any of the specified exceptions (that is, VS 2 to VS 6). Although differently expressed there is no intention to change the application of principles specified in the 6th edition.

There is also some renumbering and reordering of guidance notes as well as an update of them, with a new GN on the depreciated replacement cost method of valuation for financial reporting, upgraded from ‘valuation information paper’ status.

As for the previous (6th) edition, the intention is to ensure that the Red Book global standards align and comply with International Valuation Standards (IVS), and RICS will issue updates as necessary to ensure that this remains so. Further information about IVS evolution is included in the Introduction.

To further assist members RICS has published a ‘frequently asked questions’ paper (www.rics.org/redbook) that provides a more detailed explanation of the application of the Red Book. The FAQ paper will be revised as required when revisions and updates are published.

The revisions and changes to structure to the global valuation standards are given in the following table:

- 1 The first column briefly refers to the material in the 6th edition.
- 2 The second column indicates the new location of the material identified in the first column, as well as completely new material included in this edition.
- 3 The third column outlines the changes made to the identified standard.

6th edition	7th edition	Changes made
Title: <i>RICS Valuation Standards</i>	Title: <i>RICS Valuation Standards – Global and UK</i>	As there are now three volumes, the region to which the volume applies is included in the title.
List of contents ‘PS’	List of contents ‘VS’	As mentioned earlier, ‘practice statements’ have been changed to ‘valuation standards’.
Introduction	Introduction	The introduction is revised to explain how the global standards are set out and how IVS have been adopted. The references to compliance and enforcement now appear in VS 1.2.
Glossary	Glossary	The glossary has been reduced by removing terms that have common usage and do not require specific definition. Some terms have been revised to accord with the proposed new terms in IVS.
PS 1.1 and PS 1.2	VS 1.1	This standard sets out the circumstances in which global standards apply mandatorily and identifies permitted exceptions to the procedural standards (VS 2 to VS 6). The exceptions have been relocated into slightly different categories.
PS 1.2 and PS 1.3	VS 1.2	This standard sets out all the compliance requirements and the disclosure of <i>departures</i> .
	VS 1.3 (new)	This standard contains advice on the application of national association valuation standards previously within the Introduction.
	VS 1.4 (new)	This new standard requires terms of engagement to be agreed. The details of the terms of engagement remain in VS 2. This is incorporated to remove any suggestion that by departing from the procedural standards there is no need to agree terms of engagement.
PS 1.4 to PS 1.8	VS 1.5 to VS 1.9	No changes have been made.

Appendices		All the appendices are now in one section rather than following the related valuation standard.
Appendix 1.1	Appendix 1	This appendix has not changed.
PS 2	VS 2	No changes have been made.
Appendix 2.1	Appendix 2	This appendix has not changed.
Appendix 2.2	Appendix 3	This appendix has not changed.
Appendix 2.3	Appendix 4	This appendix has not changed.
PS 3	VS 3	No changes have been made to these standards.
PS 4	VS 4	These standards originally reproduced material published by the International Valuation Standards Council (IVSC). None of that material will appear in the same format in the new IVS. New application standards on financial statements, secured lending and public sector valuations are expected to be included in the new IVS, and this section will be revised later in 2011.
Appendix 4.1		This appendix has been deleted.
Appendix 4.2		This appendix has been deleted.
Appendix 4.3	Appendix 8	No changes have been made.
Appendix 4.4	Appendix 5	No changes have been made.
PS 5	VS 5	No changes have been made.
PS 6	VS 6	No changes have been made.
Appendix 6.1	Appendix 6	No changes have been made.
Appendix 6.2	Appendix 7	No changes have been made.
Appendix 6.3		This appendix has been deleted. The guidance on reporting fair value will be in the new IVS and dealt with in VS 4 when revised.
GN 1	GN 2	This GN, valuations of individual trade related property, has been extensively revised.

GN 2	GN 5	This guidance, plant & equipment, is under review.
GN 3	GN 3	No changes have been made to this GN on portfolios and groups of properties.
GN 4		This GN has been deleted.
GN 5	GN 1	This GN, valuation certainty, has been extensively revised.
GN 6		This GN has been moved to UK guidance notes section.
GN 7	GN 4	No changes have been made to this GN, personal property.
	GN 6	Depreciated replacement cost (DRC) method of valuation for financial reporting, is a new GN. It was originally published as a valuation information paper.
	GN 7	Discounted cash flow for commercial property investments is a new GN. It was originally published as a separate GN.

Acknowledgments

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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* was published in April 2011.

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The full text of the official version may be obtained from the IVSC, 41 Moorgate, London EC2R 6PP, UK, www.ivsc.org.

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IRR V supports only the global standards and guidance notes of this volume.

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Introduction

1 Purpose of these standards

1.1 This is the 7th edition of the *RICS Valuation Standards*. The original standards were published in 1976 and have become colloquially known as the 'Red Book'.

1.2 The purpose of the global valuation standards is to provide an effective framework, within the Rules of Conduct, so that users of valuation services can have confidence that a valuation provided by an RICS member is objective and delivered in a manner that is consistent with internationally recognised standards including those set by the International Valuation Standards Council (IVSC) (see section 2). 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 in the case of a material breach.

1.3 These standards set out procedural rules and guidance for valuers in the conduct of most types of valuation instructions. They 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.

1.4 The standards define and ensure:

- 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 in relation to content of valuation reports; and
- proper and adequate disclosure of relevant matters where valuations may be relied on by a third party.

2 International Valuation Standards (IVS)

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

2.2 At the time of going to press, the 8th (2007) edition of the IVS was shortly to be replaced with a new 9th (2011) edition, derived from an exposure draft published in June 2010. RICS will publish updates to this Red Book edition as necessary once the final form of the IVS is known, and will consolidate those amendments into a further edition in due course. Progress on IVS is accessible on www.ivsc.org.

3 Publication and structure

3.1 The primary resource for these standards is the RICS website (www.rics.org/redbook). This provides links to the global standards, national association valuation standards, guidance notes, exposure drafts, valuation alerts and other valuation material.

3.2 Hard copy versions of the standards are available from RICS. These are provided in separate volumes as:

- global valuation standards, 7th edition (April 2011);
- combined global and UK valuation standards, 7th edition (April 2011); and
- combined global and India valuation standards, 1st edition (April 2011).

3.3 The global standards will be available in Chinese, Dutch, English, French, German, Italian, Russian, Portuguese and Spanish.

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

4 Arrangement of these standards

4.1 The arrangement of these standards is:

Introduction

Glossary

Valuation standards

VS 1 Compliance and ethical requirements

VS 2 Agreement of terms of engagement

VS 3 Basis of value

VS 4 Applications

VS 5 Investigations

VS 6 Valuation reports

Appendices

Guidance notes.

4.2 Valuation standards are denoted by the use of a VS reference number (for example 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 referred to in the commentaries to the valuation standard that will help in 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 below:

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. Interim amendments and additions will be made to the web-based publication as required, but for the printed version they will be included only in the subsequent, approximately annual, reprint.

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 approved for publication by the RICS Valuation Standards Board.

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, become mandatory on the effective date of the next 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 standards in the 7th edition come into effect on 2 May 2011 and apply to all valuation reports issued on or after that date. Where subsequent amendments have been made the relevant effective date is 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 these standards that have a special or restricted meaning. Terms not appearing in the glossary are to be given their common dictionary meanings. Where a term is used as defined, it will be identified in the text with an *italic* font.

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, needs not be verified by the valuer as part of the valuation process. Typically, an <i>assumption</i> 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 principles of a valuation.
date of the report	The date on which the valuer signs the report.
date of valuation	The date on which the valuation applies. This date may be before, or the same as, the date of report but it cannot be after that date. (May also be known as <i>valuation date</i> .)
departure	Special circumstances where the mandatory application of the <i>valuation standards</i> may be inappropriate or impractical, or the valuer may be required to comply with non-RICS <i>Valuation Standards</i> .
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	The estimated price for the transfer of an asset or liability between identified knowledgeable parties that properly reflects the respective interests of those parties.

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 <i>third-party</i> users. <i>Financial statements</i> carry a measure of public accountability that is developed within a regulatory framework of accounting standards and the law.
firm	The <i>firm</i> or organisation for which the valuer works, or through which the <i>member</i> trades.
guidance notes	<i>Guidance notes</i> provide further material and information on good practice appropriate for particular types of circumstances. Where procedures are recommended for specific professional tasks they are intended to embody 'best practice' and are procedures which, in the opinion of RICS and IRRV, <i>members</i> should normally adopt in order to demonstrate the required level of professional competence.
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 <i>firm</i> responsible for preparing the enterprise's financial records and/or reports. An <i>internal valuer</i> 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 with the objective of achieving uniformity in accounting principles. The standards are developed within a conceptual framework so that elements of <i>financial statements</i> are identified and treated in a manner that is universally applicable. These standards were previously known as International Accounting Standards (IAS).
investment value, or worth	The value of an asset to the owner or a prospective owner. (May also be known as <i>worth</i> .)

market rent (MR)	The estimated amount for which a property, or space within a property, should be leased on the <i>valuation date</i> 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.
Market Value (MV)	The estimated amount for which an asset or liability should exchange on the <i>valuation date</i> between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.
marriage value	See <i>synergistic value</i> .
member	A Fellow, Professional <i>member</i> , Associate <i>member</i> or Honorary <i>member</i> of the Royal Institution of Chartered Surveyors (RICS) or a <i>member</i> of the Institute of Revenues Rating and Valuation (IRRV).
open market value (OMV)	A <i>basis of value</i> supported by the first four editions of the Red Book. Its application provides the same result as <i>Market Value</i> .
registered for regulation/registered by RICS	(a) A <i>firm</i> that is registered for regulation by RICS under the RICS bye-laws. (b) A <i>member</i> who is registered as a valuer under the Valuer Registration Scheme (VRS).
special assumption	An <i>assumption</i> that assumes facts that differ from the actual facts existing at the <i>valuation date</i> .
special purchaser	A purchaser to whom a particular asset has <i>special value</i> because of advantages arising from its ownership that would not be available to general purchasers in the market.
special value	An amount that reflects particular attributes of an asset or liability that are only of value to a <i>special purchaser</i> .
specialised property	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.

synergistic value, or marriage value	An additional element of value created by the combination of two or more interests where the value of the combined interest is worth more than the sum of the original interests. (May also be known as <i>marriage value</i> .)
terms of engagement	Written confirmation of the conditions that either the <i>member</i> proposes, or that the <i>member</i> and client have agreed shall apply to the undertaking and reporting of the valuation.
third party	Any party, other than the client, who 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. For example, in relation to property, land and buildings held for sale by builders and development companies.
valuation standard	A statement of the highest professional standards that apply mandatorily to <i>members</i> when providing written valuations.
worth	See <i>investment value</i> .

Valuation standards

VS 1 Compliance and ethical requirements

VS 1.1 Application of these standards: extent and exceptions

These standards are of global application.

All *members* of RICS and IRRV, and *firms* regulated by RICS, are required to 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:

- the advice is expressly in preparation for, or during the course of, negotiations or possible litigation;
- the valuer is performing a statutory function or has to comply with prescribed statutory or legal procedures;
- the valuation is provided solely for internal purposes;
- the valuation is provided in connection with certain agency or brokerage work; and
- 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 to the provision of valuations that ensure valuers achieve and maintain defined levels of qualification, knowledge, skill and experience. In turn

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 of this section. ‘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:

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 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 the following paragraph.

It also includes giving advice where the client is considering the action to be taken in connection with 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, for self assessment of a tax liability.

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 (for instance, 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 and practical 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 any standard falling within VS 1.3, RICS national association valuation standards.

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, and the fact that it is without liability, is expressly recognised and agreed as part of the terms of its provision.

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 and brokerage standards*, effective from July 2011. This exception does not apply if the client requires a purchase report that includes a valuation.

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, Personal property).

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 2010) and the IRRV Code of Conduct, from which the following key requirements are extracted:

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

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

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VS 1.2 Compliance, regulation and the requirement to disclose departures

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

Valuers must also comply with the requirements of the RICS Valuer Registration Scheme where VS 2 to VS 6 are of mandatory application.

Commentary

Compliance within firms

1. There is an individual responsibility on all RICS *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*:** Whilst it is understood that such *firms* may have their own corporate processes over which RICS cannot exert control, individual *members* in these *firms* who have the responsibility for the valuation are required to comply with these standards.

Where these 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 these standards. 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 these 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 such a contribution will also comply with these standards as far as possible.

Compliance with other valuation standards

2. RICS recognises that the valuer may be requested to provide a report that complies with the *valuation standards* other than the *RICS Valuation Standards* (which incorporate IVS). In all cases the valuer must include a statement that the valuation will comply with the *RICS Valuation Standards* (see VS 2.1 (p) and VS 6.1 (p)) and that any specific requirement(s) within any other named standards will be complied with.

Departures

3. 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.
4. If there are special circumstances where the application, in whole or in part, of a specific *valuation standard* is considered to be inappropriate, they must be confirmed and agreed with the client as *departures* before reporting.
5. A valuer who makes a *departure* may be required to justify the reasons for this to RICS or IRRV. If RICS or IRRV is not satisfied with the reason(s) advanced and/or the manner in which the *departure* is declared or evidenced, either body will be entitled to take disciplinary measures.
6. 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

7. *Members* undertaking valuations to which VS 2 to VS 6 of these standards apply must join the RICS Valuer Registration Scheme in accordance with the timescale and process specified. Full details of the scheme are within the regulation section of www.rics.org.
8. 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 www.rics.org.

Application to members of IRRV

9. 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 valuer *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. The IRRV and the RICS may request each other to deal with alleged breaches of these standards by those who are *members* of both bodies, and 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, an 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 the Valuer Registration Scheme (VRS).

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. Also 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, and 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 the valuation has been undertaken or contributed to by more than one valuer, 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 Rules of Conduct state that *members* shall, at all times, act with integrity and avoid any actions or situations which are inconsistent with their professional obligation.
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 can be said to be 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 value for both parties to a proposed transaction. Careful consideration must be given as to whether it is desirable to accept such an instruction. The possibility of a conflict of interest arising in the future because of divergence of the clients' respective interests should be considered. If the valuer concludes that it is not inappropriate or unwise to act for both parties, 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. A threat to a valuer's objectivity can arise where the outcome of a valuation is discussed in advance of its completion with either the client or another party with an interest in the valuation. Whilst 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 still 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 *date of valuation*, 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. In 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 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) where they have been published.

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 is 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 the person 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 the valuer in the *firm*, has that responsibility for a limited number of years. The exact period will have regard to 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 a periodic review of the valuation by another valuer, at intervals not greater than recommended in paragraph 6, 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 the 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 the relationship of the *firm* with that client.

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. Valuers are not required to provide a comprehensive account of all work ever undertaken by their *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 *date of valuation*.

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 but for which the valuer's *firm* also act. There may also be practical difficulties in identifying and quantifying 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 principles of this standard are adhered to.

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 their 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, it is the extent of the client's relationship with all those entities that 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;
- (b) the purpose of the valuation;
- (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;
- (f) the *basis, or bases, of value*;
- (g) the *date of valuation*;
- (h) disclosure of any material involvement, or a statement that there has not been any previous material involvement;
- (i) 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;
- (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.

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 confirmed in the initial confirmation could also vary.
3. 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.
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 such a form to refer to those matters which will be clarified at a later date.
5. The valuer will need to discuss and agree the extent of the investigations and *assumptions*, or *special assumptions*, that are appropriate to the circumstances and purpose of the valuation and record them in the *terms of engagement*. Any *assumptions* or *special assumptions*, or any other matter that has been identified after the settlement of the original *terms of engagement* and to 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 in connection with 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 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 is identified and exists at the *date of valuation*, 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 *date of valuation*, in order to demonstrate its impact.
3. Greater care is needed if an inherent constraint does not exist at the *date of valuation*, 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 such cases the valuation would be provided on the *special assumption* that the constraint had arisen at the *date of valuation*. The precise nature of the constraint or restriction 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. While a valuer can assist a vendor in determining a price which 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 ‘forced sale value’ should not be used.
5. 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 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 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 requirements and 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 for which the valuation is required. 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. If the valuer considers that it is not possible to provide a valuation, even on a restricted basis, the instruction should be declined.
5. 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, Valuation reports.)

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 valuer has previously inspected the property, and the client has confirmed that no material changes to the physical attributes of the property and the area in which it is situated have occurred, 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. Irrespective of any changes to the property the interval between *inspections* is a matter for the professional judgment of the valuer who will, amongst other considerations, have regard to its type and location.
4. 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 no publication will be made to *third parties*. A statement declaring this position and that the report must not be published 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 on 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 which 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 quite properly 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. For many common valuation purposes these standards stipulate the *basis* (or *bases*) of value that is appropriate.
2. A *basis of value* describes the fundamental measurement principles of a valuation. It is not a statement of the method used, nor does it describe the state or condition of the asset that is involved in the hypothetical transaction. A *basis of value* typically describes the nature of the assumed transaction, the relationship and motivation of the parties, and the extent to which the asset is exposed to the market.
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 *date of valuation*. 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 and identified in these standards coupled with any necessary *assumptions* or *special assumptions*. 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 be most likely to be achieved 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 client may require advice on the value of a particular property to that client, which may mean that the valuer will need to take into account criteria that are particular to that client, rather than those applicable in the market at large. This will involve the assessment of the *worth* of the property to that client. *Fair value* (except in the context of *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 coincide with 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 *assumptions* that might differ from those in an assessment of *Market Value* are discussed under the appropriate heading.

VS 3.2 Market Value

Valuations based on *Market Value (MV)* shall adopt the definition, and the conceptual framework, settled by the International Valuation Standards Council.

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

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Conceptual Framework, as published in International Valuation Standard 1

3.2 The term property is used because the focus of these Standards is the valuation of property. Because these Standards encompass financial reporting, the term Asset may be substituted for general application of the definition. Each element of the definition has its own conceptual framework.

3.2.1 'The estimated amount ...'

Refers to a price expressed in terms of money (normally in the local currency) 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 at 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.

3.2.2 '... a property should exchange ...'

Refers to the fact that the value of a property is an estimated amount, rather than a predetermined 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.

3.2.3 '... 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.

3.2.4 '... 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 on an imaginary or hypothetical market which cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than the market requires. The present property owner is included among those who constitute 'the market'. A valuer must not make unrealistic Assumptions about market conditions or assume a level of Market Value above that which is reasonably obtainable.

3.2.5 '... 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.

3.2.6 '... 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) which may make the price level uncharacteristic of the market or inflated because of an element of Special Value (see IVS 2, paragraph 3.8). The Market Value transaction is presumed to be between unrelated parties each acting independently.

3.2.7 '... 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.

3.2.8 '... wherein 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 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 which 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.

3.2.9 '... and without compulsion.'

Establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.

3.3 Market Value is understood as the value of a property estimated without regard to costs of sale or purchase, and without offset for any associated taxes.

©IVSC 2007, IVS 1, paragraphs 3.2 and 3.3

Commentary

1. 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.
2. *Market Value* ignores any existing mortgage, debenture or other charge over the property.
3. In the conceptual framework in IVS quoted in this standard (paragraph 3.2.1) it is clear that any element of *special value* that would be paid by an actual *special purchaser* at the *date of valuation* must be disregarded in an estimate of *Market Value*. *Special value* includes *synergistic value* (also known as *marriage value*).
4. IVS describes *special value* and *synergistic value* as follows:

Special Value can arise where an asset has attributes that make it more attractive to a particular buyer, or to a limited category of buyers, than to the general body of 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.

Synergistic Value can be a type of Special Value that specifically arises from the combination of two or more assets to create a new asset that has a higher value than the sum of the individual assets.

When Special Value is reported, it should always be clearly distinguished from Market Value.

©IVSC 2007, IVS 2, paragraphs 6.6 to 6.8

5. Notwithstanding this general exclusion of *special value* 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 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* arising from merger with another property or interests within the same property at a future date.
6. When *Market Value* is applied to plant & equipment, the word 'asset' may be substituted for the word 'property'. The valuer must also state, in conjunction with the definition, which of the following additional *assumptions* have been made:
 - the plant & equipment has been valued as a whole in its working place; or
 - the plant & equipment has been valued for removal from the premises at the expense of the purchaser.

Further information on plant & equipment valuation, including typical further *assumptions* that may be appropriate in certain circumstances, can be found in GN 5, Plant & equipment.

7. Where the property is personal property it may be necessary to interpret *Market Value* as it applies to different sectors of the market. Further information on this type of valuation can be found in GN 4, Personal property.

VS 3.3 Market rent

Valuations based on *market rent (MR)* shall adopt the definition settled by the International Valuation Standards Council.

Market Rent: The estimated amount for which a property, or space within a property, should lease (let) on the date of valuation 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 acted knowledgeably, prudently and without compulsion.

Whenever Market Rent is provided the 'appropriate lease terms' which it reflects should also be stated.

©IVSC, GN 2, paragraph 3.1.9.1

Commentary

1. The definition of *market rent* is the *Market Value* definition modified by the substitution of a 'willing lessor' and 'willing lessee' for a 'willing buyer' and 'willing seller', and an additional *assumption* that the letting will be on 'appropriate lease terms'. This definition must be applied in accordance with the conceptual framework of *Market Value* at VS 3.2, together with the following supplementary commentary.

'...willing lessor and willing lessee...'

1.1 The change in the description of the parties simply reflects the nature of the transaction. The willing lessor is possessed with the same characteristics as the willing seller, and the willing lessee with the same characteristics as the willing buyer, save that the word 'price' in the interpretive commentary to *Market Value* should be changed to 'rent', the word 'sell' changed to 'let' and the word 'buy' changed to 'lease'.

'...appropriate lease terms...'

1.2 *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.

1.3 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. *Market rent* will normally be used to indicate the amount for which a vacant property may be let, or for which a let property 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 Worth and investment value

Valuations based on *worth*, or *investment value*, shall adopt the definition settled by the International Valuation Standards Council.

Worth, or Investment Value, is: The value of property to a particular owner, investor, or class of investors for identified investment or operational objectives.

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Commentary

1. Although under some circumstances *worth* may be the same as the amount that could be realised from sale of the asset, this value is specific to a particular party and essentially reflects the benefits received by holding the asset. Therefore it does not necessarily involve a hypothetical exchange and may differ from *Market Value*.
2. An example of *worth* is the value of an investment property to a particular party which may wish to analyse the potential performance against its own investment criteria – for example, a target rate of return as opposed to those generally prevailing in the market.
3. An estimate of *worth* is likely to use *assumptions* or criteria that differ from those that would be made in an assessment of the *Market Value* of the same property. A typical example would be the use of a rate of return specified by the client rather than one determined from the market. Such 'entity specific' criteria should be highlighted by the valuer in the report, along with the fact that the value reported is not *Market Value* (also see VS 6.13).

VS 3.5 Fair value

Valuations based on *fair value* shall adopt the definition settled by the International Valuation Standards Council.

Fair Value is: The amount for which an asset could be exchanged, between knowledgeable, willing parties, in an arm's-length transaction.

© IVSC, IVS 2, paragraph 3.2

Commentary

1. *Fair value* represents 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 wider market. In addition, 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.
2. Examples of *fair value* would be the price agreed between a landlord and a tenant for the surrender or extension of a lease, or the price for a transfer of shares in a private company.
3. *Fair value* is also a measurement basis required or permitted under *International Financial Reporting Standards (IFRS)*, where its application is subject to specific additional conditions that mean that it is generally equated with *Market Value*.
4. IVS 2 notes:

- 6.2 The application of Fair Value under accounting standards is discussed in IVA 1. In accounting standards, Fair Value is normally equated to Market Value.
- 6.3 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 general 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.
- 6.4 A common application of Fair Value is for assessing the price that is fair for the shareholding in a business, where particular synergies between two specific parties may mean that the price that is fair between them is different from the price that might be obtainable in the wider market. In contrast, Market Value requires any element of Special Value, of which Synergistic Value is an example, to be disregarded.
- 6.5 For other purposes, Fair Value can be distinguished from Market Value. Fair Value requires the assessment of the price that is fair between two specific parties taking into account the respective advantages or disadvantages that each will gain from the transaction.

©IVSC 2007, IVS 2, paragraphs 6.2 to 6.5

5. An estimate of *fair value* for any purpose other than inclusion in a *financial statement* is likely to use *assumptions* or criteria that differ from those that would be made in an assessment of the *Market Value* of the same property. A typical example would be that the *fair value* might reflect the *synergistic value* that would arise in an exchange between two specific parties which would not be available on a disposal to the market at large. Such *assumptions* or criteria should be highlighted by the valuer in the report, along with the fact that the value reported is not the *Market Value* (also see VS 6.13).

VS 4 Applications

It is understood that the new IVS (see the Introduction, paragraph 2) will incorporate various application standards that will deal with valuations for *financial statements* under *IFRS*, secured lending, valuations in the public sector and standards relating to various types of asset.

Pending the revision of the *RICS Valuation Standards*, reference should be made to the IVSC website (www.ivsc.org), and where appropriate, regard should be had to those IVS that may apply to the specific purpose of the valuation. IVS are applicable where there are no local or national association *valuation standards* that take precedence.

This section will be revised, together with any additional RICS requirements, in the next edition of these standards.

Appendices 4.3 and 4.4, which were previously included in PS 4 of the 6th edition of the Red Book, have been brought forward as Appendix 5, Valuations for commercial secured lending, and Appendix 8, European Mortgage federation paper on mortgage lending value.

Where publication of the revised IVS is delayed beyond 2 May 2011, PS 4 in the 6th edition of these standards will apply until such time as the new IVS come into effect.

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

- (i) any plant & equipment which 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 – for example, 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 – for example, 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, for example, 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: planning control 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.

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;
- (b) the purpose of the valuation;
- (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;
- (f) the *basis, or bases, of value*;
- (g) the *date of valuation*;
- (h) disclosure of any material involvement, or a statement that there has not been any previous material involvement;
- (i) 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;
- (q) a statement of the valuation approach;
- (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*.

Commentary

1. The report should convey a clear understanding of the opinions being expressed by the valuer and should be couched in terms which 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 *third parties*.
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 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 in question may prepare such a document, for example where the client is required to provide it by statute, but otherwise a valuer should avoid becoming involved.
2. RICS considers that these terms 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 when providing a valuation opinion. One overriding objective of these standards is that clients should understand the meaning of different *bases of value* and the effect of different *assumptions* on the valuation.
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, *Basis of value*).
2. It is essential that both the valuer and the users of valuations clearly understand the distinction between *Market Value* and other *bases of value* and the effects, if any, that 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 *bases 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 (DRC)* 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 written down to 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 derive 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. The latter 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 on 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 which has been estimated by using *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 alternative 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 takes account of neither the costs of business closure or disruption, nor 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. Also, 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. It will frequently be the case that the potential for an alternative use in the event of the specialised use being discontinued can be broadly identified, but that the value for that use cannot be reliably determined without significant research – for example, 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 clear of such obligations.

3. There will be occasions when 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 the expense of removing it.

VS 6.9 Properties in more than one state

Where the properties are located in more than one state the report must list the properties within each state separately, and the valuation must be reported in the currency, or currencies, which have been agreed with the client.

Commentary

1. Where the properties are located in more than one state the report should be arranged so that all the properties in one state 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 state in which the property is located. Where it is agreed that 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 *date of valuation*.
3. The report must also state, in respect of each state 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 & 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.

VS 6.11 Preliminary valuation advice

Where a report that complies with these standards is in the course of preparation, 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 includes 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 referred to.

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 it is the opinion that 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 the provision of further information. 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;
- record how that information was used to justify a change in value; and
- record 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 is one that 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 the valuer's status has been met;
- the *date of valuation* 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 available, or the valuation figure known, to a mortgage applicant or borrower.

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

5. The valuer is also advised to read the whole of the 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 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. An opinion may be expressed which, if included in a public document, might have some effect on a matter which 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.

8. 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.

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 other than in accordance with a relevant *valuation standards* (a *departure*, 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.
3. Where the full report will not be published, sufficient reference to the *departure(s)* should be made in any published document. 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 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 which 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 information held will be a key determinant of

whether it is possible to act for another client, but 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 careful 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 allows the acceptance of the new instruction, then the valuer should keep a careful file note to record 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 either 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, to 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, 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 *firms* 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 done in one of two ways:

- 1 if it arises because of the valuer's own interest in the property concerned, by proper disclosure of this to interested parties; or

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

- 2 if it 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:

- 1 it is established that an irresolvable conflict exists and instructions will be declined;
- 2 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
- 3 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 *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 or not the valuer, or *firm*, accepts the instruction. 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, is either 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 4.2.2 it will be necessary to obtain the client's agreement to the proposals for managing the conflict by disclosing, 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 undertaken that 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 the *third party* or *parties*. In cases where *third parties* are identifiable at the outset, then there is a requirement that the disclosure is made promptly, meaning that this would need to be made 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 were compromised.

5.2 However, in many cases the *third parties* will be a class of individuals, for example, the shareholders of a company. Disclosure at the outset to all interested *third parties* would clearly be impossible or 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 needing to be disclosed 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 these 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 set-up 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, 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 and the knowledge of clients will range from some who have a deep understanding of the property market, 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 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 these 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 PII policies 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	<p>Requests for valuations will frequently be received from representatives of the client, and the <i>member</i> should ensure that the client is correctly identified. This is particularly relevant where:</p> <ul style="list-style-type: none">the request is made by the directors of a company, but the client is the company and the directors have a separate legal standing;

	<ul style="list-style-type: none"> a valuation is required for loan purposes and, although commissioned by the borrower, the report may be for the lender, the true client.
(b) The purpose of the valuation	<p>Valuations are required for many purposes, and it is essential that the valuer has this information so that the appropriate <i>basis of value</i> is adopted.</p> <p>If the client declines to reveal the purpose of the valuation and the <i>member</i> 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 <i>third parties</i>.</p> <p>If an unusually qualified valuation is to be provided, the terms must state that it is not to be used other than for the purpose originally agreed with the client.</p>
(c) The subject of the valuation	<p>Where the valuation is of a single property its identification will usually be straightforward. However, complications may arise, for example, where there are not clearly defined boundaries. The valuer must make certain that such matters are resolved before reporting.</p> <p>Where the valuation is of a number, or portfolio, of properties GN 3 provides guidance on property identification.</p> <p>Unless valuing an interest in the 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 <i>trade related properties</i>.</p> <p>In the case of 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 on renewal, or review, of the lease, or even if they may give rise to a compensation claim by the tenant when vacating the property.</p> <p>Where a valuation of plant & equipment is carried out concurrently with a valuation of an interest in land, it is essential that the plant & equipment valuer liaises with the valuer of the interest in the land 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 & equipment to be valued separately. GN 5 provides guidance on the identification of plant & equipment.</p>

(d) The interest to be valued	It must always be borne in mind that it is a particular ownership or interest in the property that is being valued. The <i>member</i> must agree with the client the interest(s) to be valued.
(e) The type of property and how it is used, or classified, by the client	<p>As different valuation approaches and <i>assumptions</i> are required for different types of property, it is important that the valuer ascertains not only the type of property involved, but also how it is used or classified by the client.</p> <p>Examples of different classes and categories include property that is:</p> <ul style="list-style-type: none"> ● freehold or leasehold; ● owner-occupied; ● held as an investment; ● <i>specialised property</i>; and ● property held for specified purposes (mineral-bearing land or waste management assets). <p>The agreement should also state the format in which the valuation of portfolios should be presented. GN 3 provides guidance on this aspect.</p>
(f) The <i>basis</i> , or <i>bases</i> , of value	The <i>member</i> must stipulate the <i>basis</i> , or <i>bases</i> , of value that will be reported. For certain purposes or classes of property these statements stipulate that a specific basis is used. In other cases the correct basis, or bases, to use is a matter for the <i>member's</i> professional judgment.
(g) The <i>date of valuation</i>	The <i>date of valuation</i> will need to be agreed with the client. A specific date must be agreed, as an <i>assumption</i> that it is the <i>date of the report</i> is not acceptable.
(h) Disclosure of any material involvement, or a statement that there has not been any previous material involvement	<p>In considering the extent of any material previous involvement, whether past, current or possible future, the valuer must have regard to the requirements of VS 1.</p> <p>Where there has not been any previous material involvement a statement to that effect must be made.</p>
(i) If required, a statement of the status of the valuer	<p>For some purposes the valuer may be required to state if he or she is acting as an <i>internal</i> or <i>external valuer</i>.</p> <p>Where the valuer is obligated to comply with additional requirements of independence VS 1.7 will apply.</p>

	<p>In some states the national association <i>valuation standards</i> may require certain disclosures to be made in the <i>terms of engagement</i>. 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).)</p>
(j) Where appropriate, the currency to be adopted	<p>If there is a possibility that a valuation has to be translated into a currency other than that of the country in which the property is located, the basis of the exchange rate is to be agreed.</p>
(k) Any assumptions, special assumptions, reservations, special instructions or departures	<p>It is very rare for a valuation to be reported without express or implied <i>assumptions</i>. Even when these <i>assumptions</i> 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.</p> <p>Many of the <i>assumptions</i> 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.</p> <p>Further guidance on <i>assumptions</i> and <i>special assumptions</i> can be found in Appendices 4 and 5.</p> <p>Reference must be made to any <i>departures</i> from the <i>valuation standards</i> that the <i>member</i> considers both necessary and justifiable in the circumstances.</p>
(l) The extent of the valuer's investigations	<p>The extent of the valuer's investigations is discussed in VS 5, Investigations. To avoid misunderstandings it is good practice to agree with, or at least tell, the client the scope of the task envisaged, defining the extent of the <i>member's</i> duty to obtain or verify information that may be material.</p> <p>If the client wishes to restrict the scope of the <i>member's</i> investigations VS 2.4 will apply.</p>
(m) The nature and source of the information to be relied on by the valuer	<p>If the client plans to supply information relating to the property, or directs the valuer to obtain it from a <i>third party</i>, then an agreement that the valuer can safely rely upon this information should be recorded in the <i>terms of engagement</i>.</p>
(n) Any consent to, or restrictions on, publication	<p>The <i>member</i> must stipulate in the <i>terms of engagement</i> that the <i>member's</i> prior consent in writing will be required for any reproduction or public reference to the valuation or report (see VS 6.12).</p>

<p>(o) Any limits or exclusion of liability to parties other than the client</p>	<p>Limitations are only effective if notified to the client in advance.</p> <p>The <i>member</i> should keep in mind that any insurance that protects 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 insurers agree to either a modification or a complete waiver.</p> <p>Some valuations will be for purposes where the exclusion of <i>third-party</i> 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 <i>third parties</i>. This is a matter for the commercial judgment of the <i>member</i>.</p> <p>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 <i>third-party</i> limitation clause may provide some protection, the valuer may thus become exposed to the risk of a duty of care to unknown <i>third parties</i>. It may therefore be wise, particularly in the case of valuations for lending on commercial property, for the <i>member</i> 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>
<p>(p) Confirmation that the valuation will be undertaken in accordance with these standards</p>	<p>The standards must be referred to by their full title: for example, the <i>RICS Valuation Standards – Global and UK</i>, 7th edition. This confirmation will include any statement required under VS 1.2.2.</p> <p>All agreed <i>departures</i> from the standards should be referred to within this confirmation, but the details will be set out in the information required under (k).</p>
<p>(q) Confirmation that the valuer has the knowledge, skills and understanding to undertake the valuation competently</p>	<p>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.</p>

(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 <i>firm</i> is <i>registered for regulation by RICS</i> , reference to the <i>firm's</i> complaints handling procedure, with a copy available on request	This requirement is included to emphasise the need for <i>firms registered for regulation by RICS</i> 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.	<p>Guidance on the operation of the monitoring regime, including matters relating to confidentiality, is available from www.rics.org/regulation.</p> <p>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.</p>

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 need not 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, 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 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 the interpretation of legal documents 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. If this is not done 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 will 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 impact on the value, unless a *special assumption* to that effect is agreed. The valuer must therefore state clearly that the *inspection* will not be a building survey, and must define the limits that will apply to the valuer's responsibility to investigate and comment on the structure or any defects. 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 & equipment will often have a significant impact on value. Detailed investigation will normally be outside the scope of the valuation, and 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 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 positively or adversely on the value. This information will often be readily available, but delays or expense 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 either the nature or risks of contamination or hazardous substances, or 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* (2010).

(f) Environmental matters

2.9 Some property will be affected by environmental factors that are either an inherent feature of the property itself, or of the surrounding area, which 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 through its whole life cycle, but environmental and social aspects of sustainability may also have an impact on property performance.

2.11 RICS has an online area that is the focal point for its involvement in sustainability projects, research and events: www.rics.org/sustainability.

2.12 The 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.

Appendix 4

Special assumptions

1 Introduction

1.1 This appendix contains information on *special assumptions*. Examples of the circumstances under which it may be appropriate to make *special assumptions* include:

- a situation where a bid from a *special purchaser* has been made, or can be reasonably anticipated;
- a situation where circumstances mean that the interest being valued cannot be offered freely and openly in the market;
- a past change in the physical circumstances of the property where the valuer has to assume those changes have not taken place;
- an impending change in the physical circumstances 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 *date of valuation* it is occupied;
- it is let on defined terms when, in reality, at the *date of valuation* 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 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 & 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 the circumstances ever arising under which the owner is compelled 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 other 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 is an assessment of *worth* rather than a valuation.

2.4 It is a common misconception 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. 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 clients 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 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;
- the business 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 the definition of *Market Value*. They are often particularly appropriate where the client is a lender, where *special assumptions* are used to illustrate the potential effect of changed circumstances on the value of a property as a security.

5.3 In cases of valuations 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 is to be, owner-occupied;
- property that is, or is to 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.

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 1.2.7. 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 either because some lenders do not accept that a valuation procured by a borrower or its 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’. 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, and any additional criteria for independence under VS 1.8, may confirm that they are acting as ‘independent valuers’.

3.3 In the case of a valuation for secured lending, the lender may specify additional criteria for independence. 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, prospective borrower or the property to be valued, or with 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 prospective borrower or the property to be valued must be disclosed to the lender.

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

- has a long-standing professional relationship with the prospective borrower or the owner of the property;

- is introducing the transaction to the lender, or the prospective borrower, for which a fee is payable to the valuer or *firm*;
- has a financial interest in the property;
- has a financial interest in the prospective 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.

3.6 In considering whether any previous, current or anticipated involvement with either the property or 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 materially benefit 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.

3.7 If the valuer considers that any involvement creates a conflict with his or her duty to the potential client that cannot be avoided, the instruction should be declined.

3.8 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.

3.9 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 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.

3.10 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 Examples of circumstances that often arise in valuations for secured lending where *special assumptions* may be appropriate include the following:

- 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 *date of valuation* 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 section 3) identified in the *terms of engagement* or 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;
- 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, 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 is to be, owner-occupied

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

- 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 *date of valuation* it is occupied.

Property that is, or is to be, held as an investment

5.5 Additional report contents include:

- 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 which 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;

Appendix 5 Valuations for commercial secured lending

- 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 the impact on *Market Value*, 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 of 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 *date of valuation* rather than a projection, or valuation forecast, of the likely value at the end of the development period.

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

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 specified 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 used in VS 6.1.

Item	Comment
(a) Identification of the client	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.
(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 & 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 properties are valued it may be convenient to list them in a schedule that identifies each unit of valuation (see also VS 6.9).
(d) The interest to be valued	The legal interest in each property should be stated. The extent to which vacant possession is, or may be, available (if required) should also be noted.
(e) The type of property and how it is used, or classified, by the client	For some purposes the uses, categories or classes of property 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 <i>basis</i> , or <i>bases</i> , of <i>value</i>	The <i>basis</i> , or <i>bases</i> , of <i>value</i> must be stated (see VS 6.1 and VS 6.3) and the definition must be provided in full.

	<p>A <i>depreciated replacement cost</i> valuation for inclusion in a <i>financial statement</i> 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).</p> <p>Where the report includes a valuation using <i>depreciated replacement cost</i> 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).</p>
(g) The <i>date of valuation</i>	<p>The <i>date of valuation</i> must be stated. If there has been a material change in market conditions, or the circumstances of a property or portfolio, between an earlier <i>date of valuation</i> and the <i>date of the report</i>, the valuer must draw attention to this.</p> <p>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.</p>
(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.
(i) If required, a statement of the status of the valuer	<p>Where it is a requirement, the valuer will state if he or she is acting as an <i>internal</i> or <i>external valuer</i>. Where other criteria have been adopted they must be confirmed, together with a statement that the valuer meets them.</p> <p>In some states the national association <i>valuation standards</i> may require additional disclosures to be made with regard to the status of the valuer.</p>
(j) Where appropriate, the currency that has been 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 <i>assumptions</i> , <i>special assumptions</i> , reservations, special instructions or <i>departures</i>	<p>All <i>assumptions</i> made must be stated, together with any reservations that may be required (see Appendix 3). Where the <i>assumptions</i> vary in different states the report must make this clear.</p> <p><i>Special assumptions</i> must be clearly stated (see VS 2.2).</p>

	<p>Where the valuation is undertaken on the basis of restricted information, or is a revaluation without an <i>inspection</i>, the report must include full particulars of the restriction (see VS 2.4 and VS 2.5).</p> <p>Any <i>departures</i> from the standards must be stated and explained (see VS 1.2).</p> <p>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.</p> <p>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.</p>
(l) The extent of the valuer's investigations	<p>The report must record the date and extent of any <i>inspection</i>, including reference to any part of the property to which access was not possible (see VS 5.1).</p> <p>The valuer must make it clear if the valuation has been made without an opportunity to carry out an adequate <i>inspection</i> (see VS 2.4).</p> <p>In the case of a revaluation, the report should also refer to any agreement that further <i>inspections</i> are unnecessary (see VS 2.5).</p> <p>Where a substantial number of properties are being valued, a generalised statement of these aspects is acceptable, provided that it is not misleading.</p>
(m) The nature and source of the information to be relied on by the valuer	<p>The valuer must make it clear if the valuation has been carried out without the information normally available when carrying out a valuation. The valuer must indicate in the report if (where practicable) verification is needed of any information or <i>assumptions</i> on which the valuation is based, or if information considered material has not been provided.</p> <p>If any such information or <i>assumption</i> 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 <i>assumption</i> that there have been no material changes, should be included.</p>

	Included in the report should be any additional information that has been available to, or established by, the valuer 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	<p>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).</p> <p>Where the valuer has either provided a valuation on the basis of a <i>special assumption</i>, or has made a <i>departure</i> from any of the <i>valuation standards</i>, 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 <i>special assumption</i> or <i>departure</i> (see VS 6.13).</p>
(o) Any limits or exclusion of liability to parties other than the client	<p>For some purposes valuers may be unable to exclude liability to <i>third parties</i> (see Appendix 2 (o)).</p> <p>Any limitation on disclosure of a valuation based on restricted information or instructions should be included (see VS 2.4).</p>
(p) Confirmation that the valuation accords with these standards	<p>This statement must be unequivocal, but may include a cross-reference to any agreed <i>departures</i> referred to under item (k).</p> <p>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).</p>
(q) A statement of the valuation approach	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, or limited transactions or any combination of these factors.
(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 <i>firm</i> 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 is to be made.

(s) The opinions of value in figures and words	<p>In the main body of the report the opinion of value is required in words, as well as in figures.</p> <p>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.</p> <p>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.</p> <p>‘Negative values’ must be stated separately and not set off against the positive values of assets (see VS 6.8).</p>
(t) Signature and <i>date of the report</i>	<p>The report must be signed by the person who accepts responsibility for it (see VS 1.5).</p>

Appendix 7

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. 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 2010 by an *external valuer*, Joe Smith, FRICS of Alpha Chartered Surveyors. The valuations were in accordance with the requirements of the *RICS Valuation Standards*, 6th edition, and the International Valuation Standards (IVS). The valuation of each property was on the basis of *Market Value*, subject to the following *assumptions* (include as appropriate):

- **for owner-occupied property:** that the property would be sold as part of the continuing business;
- **for investment property:** that the property would be sold subject to any existing leases; or
- **for surplus property and property held for development:** that 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 & equipment or mineral bearing land.

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 2010.

The company's freehold and leasehold properties were valued as at 31 December 2010, 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 their own figures.

Appendix 8

European Mortgage Federation paper on mortgage lending value

1 Introduction

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

Mortgage Lending Value

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

5. Mortgage Lending Value shall mean the value of the property as determined by a valuer making a prudent assessment of the future marketability of the property by taking into account the long-term sustainable aspects of the property, the normal and local market conditions, as well as the current use and alternative possible uses of the property. Speculative elements should not be taken into account in the assessment of Mortgage Lending Value. Mortgage Lending Value should be documented in a clear and transparent way.
6. All internationally recognised valuation methods also apply to the Mortgage Lending Value, subject to the type of property and the market specificities (historic, legal, etc.) where the property is located. These are:
 - comparison method;
 - income method;
 - depreciated replacement cost method.
7. Regarding the technical transposition of the definition mentioned above, the long-term validity of Mortgage Lending Value requires compliance with a certain number of steps aimed at eliminating short-term market volatility or temporary market trends. The valuer must address the following key issues when determining the Mortgage Lending Value of a property:
 - The future marketability and saleability of the property has to be assessed carefully and prudently. The underlying time perspective goes beyond the short-term market and covers a long-term period.
 - As a principle, the long-term sustainable aspects of the property such as the quality of the location, construction and allocation of areas must be taken into account.
 - As far as the sustainable yield to be applied is concerned, the rental income must be calculated based on past and current long-term market trends. Any uncertain elements of possible future yield increases should not be taken into account.
 - The application of capitalisation rates is also based on long-term market trends and excludes all short-term expectations regarding the return on investment.
 - The valuer must apply minimum depreciation rates for administration costs and capitalisation of rents.
 - If the Mortgage Lending Value is derived using comparison values or depreciated replacement costs, the sustainability of the comparative values needs to be taken into account through the application of appropriate discounts where necessary.
 - The Mortgage Lending Value is generally based on the current use of the property. The Mortgage Lending Value shall only be calculated on the basis of a better alternative use, under certain circumstances, i.e. if there is a proven intention to renovate or change the use of the property.

- Further requirements, for example with respect to compliance with national standards, transparency, content and comprehensibility of the valuation complement the legal framework for the calculation of Mortgage Lending Value.
8. There are important differences between Market Value and Mortgage Lending Value: Market Value is internationally recognised for the assessment of the value of a property at a given moment in time. It estimates the price that could be obtained for a property at the date of valuation, notwithstanding that this value could alter very rapidly and no longer be up-to-date. In contrast, the purpose of Mortgage Lending Value is to provide a long-term sustainable value, which evaluates the suitability of a property as a security for a mortgage loan independently from future market fluctuations and on a more stable basis. It provides a figure, usually below Market Value and therefore, able to absorb short-term market fluctuations whilst at the same time accurately reflecting the underlying long-term trend in the market.

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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 – that is, the probability that the valuer's opinion of *Market Value* would exactly coincide with the price achieved were there an actual sale at the *date of valuation*. 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 provide the user with increased confidence in the valuation.

1.4 Valuers should not treat a statement expressing less confidence in a valuation than usual as an admission of weakness. Indeed, if a failure to draw attention to material uncertainty gave a client the impression that greater weight could be attached to the opinion than was 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:

- status of the valuer;
- inherent uncertainty;
- restrictions on enquiries or information provided;
- liquidity and market activity; and
- market instability.

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 dependent 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, and VS 6.1 requires confirmation in the report that the valuer has sufficient experience and no conflict of interest.

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.

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 is drawn to any limitations.

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.

Market instability

2.6 Disruption of markets can arise due to unforeseen financial, macro-economic, legal, political or even natural events. If the *date of valuation* 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 an absence of, 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 valuers can be unusually testing. Although valuers should remain 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 these items are being included:

- **Use of *special assumptions*:** Where the valuer can reasonably foresee that different values may arise under different circumstances, the valuer should enter into a dialogue with the client to consider alternative valuations using *special assumptions* that reflect those different circumstances. 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 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 on 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 their 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 Valuers should emphasise within their 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 the 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 and 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 a property should exchange on the *date of valuation* between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein 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 The 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 will 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:

- (a) on the basis that trade has ceased and no trading records are available to prospective purchasers or tenants;
- (b) as in (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 to be included in the valuation should be clearly set out in the report.

5.3 Where 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, 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 and comment accordingly in the report on the potential impact on the valuation that the lack of availability of those assets would have to anyone purchasing or leasing the operational entity.

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 of 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 *date of valuation*.

5.9 The actual trading performance should be compared with similar *trade related property* types 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:

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

6 Valuation approach for a non-trading property

6.1 The valuation process for a non-trading property is the same as outlined in section 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 of 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 the basis of one or more *special assumptions*, as well as on 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:

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 Valuations for investment purposes

8.1 The basic approach to investment valuations 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, Valuations 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 in the same way 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 review thereof, 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. Valuers should highlight the importance of the trade inventory to the trading potential and value of the property.

GN 3 Valuations of portfolios and groups of properties

1 Introduction

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

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

2 Identification of separate property

2.1 Where there is doubt about what constitutes a single property, the valuer should generally 'lot', or group, the properties for valuation in the manner most likely to be adopted in the case of an actual sale of the interest(s) being valued. However, the valuer should discuss the options with the client and must take care to 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-adjointing 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 either from increased market share or from 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 by way of 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 have the effect of flooding 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.

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

3.5 Likewise, where the valuer ascribes a single value to a group of separate properties, any *assumptions* necessary to support that approach should be stated. If the valuer considers that 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 an aggregated figure is provided of the total of the *Market Values* for each individual property in a portfolio, 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. It includes antiques and fine art, furnishings, collectables and appliances. It excludes plant & 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, Exceptions).

2 Terms of engagement

2.1 The knowledge of clients will range from some which have a deep understanding of the personal property markets, to others which are unfamiliar with those markets, the terms used and 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 *Members* 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 *member* 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;
- (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 property 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 *date of valuation*;
- (h) disclosure of any material involvement, or a statement that there has not been any previous material involvement;
- (i) 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;
- (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 by the valuer 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 shall take steps as are reasonably necessary to ensure that such services are competently performed and the conclusions relied on are reasonable and credible, or 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 be dependent 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 at around the date of valuation:** 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 to the reader and is prepared with high standards of integrity, clarity and objectivity (see VS 6.1).

6.2 The generality of VS 6, Valuation reports, and published references to them, will apply to the reporting of personal property valuations. The list of minimum requirements in VS 6.1 is effectively the same as that in VS 2.1, and 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 & equipment

1 Introduction

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

1.2 Plant & 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 & 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, and whether it may be considered as either *in situ* (in place) or for removal.

1.3 Plant & 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 be 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 & 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 & 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 & 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 section 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 *assumption* may not always be appropriate, and 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 & equipment separately valued

3.1 Plant & 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 & 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, new stores and work in progress.

3.4 Although *intangible assets* fall outside the definition of plant & 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 & equipment to be subject to financing arrangements that mean they cannot be sold without the lender being paid any balance outstanding under the arrangement. 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 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 & equipment on the basis of *Market Value*, VS 3.2 requires that the valuer indicates 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 & equipment separately from the property in which it is situated, there may be time 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 provide a *Market 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). If no constraint exists at the *date of valuation*, 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.

5.3 Many of the *inspection* requirements set out in VS 5 can be readily adapted to plant & 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.

5.4 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.

5.5 Similarly there will be occasions when factors affecting the land and buildings will impact the valuation of plant & 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 & equipment in question. Many of these are specific to the plant and process being considered. Therefore the valuer must consider the nature of the plant and activity, and the purpose of the valuation and its extent, in determining how far the regulatory measure which can, or might, affect the valuation should be investigated.

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, 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 IVS defines *DRC* 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.

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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 *date of valuation*.

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 & 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 & 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 & 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 *date of valuation*. 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 *date of valuation*. 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 *date of valuation*.

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 *date of valuation* 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 *date of valuation*. 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 *date of valuation*.

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 *date of valuation* 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 & 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 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 *date of valuation*. Where this is the case, the percentage of the current replacement cost remaining at the *date of valuation* 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.

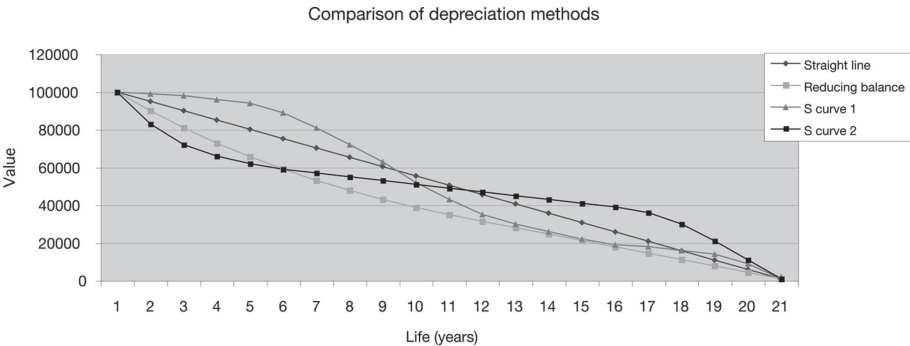
S-curve

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 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 & equipment.

Figure 1



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.

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 <i>DRC</i>	3.1–3.9	
2 Qualification of the valuer	4.1–4.2	
(a) Specialist assistance	4.3	
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Ensure file contains all relevant information on the decisions taken during the *DRC* process.

GN 7 Discounted cash flow for commercial property investments

1 Introduction

1.1 Traditionally, property investments have been valued by applying an all-risks yield (ARY) derived from the yield applicable to a market-rented investment – observed *market rent* divided by observed gross market price. The ARY subsumes *assumptions* about future cash flow that are not explicitly modelled in the cash flow, e.g. anticipated future rental value change, void periods and capital expenditure. Although some of these can be explicitly included in the cash flow (e.g. voids or capital expenditure) with suitable amendments to the ARY, the normal application of the ARY model is to capture rental value change and other anticipated future events implicitly within the yield. Growth (or change) in *market rents* is always implicit in the ARY that is applied against a rental cash flow assumed to either remain unchanged, or revert to current *market rent* when appropriate.

1.2 There remains a reticence within the real estate sector to adopting valuation approaches in which these factors are made more explicit. Nevertheless, since the price paid for an income-producing asset reflects the investor's expectations as to its potential cash flows and risks, there is a strong argument that all *assumptions* should be made explicit, especially when investment decisions are being taken on behalf of *third parties*.

1.3 Any technique should be aligned to the nature or role of the valuation. Valuation techniques are most commonly used to arrive at an estimate of the price at which the property might be sold. This capital value, based on an exchange value concept, is known as *Market Value (MV)* which has a precise definition in International Valuation Standards (IVS) (see the Glossary). It is effectively a proxy for price and should be thought of as an estimate of the contract price, i.e. the amount the buyer pays the seller.

1.4 Alternatively, the objective may be to estimate the value of the property to a particular investor. This entity-specific value is referred to as *investment value*, or *worth*. All things being equal, an investor will buy a property investment if its *investment value* is considered to exceed its *Market Value* and will sell if the property's *Market Value* exceeds that opinion of its *investment value*. An individual's opinion of the latter will almost invariably differ from the *Market Value* because everyone has different income requirements, expectations, attitudes to risk, tax position, etc. It is those differences of opinion that create a market in which investments are bought and sold.

1.5 The explicit discounted cash flow (DCF) valuation method is of greatest application in the assessment of *investment value* to assist in buy/sell decisions or selection between alternative available investments. However, it can also be used to estimate *Market Value* by adopting a set of tenable *assumptions* that are consistent with observed market prices, and then applying those *assumptions*, with appropriate adjustments, to the valuation of the subject property. Where there are no transactions, the explicit DCF model provides a rational framework for the estimation of *Market Value* not present in the ARY (capitalisation rate) approach, which relies on comparables for the identification of the ARY.

1.6 There is a school of thought that more weight should be given to such concepts as long-term economic value, mortgage lending value or sustainable value. These measures attempt to provide an assessment of a stable or mid-*Market Value*, smoothing short-term market volatility and adopting longer-term trends that obscure the short-term fluctuations. They are neither a *Market Value* nor a personal opinion of *investment value*, but may represent a useful measure of underlying security for a long-term lender. A DCF approach provides for the use of explicit *assumptions* and therefore is ideally suited for this purpose.

1.7 More detailed examination of these different concepts and definitions of value, as well as the different applications of the method to the appraisal of investment properties, can be found in many valuation textbooks. This *guidance note* is designed to be informative rather than prescriptive. Valuation techniques are continually evolving, and there is no absolute consensus within the practical or academic arenas on the best or correct approach to the use of DCFs to arrive at an *investment value* or an estimate of *Market Value*. Valuers should use their balanced judgment on the most appropriate method. The rest of this *guidance note* concentrates on the explicit DCF approach.

2 Fundamentals of the discounted cash flow approach

2.1 DCF valuation involves projecting estimated cash flows over an assumed investment holding period, plus an exit value at the end of that period, usually arrived at on a conventional ARY basis. The cash flow is then discounted back to the present day at a discount rate (also known as desired rate of return) that reflects the perceived level of risk.

2.2 The discount rate will reflect market and property-specific risks. Care has to be taken not to reflect risk factors in both the cash flow and the discount rate.

2.3 To arrive at the estimated revenue cash flow, it is necessary to reflect the investment's specific leasing pattern including rent reviews, lease renewals or re-lettings on lease expiry, void costs while parts of the property are vacant, non-recoverable outgoings and anticipated capital outlays on refurbishment or upgrade.

2.4 The exit valuation will reflect anticipated rental growth, the reversionary nature and unexpired terms of the leases at the exit date, and the application of an appropriate ARY. Depending on the holding period this may be forecast or based on equilibrium market conditions.

2.5 These components of the DCF calculation will now be examined in detail.

3 Estimating the cash flow

3.1 Cash flows should be prepared carefully to capture explicitly all information relating to income and expenditure, and should reflect, as and when appropriate, rental growth, taxation, external financing and all costs. Table 1 outlines these parameters.

3.2 Care is needed when considering depreciation to ensure double counting does not occur. Where allowance has been made for refurbishment and upgrading in the cash flow during the holding period, the exit yield should reflect the anticipated state of the property reflecting the completion of the refurbishment programme. This is particularly relevant in multi-tenanted buildings, such as shopping centres, where the landlord can control physical and, to a certain extent, functional obsolescence.

3.3 In assessing *investment value*, the valuer should have regard to the investor's judgment on the inputs to be adopted, other than the current factual matrix of data (i.e. tenure, physical attributes and lease terms). However, the client may seek the valuer's opinions on the inputs. If so requested, the valuer should adopt market-based forecasts for rental and yield movements, and should advise on appropriate discount rates having regard to sector and property-specific factors.

3.4 Cash flows can cover any time horizon but are normally undertaken for 5, 10 or 15 year periods. However, the shorter the time horizon, the greater the impact of the exit value will be upon the present value (*Market Value* or *investment value*). Transaction costs will also have a greater impact since they will have to be written off over a shorter period.

3.5 The characteristics of the specific asset should be taken into account when fixing the time horizon. An appropriate exit date may be influenced by material events in relation to the property itself, such as break clauses or lease expiries, which can lead to substantial refurbishment expenditure or voids. However, care should be exercised if the assessment of *investment value* for different properties is used to compare the advantage of buying one particular property over another. Internal rates of return (IRR) used over different time periods do not always make it possible to determine automatically which is the superior investment from the prospective owner's point of view.

3.6 For an assessment of *investment value*, the time horizon adopted should reflect the investor's anticipated investment holding period (which will normally be determined having regard to the factors mentioned earlier).

3.7 In assessing *Market Value* and analysing price, tax is not usually explicitly factored into the calculation, as comparison-based evidence is generally analysed on rentals and expenditures gross of tax. The use of DCF techniques allows tax to be factored into a calculation of *investment value*. The valuer may feel it appropriate to assess *investment value* both with and without tax implications.

3.8 A key factor that will affect both the revenue cash flow and the exit value is anticipated rental growth. Econometric forecasting involves the construction of models of the property market derived from insight into the drivers of that market, and utilises fundamentals derived from wider economic and financial market models. The models identify relationships that have occurred in the past and use leading indicators, or forecasts, to produce an estimate of each variable in the future. Such econometric modelling is not normally within the skill-set of valuers, so it may need to be outsourced.

Table 1: Information needed for preparation of DCF

Type of information	Current data	Forecasts
Tenure	<ul style="list-style-type: none"> Title, including headlease details (if applicable) Outgoings Head rents Unfulfilled statutory obligations 	
Physical attributes	<ul style="list-style-type: none"> Floor areas (net and gross) Ancillary areas and car parking Building specifications Tenants' improvements 	<ul style="list-style-type: none"> Planned or possible changes in areas/ parking provision
Lease/sublease and occupational interests	<ul style="list-style-type: none"> Tenancy details Lease expiry dates Break clauses Rent review dates Rent review terms 	<ul style="list-style-type: none"> Lease events forecasts, including probability of breaks being operated and leases renewed Duration of future voids Perpetual void allowance
Rental value	<ul style="list-style-type: none"> Rents passing (including stepped rents) Estimated rental values 	<ul style="list-style-type: none"> Growth in rental value for the location to model refurbishment/ redevelopment options Growth in actual property rents
Costs of property ownership and holding costs	<ul style="list-style-type: none"> Vacancy/void costs Unrecoverable service costs Unrecoverable management costs Letting and review costs Purchase and sale costs 	<ul style="list-style-type: none"> Inflation in maintenance and running costs Future periods on lease expiry and periods of refurbishment
Redevelopment/ refurbishment	<ul style="list-style-type: none"> Costs of redevelopment/ refurbishment Dilapidations 	<ul style="list-style-type: none"> Inflation in building costs
Finance	<ul style="list-style-type: none"> Loan details Break costs 	<ul style="list-style-type: none"> Changes in interest rates
Gearing	<ul style="list-style-type: none"> Level of debt Return on equity employed 	
Taxation	<ul style="list-style-type: none"> Income and capital gains VAT election Capital allowances 	

3.9 It is important to identify whether any future growth rate in rental value used in the valuation has been determined by forecasting growth rates before or after rental value depreciation. Forecasting rental values is often underpinned by analysing the relationship between past economic factors and rental value change. Some indicators of past rental value change are based on hypothetical prime property, while some are based on value change in a portfolio of real properties. Where a property is assumed to be subject to future refurbishment or redevelopment, two rental forecasts will be required: one reflecting depreciation to be applied to rent reviews in the existing/unimproved building; and another to forecast the rental value of the improved or replacement property.

3.10 The situation is complicated because forecasting at the local level is not usually as well-developed as forecasting at the national or regional levels, due to the poor quality and quantity of local data, coupled with the increased importance of the supply side.

3.11 Therefore, often rental forecasts will need to be made subjectively based on market expectation. Market prices can be analysed to determine a set of growth *assumptions* that, together with a selected discount rate and other *assumptions*, is consistent with market pricing. An investor making an assessment of *investment value* can consider whether that expectation is believed to be credible. Sensitivity analysis can be undertaken by the valuer by varying rental growth rates above and below perceived market sentiment.

3.12 Valuers who do not have access to formal forecasts should still be able to make informed comments on prospects for an individual property. However, the basis and background to any *assumptions* made about future changes in rental values, yields and costs should be made clear to the client.

4 Estimating the exit value

4.1 The exit value should reflect the anticipated state of the property, physically and in tenure/leasing terms, at the exit date. This should be overlaid with forecast movements in general interest rates and property yields. These forecasts should follow anticipated trend lines and should normally not try to catch volatile market movements in property yields. The tools of analysis will be looking to hone the exit yield into a long-run equilibrium yield that provides a measure of longer stability by absorbing shorter-term volatility and uncertainty.

4.2 The exit value may revert to site value where demolition of the building(s) is anticipated. In the case of leaseholds where the cash flow duration coincides with the lease expiry, the exit value will be zero, or may even be negative if dilapidations are expected to arise.

5 The discounting process

5.1 The DCF approach is a method of valuing an asset using the concepts of the time value of money. It is an explicit approach where all future cash flows are estimated and discounted to their present value. The discount rate reflects the time value of money and a risk premium, representing compensation for the risk inherent in future cash flows that are uncertain.

5.2 In simple terms, the time value of money can be considered to represent interest foregone. If currency unit (CU) 1 could be placed on deposit for a year to earn 5% interest then, broadly, CU1.00 receivable in a year's time has a present value of CU1 divided by 1.05, which equals 0.952. This is because the CU0.952 could be deposited to earn 5%, i.e. 0.048 interest, so that it would accumulate to CU1.00 after a year.

5.3 This presupposes that the CU1.00 in a year's time is certain, but it might not be. If the amount of the receipt is uncertain, the investor will not be willing to pay as much, maybe only CU0.90 instead. If so, the potential receipt of (approximately) CU1.00 has been 'discounted' not by 5%, but by 10%. So the discount rate will always reflect the investor's perception of risk. In this case, the 10% discount rate reflects 5% for the time value of money, plus a 5% risk premium.

5.4 This discount rate is then used to discount the anticipated cash flows:

CU100 receivable in 1 year's time is worth $\left(\frac{100}{1.10}\right) = 90.91$;

CU100 receivable in 2 years' time is worth $\left(\frac{100}{1.10}\right) / 1.10$ or $\left(\frac{100}{1.10^2}\right) = 82.64$; and

CU100 receivable in 3 years' time is worth $(100/1.10/1.10/1.10)$ or $\left(\frac{100}{1.10^3}\right) = 75.13$.

5.5 The result of this calculation is the net present value (NPV), defined as the present value of all future expected income and capital flows, discounted at the investor's target or required rate of return.

5.6 Although an ARY valuation conventionally treats all rent payments as received annually in arrears, an explicit DCF valuation should always reflect the actual cash flow frequency. To discount (e.g.) a quarterly cash flow, a quarterly discount rate must be applied. The quarterly equivalent of an annual discount rate is derived by the formula $(1 + i)^{0.25} - 1$. So for example, to discount at 10% per annum, the quarterly cash flow must be discounted at $1.10^{0.25} - 1 = 2.411\%$ per period.

5.7 If cash flows are receivable in advance, for example rents receivable quarterly in advance, the first period's receipt is not discounted and the second period's receipt is discounted by one period. The Microsoft Excel function for NPV assumes cash flows at the end of each period, so to reflect rents received in advance the NPV should be multiplied by $(1 + i/100)$, where (i) is the discount rate per period.

5.8 IRR is the discount rate which, when applied to all future expected income and capital flows, equates the price with the present value of these discounted income flows. The NPV is therefore zero. IRR can be used to compare potential returns from alternative investments whose purchase prices are known.

5.9 IRR can be derived only by an iterative trial and error process, which is the method used by spreadsheet IRR formulae. In Excel, an educated guess can be provided to speed up the calculation. In some instances, where the calculated cash

flows move from positive to negative and back again (or vice versa), there may not be a unique IRR, but this is a mathematical aberration. Normally, the differing answers will be far apart, but it would be prudent to test the 'most likely' figure by checking that, at the IRR rate adopted, the NPV does equal to zero.

5.10 IRR is used to calculate annual property performance of a property fund and, in that context, is sometimes described as the money weighted rate of return (MWRR). However, such a measure fails to recognise the significance of the timing and magnitude of capital inflows and outflows throughout the measurement period. If one fund experiences a large inflow of investment capital just before a bull market, whereas a competing fund suffers a capital outflow at the same time, the former might superficially appear to have performed better than the latter.

5.11 Using time weighted rate of return (TWRR) neutralises the effect of cash flow timings so that the relative skill of an individual fund manager can be assessed over a given time period. TWRR is simply the geometric mean rate of return, calculated by taking the n th root of a series of intermediate returns over n periods. For instance, if the returns over four successive periods are say 1, 2, 3 and 4%, the TWRR is given by: $TWRR = ((1.01) \times (1.02) \times (1.03) \times (1.04)) - 1 = 0.024939$ (or 2.4939%). If there are no intermediate cash flows over the period of analysis, the MWRR and TWRR measures will be identical.

6 Selecting the discount rate

6.1 Assessments of *investment value* should take into account the client's return on equity employed where required. When instructed by the client, the costs of finance (i.e. interest payments, arrangement fees) can also be factored into the cash flow. Further adjustment may be necessary to the discount rate adopted to reflect the additional risk incurred by undertaking a geared position, as opposed to an investment that is 100% equity financed.

6.2 Care should be taken to avoid double counting of risks by reflecting them both in the cash flows and in the discount rate. For example, if the cash flow assumes the exercise of all lease breaks and consequent voids, then the discount rate can be lower since the risk (the downside) has already been reflected in the cash flow.

6.3 The appropriate discount rate will be the rate of return that adequately compensates the investor for the risks taken. As risk rises, the required compensation for the level of risk should also rise, reflected in a rise in the discount rate. The discount rate (the target rate of return) is usually derived by reference to the return on an alternative form of perceived low-risk or riskless asset (frequently the benchmark is the gross redemption yield on government gilts or cash), plus appropriate additions for risk.

6.4 In the finance literature, the capital asset pricing model (CAPM) draws a distinction between market risk and specific risk. Market risk, also known as systemic risk, affects all assets and cannot be eliminated through diversification. Specific risk, however, is unique to each asset and is therefore uncorrelated with the market.

6.5 The dominant theme of modern finance is that only market risk is rewarded; as specific risk can be diversified away, investors cannot expect to be compensated for it. Data on the actual performance of property assets, however, demonstrate

huge variation in risk/return in a way that CAPM would not predict, driven in large part by the heterogeneity of the asset class; no two properties are the same. So for commercial real estate, in many cases specific risk matters.

6.6 The desired rate of return (also referred to as the discount rate or target rate) is conventionally constructed from a risk-free rate and market risk premium; for real estate, investors may also choose to add specific risk premiums. While this may seem to be a relatively straightforward process, actually determining the risk premium is more complex. Although some areas can be estimated quantitatively from historic data, a number of factors, e.g. the potential impact of carbon pricing on the appropriate discount rate, resist that kind of analysis. As a result, investors are required to make subjective or qualitative adjustments to discount rates. The positive interpretation of this is that being aware of a risk, even if one cannot quantify it exactly, is the first step in controlling it.

6.7 The following lists the salient factors in deriving a property risk premium:

- 1 Risk-free rate of investment
- 2 Market risks
 - Illiquidity upon sale (e.g. lot size, transaction times, availability of finance)
 - Failure to meet market rental expectations (forecast rental growth)
 - Failure to meet market yield expectations (forecast yield shift)
 - Risk of locational, economic, physical and functional depreciation through structural change
 - Risks associated with legislative change (e.g. planning/privity of contract, changes in fiscal policy)
- 3 Specific risks
 - Tenant default on rental payment (covenant risk)
 - Risk of failure to re-let (void risks)
 - Costs of ownership and management
 - Differing lease structures (e.g. rent review structure, lease breaks).

6.8 The risk-free return is normally taken to be the gross redemption yield on a medium-dated government gilt, preferably of the same duration as the assumed holding period of the investment. (Alternatively it is possible to adopt the real return of index-linked gilts, in which case this needs to be applied to cash flows expressed in real terms.) Equally, geared investors or property companies frequently have reference to debt costs or weighted average cost of capital (WACC) as the core metric against which assets are assessed.

6.9 The second group – risks of structural change or market failure – are those that may affect the market as a whole, particular subsectors or groups of property. The structural impacts on the in-town retail market brought about by the introduction of out-of-town retailing and changes to property taxation such as VAT are good examples of this. As such, these risks could be called market or systemic risks.

6.10 The third group – property, non-market or ‘unsystemic’ risk factors – are, broadly speaking, risks associated with individual assets.

6.11 These definitions (market/non-market) are relatively broad as none of the factors are entirely separable or mutually exclusive. For example, the risk of failure to meet market yield expectations could be a function of any one factor, or a combination thereof. Quite clearly then, the degree of separation of the various risk factors and their incorporation into a DCF are of key importance in the validity of an appraisal.

6.12 Alternative approaches to determining the target rate of return might be to adopt:

- (a) a single discount rate for all property investments;
- (b) a discount rate for each class of property – either by use (offices, shops, etc.), subtype (unit shops, shopping centres, etc.) and/or location;
- (c) a discount rate reflecting the risks of a specific property cash flow; or
- (d) different discount rates applied to different components of the cash flow according to their risk – for example the passing contractual rent until lease expiry (risk dependent on known tenant covenant); reversionary rent at future rent reviews (risk dependent on known tenant covenant and market rental change); and rental income beyond lease expiry (risk dependent on unknown tenant covenant and market rental change).

6.13 Determining separate risk premiums for each risk factor using method (c) given in paragraph 6.12 is a difficult and time-consuming process requiring specific research, which in most cases may be either impossible (given the poor quality of individual property data and secrecy attached to it) or impractical, given the scope and size of the various investment markets.

6.14 In addition, there is some degree of overlap between risk factors and hence difficulty in eliminating double counting of risk in some form. In any event, it is commonly regarded as more appropriate to incorporate property-specific risks into the cash flow, for example reflecting the risk of increased void levels in a property by adjusting the length of the void period. Therefore, while market risks are customarily incorporated in the discount rate, non-market property risks are, where possible, built into the cash flow.

6.15 At the other extreme, method (a) adopts a single discount rate for all property investments, reflecting that different classes of assets (equities, property, etc.) involve different levels of risk. For example, it is recognised that investment held in property is generally less liquid than that held in shares. Hence, a premium can be derived to account for the return required to compensate an investor in a single market (e.g. property as opposed to gilts or equities) for the risks (of market failure or liquidity).

6.16 Such an approach assumes that all sector-specific risks can be reflected in the cash flow – including the exit yield. This is unlikely to be possible, as the differences in submarkets will affect the cash flow during the holding period as well as the exit yield. In this connection, different submarkets (offices versus shops, or City of London versus provincial offices) exhibit different degrees of volatility and hence different degrees of risk. Adopting a single property market discount rate and property-specific cash flow risks (voids, outgoings, etc.) would disregard these sector-specific (and/or location-specific) risks.

6.17 Although each approach has advantages and disadvantages, this *guidance note* commends the use of method (b), possibly in combination with method (d), which distinguishes between covenant risk and market risk.

6.18 In many circumstances, investors will have already set appropriate discount rates (target rates) for an assessment of *investment value*. However, it is not uncommon for valuers to be asked to contribute to setting these figures. At the very least, valuers should be conversant with their clients' thinking in determining the discount rate, as this may affect the valuers' treatment of other elements of the cash flow.

6.19 Although method (b) relies on the principle of grouping risks, particular risk factors specific to an individual asset may occasionally be reflected in the discount rate. (For example, it would not be unusual for a valuer to adjust a discount rate for a shopping centre to reflect the risk of direct competition from a nearby scheme under construction.)

6.20 There are two broad approaches to calculating risk premiums: *ex post* and *ex ante*. *Ex post* approach generally focuses on a historic review of relative property returns (be it at all property, sector or individual asset levels) to the selected risk-free rate over as long a time period as possible. The downside to this approach is that while it can inform what the risk premium has been historically, this may be different from what it *should* have been, or indeed what it may be in the future. Equally, all the various risks to property are wrapped up in one calculation, so it is not possible to determine what has driven the risk premium to a particular level.

6.21 Hence many investors have attempted to construct *ex ante* estimates of the risk premiums. Several of the market risks in paragraph 6.7 can be estimated quantitatively with reference to historic experience; for example, information on transaction times and valuation versus sale price differences can be used to estimate liquidity premiums. However, the risks of structural change will almost always come down to a subjective/qualitative assessment.

6.22 Estimating premiums for specific risks is particularly challenging. Whilst a number of investors have attempted to use data to quantify these estimates, it is felt to be more usual practice for most investors to make basis points adjustment to hurdle rates based on experience. For instance, a 25 basis points (a quarter of 1%) increase could be applied for a Central London office investment that suffers from being slightly off core, or a 25 basis points reduction could be given for an industrial property that benefits from an unusually long lease. These adjustments are likely to vary across the property types, reflecting the particular factors that are key to driving value.

6.23 Note that investors' perception of risk premiums is not stable over time. As an example, this has been reflected in very little allowance being made for the illiquidity of property relative to equities and bonds. Equally in less positive market conditions, overly bearish *assumptions* are made about the ability to sell down. Secondly, the increasing role of multinational investors across property markets places emphasis on a wider range of factors than has been the case in the past. Most important amongst these are market transparency and governance, political and currency risk.

7 Reporting

7.1 Reports must comply with VS 6, Valuation reports.

7.2 Clarity regarding sources of information, any *assumptions* or *special assumptions* made, and identification of areas of potential value or cost that have

been excluded is crucial and represents good practice. Where a DCF method has been used the cash flow projections should be disclosed, along with the rationale for the discount rate.

7.3 If the *investment value* is materially different from *Market Value*, a statement to that effect must be made.

7.4 As the *investment value* is specific to the client in question, the valuer should confirm to the client that the valuation is to be used solely by the client and its professional advisers. It is not intended to be available or suitable for use by *third parties*.

Appendix to GN 7: Discounted cash flow valuation worked example

The task is to calculate the *investment value* (or *Market Value*) of an office building as at December 2009. There are three tenancies:

- The 300m² ground floor is let at CU35,000 per annum on a lease expiring in June 2011, following which there is expected to be a 12 months void. Outgoings will be incurred during the void period at the rate of CU60/m² plus, after three months, property tax of CU90/m². It is estimated that CU500/m² will need to be spent on refurbishment, before achieving a re-letting subject to a 12 months rent-free period. The current headline rental value is considered to be CU40,000 per annum, expected to increase to approximately CU50,000 per annum by the June 2012 re-letting date.
- The lease of the first floor (400m²) at CU40,000 per annum expires in December 2013. Assuming six months void, six months rent-free, there will be void outgoings of CU60/m², property tax of CU90/m² after three months and CU400/m² in refurbishment cost. Current headline estimated rental value (ERV) of CU60,000 per annum will be expected to increase to approximately CU69,000 per annum by the June 2014 re-letting date.
- The lease of the second to fifth floors (1,600m²) at CU190,000 per annum runs until September 2017, subject to a rent review in September 2012. The current headline rental value is estimated to be CU240,000 per annum, expected to increase to CU262,000 per annum by September 2012 when a 5% effective rent discount is expected to be applicable at rent review.

A five-year holding period is assumed. At that exit date, the first floor will have just become income-producing again. At the exit date, the investment will be reversionary with passing rents totalling CU368,400 per annum against ERVs totalling CU403,500 per annum. The expiry of the lease of the second to fifth floors will be two- and three-quarter years away, so the void, void costs, refurbishment cost and re-letting at ERV need to be factored in to the ARV exit valuation. Having regard to the risk profile of the investment at the exit date and anticipated market conditions, an equivalent yield of 7.25% is considered appropriate, producing an exit value, net of purchaser's costs, of CU4.48 million.

The cash flows can then be totalled and discounted back at a discount rate reflecting the perceived risk profile of the investment. At a 10% discount rate the value is CU3.56 million or CU3.37 million net of 5% purchase costs.

Discounted cash flow valuation – worked example

Tenancies						Void assumptions at lease expiry					
	Area	Rent	ERV	Rent review	Effective rent discount	Expiry	Void mths	Rent free mths	Void S/chg /M2 p.a.	Void taxes /M2	Returb cost
	M2	CU p.a.	CU p.a.								
Ground	300	36,000	45,000			Jun 2011	12	12	CU60	CU90	CU500
1st	400	40,000	60,000			Dec 2013	6	6	CU60	CU90	CU400
2nd-5th	1,600	190,000	240,000	Sep 2012	5.0%	Sep 2017	6	6	CU60	CU90	CU400

Growth assumptions																					
	Dec 2009	Mar 2010	Jun 2010	Sep 2010	Dec 2010	Mar 2011	Jun 2011	Sep 2011	Dec 2011	Mar 2012	Jun 2012	Sep 2012	Dec 2012	Mar 2013	Jun 2013	Sep 2013	Dec 2013	Mar 2014	Jun 2014	Sep 2014	Dec 2014
Assumed growth																					
Rental values	0.0%	0.0%	0.0%	0.0%	0.0%	6.0%	6.0%	6.0%	6.0%	4.0%	4.0%	4.0%	4.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Expenses	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Index																					
Rental values	1.000	1.000	1.000	1.000	1.000	1.015	1.030	1.045	1.060	1.070	1.081	1.092	1.102	1.111	1.119	1.127	1.135	1.144	1.152	1.161	1.170
Expenses	1.000	1.007	1.015	1.022	1.030	1.038	1.045	1.053	1.061	1.069	1.077	1.085	1.093	1.101	1.109	1.117	1.125	1.134	1.142	1.151	1.159

Discounted cash flow valuation – worked example (continued)

Cash flow (CU000s) over a 5-year hold period																		Exit	
	Dec 2009	Mar 2010	Jun 2010	Sep 2010	Dec 2010	Mar 2011	Jun 2011	Sep 2011	Dec 2011	Mar 2012	Jun 2012	Sep 2012	Dec 2012	Mar 2013	Jun 2013	Sep 2013	Dec 2013	Dec 2014	
Ground	Rent	9.0	9.0	9.0	9.0	9.0	void	void	void	void	r/free	r/free	r/free	r/free	12.6	12.6	12.6	12.6	
	Refurb cost						(156.8)												
	S/chg+taxes						(4.7)	(11.8)	(11.9)	(12.0)									
	Letting fee										(5.0)								
1st	Rent	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	r/free	
	Refurb cost																(180.1)		
	S/chg+taxes																(6.8)	(17.0)	
	Letting fee																	(6.9)	
2nd-5th	Rent	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	62.2	62.2	62.2	62.2	62.2	62.2	62.2	
	Net exit proceeds (see calculations below)																	4477.2	
Overall cash flow		66.5	66.5	66.5	66.5	66.5	66.5	66.5	66.5	45.6	45.5	52.5	72.2	72.2	72.2	84.8	84.8	74.8	4477.2
Net present value (NPV) at annually 10.00%		quarterly 2.411%		3557.1															
Less purchaser's cost		5.50%		(185.4)															
Investment value, net of purchase cost		3,372		CU000s															
Note: Costs inflated to Dec 2014 level for table below																			
2nd-5th floor void costs, as at exit date																			
	Total	Sep 2017	Dec 2017	Mar 2018															
Refurb cost	(185.5)	(185.5)	—	—															
Rates+S/chg	(389.5)	(111.3)	(278.2)																
Letting fee	(28.1)			(28.1)															
Total void costs	(603.1)	(296.8)	(278.2)	(28.1)															
Yrs deferred		2.75	3.00	3.25															
PV @ 7.25%	(492.7)	(244.8)	(225.5)	(22.4)															

India guidance notes

India GN 1 Valuation for financial statements

1 Introduction

1.1 This *guidance note* outlines the recommended practices for valuing real estate assets for the purpose of reporting in the relevant *financial statements* in accordance with the Accounting Standards (AS) in India. It endeavours to consider the specific accounting standards and guidelines applicable in India, and to integrate the core principles defined in the global *valuation standards* within an Indian context.

1.2 Valuations for the purpose of financial reporting are carried out to reflect the values of the real estate holdings and investments of business enterprises in their *financial statements*. This is for the benefit of shareholders, government authorities and retail investors in order to reduce information asymmetries and enhance efficiencies of financial market and information dissemination.

1.3 Apart from facilitating investor protection and efficient financial markets, adequate disclosures about real estate valuations for financial reporting are also important for taxation purposes from both a capital gains and an income tax perspective (depending on the purpose of the real estate ownership). Reporting of valuations of assets and properties for the disclosure of financial information in *financial statements* is generally governed by the comprehensive standards applicable in a particular country or jurisdiction.

1.4 The AS in India are issued by the Institute of Chartered Accountants of India (ICAI), a statutory body formed through an act of Parliament, and are prepared by its Accounting Standards Board (ASB). These AS have been given legal recognition under the *Companies Act* 1956 and require compliance from the respective constituents of various regulatory bodies, such as the Securities and Exchanges Board of India (SEBI), the Reserve Bank of India (RBI) and the Insurance Regulatory and Development Authority (IRDA). These standards are available at www.icai.org.

1.5 The key AS relating to valuation of real estate assets, which can be also be found in the Compendium of Accounting Standards (ICAI, 2006), are as follows:

- AS 2 Valuation of Inventories;
- AS 6 Depreciation Accounting;
- AS 10 Accounting for Fixed Assets;
- AS 13 Accounting for Investments; and

- AS 28 Impairment of Assets.

1.6 In addition, the following AS contain valuation treatment for special situations:

- AS 14 Accounting for Amalgamation;
- AS 16 Borrowing Costs; and
- AS 19 Leases.

1.7 With the aim of converging the Indian AS and *International Financial Reporting Standards (IFRS)*, the ICAI is working towards modifying the existing AS and issuing more relevant ones. However, the exact timetable of full convergence or applicability of *IFRS* in India has still not been officially announced. Hence, the valuation of properties for *financial statements* in India has to be in line with the bases and principles defined in the Indian AS.

1.8 As the AS are compulsory for inclusion in *financial statements*, which are mandated to be prepared at least once a year, they implicitly make it necessary to carry out a valuation at the end of every financial year. However, AS 28 recommends assessment of assets for impairment at each balance sheet date, except for some specific assets including inventories. Where impairment is suspected the valuer may be requested to provide a valuation as part of that test. Similarly, revaluation under AS 10 can be carried out at any point of time, at the discretion of the management.

1.9 The Indian AS do not categorise *external* or *internal valuers*, but RICS considers it best practice for such valuations to be carried out by independent valuers who are not employed by the concerned entity.

1.10 The valuer should agree with the client the appropriate basis of valuation when confirming the *terms of engagement*, based on the purpose of valuation. For different categories of property, different bases may be required. Further guidance on the identification of categories and the appropriate basis is given in section 4.

1.11 The client may ask the valuer to liaise with its auditors either before or after the report is made. India GN 1 appendix 1 provides information about the relationship between the valuer and the auditor.

1.12 The AS use the term 'fair market value' instead of *fair value* as defined in the Glossary and explained in VS 3.5. They principally yield the same result (see section 7), as there is no material difference between these two *bases of value*. Therefore wherever the term *fair value* is being used in reporting, the valuer should include an explanatory note regarding its definition being based on AS 13 or VS 3.5.

2 Applicability of Accounting Standards

2.1 Clause 3.3 of the Preface to the Statements of Accounting Standards covers the applicability of accounting standards by various enterprises. It is reproduced as follows:

1.1.1 Accounting Standards are designed to apply to the general purpose financial statements.... Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative¹ or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes.

© ICAI, AS Preface, 3.3, 2004

¹ With the issuance of this revised Preface, General Clarification (GC) – 12/2002, Applicability of Accounting Standards to Co-operative Societies, issued by the Accounting Standards Board in October 2002, stands superseded.

2.2 The ICAI has classified enterprises into three distinct levels: Level I, Level II and Level III. The definitions of all three classes are given in India GN 1 appendix 2.

2.3 The mandatory application of all or some of the AS depends upon the classification of enterprise. However, some of the other applicable laws and statutes make these AS applicable to an enterprise irrespective of its classification, such as the following:

- section 211 of *Companies Act* 1956 requires that every profit and loss account and balance sheet of the company shall comply with the AS issued by the ICAI; and
- it has been clarified by the ICAI that the AS are mandatory in respect of *financial statements* audited under section 44AB of the *Income Tax Act* 1961.

2.4 The valuer is advised to consult and agree with the management (see India GN 1 appendix 3) and auditors to confirm the applicability of the AS to the enterprise and the relevant asset. Where the standard is not mandatory or applicable to the enterprise, it is advisable to adopt the principles and guidance issued in the global *valuation standards*.

3 Bases of value

3.1 Indian AS require assets to be included in *financial statements* on the basis of either their cost less depreciation or current value.

Cost bases

3.2 In accordance with AS 2 Valuation of Inventories, properties that are held as 'inventories' to be sold in course of business by real estate development entities can be reported at 'cost'.

3.3 AS 13 Accounting for Investments recommends that properties held as 'investments', which are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise, are to be reported at 'cost'.

3.4 Where properties are considered 'fixed assets', in AS 10 Accounting for Fixed Assets the 'historical cost' is recommended for reporting the value of 'fixed assets' in the *financial statements*.

Valuation bases

3.5 Net realisable value is also recommended by AS 2 with respect to reporting the value of 'inventories' in *financial statements*.

3.6 For properties held as 'fixed assets', fair market value as defined in AS 10 (see paragraph 7.8) is recommended in case of revaluation, although existing use value and depreciated replacement value as defined by this standard may also be used.

3.7 Value in use as defined in AS 28 concerning impairment of assets held by an entity may be used in revaluation of 'fixed assets'.

4 Date of valuation

4.1 For any valuation for inclusion in a *financial statement*, the effective date of valuation is the date of the statement.

4.2 For practical purposes a valuation may need to be prepared before the effective date of the statement. If the valuation was prepared in advance and there has been a significant change between the *date of valuation* and the date of the statement either in market conditions or to the property valued, this must be stated in any published reference.

5 Classification of properties

5.1 Within the framework of the AS, assets can be treated as any of the following:

- inventories;
- fixed assets; or
- investments.

The value of the assets to be reported in the *financial statement* will be on the basis of the accounting policies adopted by respective entities.

Inventories

5.2 'Inventories', as defined in AS 2, refer to assets that are:

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

5.3 The valuation of inventories is required for financial reporting until revenues arising from their disposal or deployment are realised.

5.4 Properties developed for sale by an entity involved in the development of real estate are classified as inventories.

Fixed assets

5.5 'Fixed assets', as defined in AS 10, are held by an entity with the intention of using those assets to produce or provide goods or services. They are not held for sale in the normal course of business.

5.6 Properties held as fixed assets by entities which are not in the business of property development or trading are essentially owner-occupied.

Investments

5.7 As defined in AS 13, 'investments' are assets held by an enterprise for earning income through dividends, interest and rentals, for capital appreciation or other benefits, excluding any stock-in-trade.

5.8 AS 13 further defines 'investment properties' as investments in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. It thereby makes it clear that any property developed by an entity for earning income by way of letting also forms part of investments, and not fixed assets.

6 Valuation for inventories

6.1 Properties, including land and buildings, classified as inventories should be valued in accordance with AS 2, which states that inventories should be included at the lower of the cost and net realisable value.

6.2 Net realisable value is defined in AS 2 as follows:

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

© ICAI, AS 2, paragraph 3.2

6.3 As an accounting principle, the AS forbids carrying any asset on the *financial statements* at a value higher than that which can be expected to be realised from its sale or use. In accordance with this principle, AS 2 prescribes reporting of inventories, including properties, at lower of the cost or net realisable value.

6.4 With the identification of various elements of cost to be considered, the formulae and techniques of measurement of cost is elaborated in AS 2.

6.5 'Costs of completion', as referred to in the definition of net realisable value (see paragraph 6.2), must include costs incurred towards construction and bringing the properties held as inventories to its current state. These costs include site works and the fees and expenses of the architects, engineers, quantity surveyors, project managers, solicitors and other professional advisers employed on the project.

6.6 According to AS 2, financing costs are not considered to be related to bringing the inventories to its current form and location, and therefore are not to be included in the cost.

6.7 The valuer may be asked to assist with apportioning costs. In such a case, the cost of construction will be roughly the same as the cost to complete, plus the actual cost of the land, although the inclusion of any interest charges, land acquisition costs and non-recoverable taxes will depend on the accounting policy of the concerned entity. The valuer should discuss this with the client and state in the report whether or not such items have been included in the total amount reported.

7 Valuation of fixed assets

7.1 Accounting for fixed assets is governed by AS 10, which is applicable to properties, including land and buildings. Fixed assets are defined as follows:

Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

© ICAI, AS 10, paragraph 6.1

7.2 AS 10 prescribes reporting fixed assets on gross book value, defined as follows:

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

© ICAI, AS 10, paragraph 6.3

Historical cost

7.3 'Historical cost', referred to in the definition of gross book value (see paragraph 7.2), pertains to the purchase or acquisition price and any costs incurred towards bringing the fixed asset to its current working condition.

7.4 Where the asset is being developed or constructed by an entity, the historical costs need to include costs directly attributable to the construction and subsequent improvement of the asset, so as to enhance its future benefits. These costs include site works, and the fees and expenses of the architects, engineers, quantity surveyors, project managers, solicitors and other professional advisers.

7.5 The historical cost for a self-constructed asset would also include any borrowing costs directly attributable towards the acquisition or construction of the specific asset. The estimation of borrowing costs that can be allocated to such assets is covered in AS 16 (see India GN 1 appendix 4).

Depreciation

7.6 In order to report the net book value, the historical cost taken as gross book value needs to be adjusted for depreciation, in accordance with AS 6 Depreciation Accounting. AS 6 prescribes adopting a straight-line or reducing balance method for estimating depreciation amount in accordance with rates suggested in a relevant statute such as the *Companies Act* 1956. However, it also allows the management the discretion to adopt a rate in variance with the rates prescribed in the statute, as long as it is still in accordance with it.

7.7 The depreciation rates are based on the assessment of the useful life of the asset, and any changes from statutory rates need to be explained and disclosed. Thus, a valuer may be required to offer an opinion on the remaining useful life of the asset and the relevant rate of depreciation. In accordance with AS 6, such opinion needs to be made on the basis of:

- expected physical wear and tear;
- obsolescence; and
- legal or other limits on the use of the asset.

The assessment of these factors may require highly specialised skills and knowledge. The valuer must possess these in order to undertake the assessment completely and recognise what assistance may be required from other professionals. Accounting for depreciation is detailed in India GN 1 appendix 5.

Non-monetary acquisition

7.8 Where the fixed asset is acquired through the exchange of any other asset or for any non-monetary consideration, AS 10 provides for reporting its value on the basis of fair market value, which is defined as follows:

Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

© ICAI, AS 10, paragraph 6.2

7.9 In principle, the definition of 'fair market value' as prescribed in AS 10 conveys the same meaning as *fair value* (see VS 3.5).

Revaluation

7.10 AS 10 provides that the historical cost of fixed assets may be substituted by the revalued amount in the *financial statements*. Although AS 10 lays down the principles to be followed while reporting the net book value of the fixed assets, no specific bases have been prescribed for revaluation. The valuer should use one of the following bases, depending on the type of asset and how it is used or classified by the entity:

- existing use value (see UKVS 1.3 of the *RICS Valuation Standards – Global and UK* (the 'UK Red Book')); and
- *Market Value* (see VS 3.2).

Existing use value is defined as follows:

The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction, after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion, assuming that the buyer is granted vacant possession of all parts of the property required by the business and disregarding potential alternative uses and 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.

© *RICS Valuation Standards – Global and UK*, UKVS 1.3, 2011

The provision of revaluation for fixed assets notwithstanding, AS 10 prescribes that revaluation of a class of assets should not result in the net book value being greater

than the recoverable amount of the assets for that class. Hence, the valuer must very clearly communicate this principle in the valuation report.

Others

7.11 AS 16 specifies that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset (which takes a substantial period of time to prepare for its intended use or sale) should be capitalised as part of the cost of that asset. Further details on borrowing cost are covered in India GN 1 appendix 4.

7.12 It is advisable that the valuer discusses the issue of borrowing cost with management and the auditors before deciding the scope of work for the valuation and discloses in the report about the treatment of the issue separately.

8 Valuation for investment

8.1 Accounting for Investments is covered under AS 13, and classifies land and buildings as investment properties, which is defined as:

An investment property is investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

© ICAI, AS 13, paragraph 3

8.2 AS 13 differentiates the bases of valuation for short-term investments, known as 'current investments', from that for investment properties being classified as long-term investment.

8.3 The reporting basis for investment properties in AS 13 is the acquisition price, where there has been a monetary consideration.

8.4 Where any non-monetary transaction leads to the acquisition of an investment property, the cost is taken as the fair market value on the date of transfer, as set out in paragraphs 7.8 and 7.9.

9 Valuation for impairment assessment

9.1 AS 28 deals with the subject of the impairment of assets, defining an asset as the impaired when the carrying amount of the asset exceeds its recoverable amount. These terms are defined in AS 28 as follows:

Recoverable amount is the higher of an asset's net selling price and its value in use.

Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

© ICAI, AS 28, paragraph 4

9.2 AS 28 requires entities to review their assets for 'impairment' at every balance sheet date. According to applicable statutes such as the *Companies Act* 1956 and the framework developed by the ASB of the ICAI, this has to be at least annually.

9.3 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 or its net selling price. In other words, the amount on the balance sheet should be written down to the higher of either the current value of the future benefits that the entity would derive from the continued use of the asset, or the proceeds it would derive from the asset's immediate retirement and disposal.

9.4 Net selling price, as defined in AS 28, is very similar to the definition of fair market value (see paragraph 7.8) except for an adjustment regarding costs that may be required to be incurred to achieve the sale. The valuer may use the same approach and techniques to arrive at the net selling price, as adopted for estimating the fair market value, and subsequently adjust it for any disposal costs.

9.5 However, detailed cash flow projections of Level II and III enterprises (see India GN 1 appendix 2) are often not readily available. Therefore these types of enterprise are allowed to measure the value in use on the basis of reasonable estimate thereof, instead of computing the value in use by present value technique.

9.6 The revision of the definition of value in use that allows for 'a reasonable estimate' (see paragraph 9.5) suggests that instead of using the present value technique, a reasonable estimate of the value in use can be made. Consequently, if a Level II or III enterprise chooses not to measure the value in use by using the present value technique, the relevant provisions of AS 28 (such as discount rate) would not be applicable.

9.7 The valuer, after consulting with management and the auditors on the category of the enterprise, can thus estimate the value by using an appropriate method.

9.8 The judgment regarding the requirement of impairment assessment is left to the enterprise or entities, based on certain internal and external factors identified in AS 28. The valuer may not be competent to judge all the factors listed in AS 28 and, in context of impairment assessment, may only be able to offer an opinion on the following:

- significant decline in asset value, more than expected in normal use or passage of time;
- increase in market interest rates, or other market rates of return on investments, which are likely to affect the discount rate used in calculating an asset's value in use and to decrease the asset's recoverable amount materially;
- available evidence of any obsolescence or physical damage of an asset; and
- relevant indications that the economic performance of an asset is, or will be, worse than expected.

10 Events occurring after the balance sheet date

10.1 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 disclosure events.

10.2 The AS state that an event which occurs between the balance sheet date and the date on which the *financial statements* are approved may warrant the need for adjustments to assets and liabilities as at the balance sheet date, or may require disclosure.

10.3 An adjusting event is one which provides evidence of conditions, favourable and unfavourable, that exists at the balance sheet date.

10.4 Events that arise after the balance sheet date that could not be anticipated at that time are classified as 'disclosure events'. These are not to be adjusted in the *financial statements*, but a disclosure of it is required.

10.5 The valuer is advised to take management or the auditors' representation of any such events and disclose this in the report appropriately.

11 Valuation of leasehold assets

11.1 If property is leasehold in nature then the valuer needs to follow the approach prescribed in AS 19. Accordingly, AS 19 is applicable to all leases other than following real estate transactions:

- lease agreements to explore for, or use, natural resources such as oil, gas, timber, metals and other mineral rights; and
- lease agreements to use land.

11.2 Property leases are treated as either operating leases or finance leases under AS 19.

11.3 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. For detailed guidance, see UKGN 1, Land and buildings apportionments for lease classification under *IFRS*, in the 7th edition of the UK Red Book. The valuer must consult with management and/or the auditors for the treatment of lease in books of accounts and value the asset accordingly.

Operating leases

11.4 According to AS 19, all operating leases have to be valued as fixed assets by the lessor. The applicable guidelines are discussed in section 7 on valuation of fixed assets.

Finance leases

11.5 AS 19 prescribes that all finance leases have to be recognised as an asset and an obligation to pay future rentals. In addition, they must be valued at the lower of fair value or present value of the minimum lease payments (including guaranteed residual value) from the standpoint of the lessee. AS 19 defines fair value as follows:

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.

© ICAI, AS 19, paragraph 3.8

In principle this definition conveys the same meaning as *Market Value*.

11.6 The valuer is advised to refer to A19 Valuation of Inventories for clarification on calculation of present value of minimum lease payments and various definitions provided by this standard.

11.7 The AS does not explicitly require the value of land and buildings to be segregated, but it does require depreciation on leased assets. Hence, the valuer is advised to allocate the value to land and buildings separately so that the depreciation can be applied to the buildings element. Further details on this are provided in UKGN 1 in the 7th edition of the UK Red Book.

11.8 Initial direct costs incurred to secure a leased asset are considered direct costs and are included as part of the amount recognised as an asset under the lease. Hence, the valuer must clarify this with the auditors and disclose the treatment of the same consideration in the valuation separately in the report.

11.9 Other AS (such as AS 6 and AS 28) are equally applicable to leased assets, hence the valuer is advised to apply the same valuation methods and techniques to leased asset as well.

12 Valuation for amalgamation and merger

12.1 A valuation for an amalgamation or merger of two entities must be in accordance with AS 14 Accounting for Amalgamations.

12.2 AS 14 classifies amalgamation into two types based on the intention of the transaction: amalgamation in the nature of merger, and amalgamation in the nature of purchase.

12.3 Under amalgamation in the nature of merger, the transferee company has to value its assets at their carrying amount in the books of transfer or company. It also has the option to recognise its assets at their respective book value or fair value. Such fair value has to be estimated from the perspective of the transferee company.

12.4 In principle this definition of fair value conveys the same meaning as *Market Value* (see VS 3.2).

12.5 The valuer needs to obtain the classification of the merger from management and the auditors, and apply the relevant valuation methods.

13 Valuation for local bodies

13.1 Until recently, most of the local bodies were following a single-entry bookkeeping system under a cash basis. However, now many local bodies in the country are shifting to an accrual basis of accounting, particularly after the issuance of the National Municipal Accounts Manual (NMAM) in 2007 by the Ministry of Urban Development, a branch of the government of India. This manual is supported

by the Comptroller and Auditor General of India, of the National Institute of Urban Affairs and Indo United States Agency for International Development (USAID) Financial Institutions Reforms and Expansion (FIRE-D) Project, and the inputs were provided by the ICAI.

13.2 Recognising the need to harmonise and improve accounting and financial reporting among local bodies, the ICAI founded the Committee on Accounting Standards for Local Bodies (CASLB).

13.3 The AS formulated by the CASLB do not override the statute/law that governs the issue of general purpose *financial statements* of a particular local body. Local bodies may follow Generally Accepted Accounting Standards (GAAP) during the transitional period until the Accounting Standards for Local Bodies (ASLB) are issued by this committee. Once they are issued, local bodies should follow the ASLB and not the corresponding AS issued by the ICAI.

13.4 As stated by the ICAI, the ASLB will be recommendatory in nature for the initial years of use by the local bodies. They will then become mandatory for local bodies in a state from the date specified in by the state government concerned. The valuer is advised to confirm this with management and the auditors before undertaking the assignment. When such standards are not applicable, the valuer is recommended to follow the practices described by the ASLB.

13.5 For the purpose of AS, local bodies are defined as follows:

The term 'Local Body' may be defined as a local self-government at the third tier of governance in an administrative and geographical vicinity, e.g., a municipal corporation, a municipality or a panchayat. In many cases, the Local Bodies delegate their functions such as building of schools, city roads, parks, running transport services, providing water supply etc., to some other bodies that may or may not be controlled by the Local Bodies, e.g. development authorities, boards, parastatals. Such bodies may be constituted, in partnership with private sector or otherwise, directly or indirectly by or on behalf of a Local Body to promote or carry out some specific objective(s) or function(s) of the Local Bodies. Such bodies may be constituted under a statute. The term 'Local Body' would also encompass such bodies.

© ICAI, ASLB, Preface, paragraph 1.3

13.6 So far the ICAI has published six ASLBs relating to accounting standards applicable for financial reporting of local bodies. Accounting treatment of property, plant & equipment is covered under ASLB 5 (see India GN 1 appendix 6). This standard deals with the reporting of financial information related to the local body's investment in property, plant & equipment, encompassing land and buildings, excluding heritage properties.

India GN 1 appendix 1: Relationship with the auditor

1 Introduction

1.1 This appendix provides guidance to *members* on the valuer's relationship with the auditor when valuations are to be disclosed in published *financial statements*. It also gives an indication of the information that the auditor is likely to require.

2 The auditor's role

2.1 According to standards on auditing issued by the Auditing and Assurance Standards Board (AASB) of the ICAI, an auditor is required to express an opinion on whether the *financial statements* have been prepared, in all material respects, in accordance with the applicable financial information.

2.2 The AASB's Auditing and Assurance Standard (AAS) 9 Using the Work of an Expert states the following:

When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

- professional qualifications, licence or membership in an appropriate professional body, and
- experience and reputation in the field in which the evidence is sought.

© ICAI, AAS 9, paragraph 7

2.3 The auditor is also required to consider the objectivity of the expert. Where the expert is either employed by, or related in some manner to, the client, the auditor may consider engaging another expert.

2.4 This involves an assessment of whether the substance of the expert's findings is properly reflected in the *financial statements* or supports their assertions, and gives consideration to:

- the source data used;
- the *assumptions* and methods used, and, if appropriate, their consistency with the prior period; and
- the results of the expert's work in the light of the auditor's overall knowledge of the business and the results of the audit procedures.

2.5 When considering whether the expert has used appropriate source data, the auditor may consider:

- making inquiries of the expert to determine how the latter has decided that source data are sufficient, relevant and reliable; and
- conducting audit procedures on the data the client provided to the expert to obtain reasonable assurance that the data are appropriate.

2.6 The appropriateness of *assumptions* and methods used, as well as their application, are the responsibility of the expert. The auditor does not have the same expertise and therefore cannot always challenge the expert's *assumptions* and methods. However, the auditor should obtain an understanding of them to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of the audit procedures used.

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

3 The auditor's requests and the valuer's response

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

3.2 The auditor may ask the valuer to produce information and explanations relating to the purposes of the audit. There is no legal relationship between the auditor and an *external valuer* engaged by the client. The valuer can therefore refuse to produce the file and even refuse to answer the auditor's questions. This does not apply to an *internal valuer* employed by the entity and who is an officer of the company within the meaning of the applicable statute. However, if an *external valuer* refuses to co-operate this could constitute a limitation on the scope of the auditor's work. This may lead the auditor 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.

3.3 The valuer should therefore be prepared, and have the management's permission, to cooperate with any auditor. In addition, the valuer should bring to the auditor's attention and discuss, prior to issue of the report, matters relating to the valuation which may have an impact upon the audit and the auditor's responsibilities. Conversely, there will be occasions when the valuer should accommodate the opportunity to verify information and *assumptions* relevant to the valuation. In some cases, a discussion between the auditor 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.

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

India GN 1 appendix 2: Classification of enterprises

1 Introduction

1.1 This appendix provides guidance on the classification enterprises as determined by the ICAI Council. The Council has classified entities into three categories: Level I, Level II and Level III. Level II and III entities are considered as small and medium enterprises (SMEs). The criteria for the different levels are given in this appendix.

2 Level I enterprises

2.1 Enterprises that fall within one or more of the following categories, at any time during the accounting period, are classified under Level I:

- those whose equity or debt securities are listed, whether in India or elsewhere;
- those which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard;
- those carrying on insurance business;
- banks including cooperative banks;
- financial institutions;
- all commercial, industrial and business reporting enterprises whose turnover for the immediately preceding accounting period on the basis of audited *financial statements* exceeds Rs. 50 crore (turnover does not include 'other income');
- all commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period; and/or
- holding and subsidiary enterprises of any one of the above at any time during the accounting period.

3 Level II enterprises

3.1 Enterprises that do not fall within Level I, but do fall within one or more of the following categories, are classified under Level II:

- all commercial, industrial and business reporting enterprises whose turnover for the immediately preceding accounting period on the basis of audited *financial statements* exceeds Rs. 40 lakhs, but does not exceed Rs. 50 crore (turnover does not include 'other income');

- all commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore, but not in excess of Rs. 10 crore at any time during the accounting period; and/or
- holding and subsidiary enterprises of any one of the above at any time during the accounting period.

4 Level III enterprises

4.1 Enterprises that do not fall within Level I or II, and fall within one or more of the categories discussed below are considered as Level III. Those that do not disclose certain information pursuant to the exemptions or relaxations available to an SME should state this fact.

4.2 Where an enterprise has previously qualified for any exemption or relaxation (being under Level II or III) but no longer qualifies for either in the current accounting period, the relevant standards/requirements become applicable from the current period. However, the corresponding previous period figures need not be disclosed.

4.3 Where an enterprise has been classified under Level I but subsequently ceases to be so classified, the enterprise will not qualify for the exemptions or relaxations available to Level II until the enterprise ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an enterprise that has been classified under Level I or II but subsequently gets categorised under Level III.

India GN 1 appendix 3: Definition of management

1 Introduction

1.1 The term 'management' is not defined in any AS, however, it is defined in Standard on Auditing (SA) 260 (Revised) Communication with Those Charged with Governance, which is given in the following paragraph. The same definition can be used by valuer for this *guidance note*.

2 Management

2.1 Management is defined in SA 260 as follows:

The person(s) with executive responsibility for the conduct of the entity's operations'. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. Management is responsible for the preparation of the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving the entity's financial statements (in other cases those charged with governance have this responsibility).

© ICAI, SA 260, paragraph 6(b)

3 Those charged with governance

3.1 Those charged with governance is defined in SA 260 as follows:

The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector undertakings or an owner-manager. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility).

© ICAI, SA 260, paragraph 6(a)

India GN 1 appendix 4:

Measurement of borrowing cost

1 Introduction

1.1 This appendix outlines key guidance given in AS 16 Borrowing Cost. AS 16 is designed to give treatment of interest/finance costs incurred for production of inventory for sale and construction of fixed asset or investment property.

1.2 The standard prescribes that all borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.

2 Borrowing cost

2.1 Borrowing costs are interest and other costs incurred by an entity when borrowing funds. According to AS 16, they may include the following:

- (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- (b) amortisation of discounts or premiums relating to borrowings;
- (c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- (d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

© ICAI, AS 16, paragraph 4

3 Qualifying asset

3.1 AS 16 defines a qualifying asset as follows:

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

© ICAI, AS 16, paragraph 4

3.2 Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition and investment properties. The valuer should consult with management and the auditors about classifying the asset as a qualifying asset, especially in case of inventory where generally interest cost is not capitalised.

4 Capitalisation amount

4.1 Borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred during the period, less any income on the temporary investment.

4.2 For funds that are borrowed generally and used to obtain a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. AS 16 states:

The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

© ICAI, AS 16, paragraph 12

4.3 The valuer should coordinate with management and the auditors and obtain information about the secured/unsecured loans, purpose of loan and costs attached with it to calculate eligible borrowing cost.

4.4 When the book value or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the book value is written down or written off to that extent. The valuer is advised to check this condition and provide proper treatment to the final valuation.

5 Commencement and cessation of capitalisation

5.1 AS 16 states:

14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

- (a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;
- (b) borrowing costs are being incurred; and
- (c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

19. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

© ICAI, AS 16, paragraphs 14 and 19

India GN 1 appendix 5: Accounting for depreciation

1 Introduction

1.1 This appendix provides information on the accounting concepts and standards governing the consideration of depreciation for the purposes of *financial statements*, as outlined in AS 6 Depreciation Accounting. AS 6 applies to all fixed assets, with the exception of 'investment properties' as defined in AS 13 Accounting for Investments.

1.2 Both AS 6 and AS 10 deal with depreciation of assets carried in an entity's accounts either at cost or at valuation. This appendix refers expressly to land and buildings, but the material on depreciation applies equally to plant & 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 at which the asset is included in the balance sheet. The accountant 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 AS 6 states the following:

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

The depreciation of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

© ICAI, AS 6, paragraphs 3.1 and 20

2.2 The depreciation method used should reflect, as fairly as possible, the pattern in which the asset's economic benefits are depleted by the entity. In context of land and buildings, the useful life of an asset as defined in AS 6 is the period over which a depreciable asset is expected to be used by the enterprise. Therefore, this may

be the total physical or economic life of the asset, 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.

2.3 In normal circumstances, depreciation is not applicable to freehold land. Exceptions to this include land which has a limited life due to depletion (for example, by the extraction of minerals), or which 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 statutory provision, such as planning permission or approval or license, for a limited period after which it would be necessary to revert to a less valuable use.

2.4 Leasehold assets, by their nature, must 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.

2.5 The assessment of depreciation and useful life of the asset are the responsibility of the management of the company. However, the valuer should expect to be consulted on matters relevant to his or her assessment, such as the degree of obsolescence, condition, market factors and town planning.

3 The depreciable amount

3.1 To maintain consistency in application of depreciation on the asset, the valuer should choose the basis of calculating the depreciable amount in consultation with the management and auditors.

3.2 AS 6 states:

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for Historical Cost in the financial statements, less the estimated residual value.

© ICAI, AS 6, paragraph 3.4

3.3 Residual value is defined as the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

3.4 Fixed assets may be carried in *financial statements* on either historical cost less subsequent depreciation as appropriate, or revaluation (see AS 10, paragraphs 27 to 30). The selection of either will normally constitute the first stage in the estimation of the depreciable amount.

3.5 If historical cost is chosen as the basis, the fixed asset, whether acquired or self-constructed, should initially be measured at its cost. This could be either:

- the price paid for a completed property plus directly attributable costs (as set out in AS 10, paragraphs 20 to 26); or
- the cost of the land and cost of erecting the building, plus directly attributable costs previously mentioned.

The valuer may be asked to provide an estimate of residual value in order to calculate the depreciable amount. Paragraph 10 of AS 6 states the following:

If the residual value after depreciation likely to be significant, it is to be estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

© ICAI, AS 6, paragraph 10

3.6 Where the useful life of the asset to the entity is considered to be equal to the physical or economic life of the buildings comprising the asset, the valuer will need to consider whether the residual value will include 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.

3.7 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 over which the asset is to be depreciated, which would become the anticipated period of ownership.

3.8 Land and buildings comprise separate components of a 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, the valuer must ascertain the amount applicable to the buildings, as land is not subject to depreciation in normal circumstances (for general guidance on apportionments see UK appendix 4).

4 Investment properties

4.1 It should be noted that under AS 13 periodic charges for depreciation are not required for investment properties.

India GN 1 appendix 6: Accounting for local body investment in property, plant & equipment

1.1 This appendix deals with ASLB 5 on accounting treatment of property, plant & equipment. This standard deals with the reporting of financial information related to the local body's investment in property, plant & equipment, encompassing land and buildings but excluding heritage properties.

1.2 When considering the residual value referred to in paragraph 12 of ASLB 5, reference should be made to the guidance in India GN 1 appendix 5, section 3.

1.3 ASLB 5 recommends reporting the assets on the *financial statements* at fair value as at the date of acquisition, when an asset is acquired at nil or nominal consideration, or at 'cost', which is defined as follows:

Cost is the amount of cash or cash equivalents paid and the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

© ICAI, ASLB 5, paragraph 12

1.4 ASLB 5 recommends that all property, at first time of recognition, should be valued at its cost, and wherever an asset is acquired at nil or nominal consideration, its cost should be measured at its fair value as at the date of acquisition.

1.5 Guidance on the determination of fair value under ASLB 5 accompanies, but is not a part of ASLB 5. It is reproduced as follows:

1. If no evidence is available to determine the market value in an active and liquid market of an item of property, plant and equipment, the fair value of the item may be established by reference to other items with similar characteristics, in similar circumstances and location. For example, the fair value of vacant 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 manmade structures, fair value may be determined by a valuer using depreciated replacement cost, or the restoration cost or service units approaches. 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 building belongs to a Local Body may be reproduced rather than replaced with alternative accommodation because of its significance to the community.

2. If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment, an entity may need to estimate fair value using, for example, reproduction cost, depreciated replacement cost, or the restoration cost or service units approaches. The depreciated replacement cost of an item of property, plant or equipment may be established by reference to the market buying price of components used to produce the asset or the indexed price for the same or a similar asset based on a price for a previous period. When the indexed price method is used, judgment is required to determine whether production technology has changed significantly over the period, and whether the capacity of the reference asset is the same as that of the asset being valued.

© ICAI, ASLB 5, appendix

This is conceptually similar to *Market Value* as explained in VS 3.2 and yields similar results.

1.6 For measurement in case of subsequent recognitions the local body has the option to value it at cost or at the revalued amount.

1.7 The cost of an asset, under ASLB 5, is defined as follows:

The cost of an item of property, plant and equipment comprises:

- (a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

© ICAI, ASLB 5, paragraph 26

1.8 The recognition of an asset at a revalued amount should be done only when its fair value can be reliably estimated. The valuer is advised to provide adequate rationale for estimation of fair value in the report, so as to facilitate the decision regarding reporting of the concerned asset.

1.9 ASLB 5 has prescribed a methodology (see paragraph 13.11) to be followed while valuing the asset, where:

- market based evidences are available; and
- where it is not readily available.

The valuer must take cognisance of the prescribed methodology, while undertaking valuation of an asset for a local body.

1.10 According to ASLB 5, land and buildings are separable assets and are required to be accounted for separately, even if they are acquired together. Thus the valuer is advised to get a confirmation from the client regarding the apportionment of the value for land and buildings separately and report the same accordingly.

1.11 To the extent that a local body borrows funds specifically for the purpose of acquiring, constructing or producing an asset, it can capitalise the cost until after all the activities necessary to prepare the asset for its intended use or sale are complete.

1.12 In accordance with ASLB 5, when the carrying amount or the expected ultimate cost of the property exceeds its recoverable amount or net realisable value, the carrying amount is either written down or written off. The definitions of recoverable amount and net realisable value are similar as given in AS 28 and explained in section 9 of the *guidance note*.

1.13 The local body shall adjust the amounts recognised in its *financial statements* to reflect adjusting events (those that provide evidence of conditions that existed at the reporting date) after the reporting date. The valuer is advised to take the local body or auditor's representation of any such events and disclose this in the report appropriately.

India GN 2 Valuation for secured lending

1 Introduction

1.1 This *guidance note* focuses on valuation services provided for a client that is considering making loan facilities available against the security of commercial or residential land and/or buildings in India.

1.2 Although the Indian property market is relatively immature, it has had a long history. The operation of the market is therefore based around well established practices, many of which are unique to the Indian system. This *guidance note* therefore identifies the particular aspects of the Indian market that the valuer needs to consider when undertaking a valuation for secured lending purposes. A brief background to the market is provided in India GN 2 appendix 1.

1.3 Secured lending to the real estate sector has become a significant activity for Indian banks. The Reserve Bank of India (RBI) has issued guidelines on exposure to commercial real estate lending (see India GN 2 appendix 2). In addition, the Indian Banks' Association (IBA), the National Housing Bank (NHB) and the School of Planning and Architecture (SPA), New Delhi, have produced a discussion document entitled *Handbook on Policy, Standards and Procedures for Real Estate Valuation by Banks and HFLs in India*. This *guidance note* has been produced in light of current market conditions and takes account of the banks' responses to them.

2 Basis of value

2.1 Valuations for secured lending purposes should normally be on the basis of *Market Value*, in accordance with the terms of Appendix 5, Valuations for commercial secured lending. *Market Value* is defined in VS 3.2.

2.2 If a *departure* from *Market Value* is justified this must be identified and explained in the valuation report. Any significant difference between *Market Value* and the reported figure must be clearly identified.

2.3 *Specialised properties* may have a limited value except as part of a business, and a valuation assuming vacant possession or alternative uses may be required.

3 Special features of the Indian market

3.1 Lenders' policy and guidance

3.1.1 RBI, which is the central government bank that sets rules and regulations for all banking operations in India, has framed certain guidelines that govern lending to

the real sector. RBI defines real estate as ‘an immovable asset – land (earth space) and the permanently attached improvements to it’.

3.1.2 In January 2009, RBI reissued guidelines entitled Definition of Commercial Real Estate Exposure (Cir. No. 69 /09.22.010/2009-10), in line with the income-producing real estate (IPRE) definition under Paragraph 226 of the Basel II Framework (see India GN 2 appendix 2).

3.1.3 The valuer should be aware of the RBI guidance, as it is likely to affect the lender’s policy towards a loan; for example, it may influence the ability of the bank to make the loan, and the cost of that loan to the borrower. While the cost of loans can in theory have an impact on the attractiveness of a property in the market, and hence its value, there is at present little evidence of the application of the RBI guidelines influencing values in India.

3.2 Tenure and title

3.2.1 The land registration system in India is ambiguous and lacks transparency due to the absence of any central or state-wide record system where building plans, site plans, survey maps, caveats and other relevant title documents are available to the public on request. The 2010 Land Registration Bill is designed to improve the situation, but until it is enacted and takes full effect the valuer is advised to undertake reasonable research to check the title documents and to ensure that the title is free of any encumbrances or claims. Where this cannot be achieved adequately, it must be explicitly stated in the report along with any consequent *assumptions* that have had to be made.

3.2.2 The majority of land in India is under freehold ownership, but development sites are frequently offered by state governments on a leasehold basis. Leases may vary from 30 to 999 years depending on time of lease, location and requirements of the parties involved. Certain states, for instance Rajasthan, West Bengal and Uttar Pradesh, offer leases for periods of 90 to 99 years. A nominal premium or rent may be payable to the government authority upfront or on an annual basis during this period, and the lease is renewable at the option of the lessor.

3.2.3 Care should be undertaken to ensure that such land parcels are valued in accordance with the type of interest held. The valuer must make reasonable efforts to obtain the ownership documents from the client and verify the interest/rights or, in the absence of such information, cite *assumptions* made in the report.

3.2.4 Property ownership in India is often inherited from the previous generation. This can lead to more than one person claiming the rights to a property or to two claims of ownership of an indivisible unit. This can affect the marketability, and hence the value, of the property. The valuer is not expected to offer any legal due diligence, but any known legal dispute or related matter should be referred to in the report. Unless the effect of a dispute on value is clear, the valuer is advised to report the opinion of value assuming no encumbrance, but should clearly report any disputed legal matters that might affect the reported figure.

3.3 Other documentation requirements

3.3.1 It is common for a property not to have a street address or a number assigned to it. The valuer should endeavour to obtain all information necessary to confirm the proper address and identity of the property being valued.

3.3.2 While conducting a valuation of an existing structure or an improved property in India the valuer should ensure that all relevant documentation is seen. In addition to the title deeds and any leases, the most important documents include:

- completion certificate;
- occupation certificate;
- government licenses;
- environmental clearances;
- fire safety inspection certificate;
- site, layout and floor plans; and
- evidence of payment of charges to local authorities for external development (e.g. provision of water, electricity, sewage, pipelines).

3.3.3 Where relevant documentation is unavailable this should be stated in the report. In addition, *assumptions* made following site *inspection* or otherwise should be clearly stated.

3.4 Inspection

3.4.1 The valuer should visit every property subject to valuation and undertake an appropriate *inspection*. In the case of Indian real estate the *inspection* should include, but is not necessarily limited to, the following items:

- **Facilities and condition:** the report should include comments on the condition of the property and any improvements to it, its functional utility, deferred maintenance, structural defects, etc., and provide an adequate description of the interior and external components of the property.
- **Encroachment:** due care should be taken to ascertain that the property is not affected by any apparent encroachment. This might include:
 - extension of balconies or ground coverage beyond permissible limits;
 - construction of more than the permitted number of floors; and/or
 - unclear boundaries leading to ownership disputes.
- **Access road:** the main road that provides access to the property should be identified and noted in the report, both to aid property identification and to assist in confirming later that the property has an adequate and legal right of access.
- **Age and future economic life:** it is advised that information is gathered about the age of the building and any improvements from the owner and/or from the *inspection*. The remaining economic life of the building and its services after allowance for its current usage and condition should also be estimated.
- **Occupation:** the report should indicate if the property is vacant, occupied by the owner or leased to a tenant.
- **N-E-W-S neighbours:** information about the immediate neighbouring developments to the subject property on all sides – north, east, west and south – should be incorporated in the valuation report.

3.5 Market information

3.5.1 In India, critical market information is in shorter supply than in more established markets, making price discovery much harder. During the next few years, accurate information on market transactions will be essential in creating an efficient, liquid market, but at present the valuer may need to make due allowance for less reliable or scarcer market data.

3.5.2 Reported or registered sale prices are frequently inaccurate, and particular care has to be taken not only in verifying the sale price of comparable transactions but also with the title, registered owner(s) and survey numbers.

3.5.3 Price concessions – for example, an assured rental income guarantee, a contribution towards fitting out costs or a rent-free period – are often agreed among developers, landlords, purchasers and tenants. The extent of, and appropriate allowance made for, them will need to be assessed when analysing comparable evidence or valuing a property to which such concessions apply.

3.5.4 Additional sources of income, for example licence fees for aerials, satellite dishes, parking charges and service charges in excess of costs, should also be noted and due allowance made in the valuation.

3.5.5 There is a frequent lack of comparable market data and an often uncertain quality of the existing valuation evidence for commercial or residential property in India. This means the valuer may have to rely on less conventional sources of data, and more on personal market knowledge and experience to a greater extent than would be required in more developed markets. As a result, the valuation figure may be subject to a greater degree of uncertainty.

3.5.6 VS 6.1 states that valuation reports should not be misleading, so any uncertainty in the valuation figure must be reported and the reasons should be given. Further advice on valuation uncertainty may be found in GN 1, which identifies the circumstances in which uncertainty may arise and how it should be reported.

3.6 Leases

3.6.1 The length of occupational leases for residential properties is usually limited to 11 months because of Indian tenancy right laws. Commercial leases usually vary between three and nine years. Lease term details should be included in the report as the length of the lease term may have an impact on *Market Value*.

3.6.2 It is recommended that the valuer requests the lender to obtain copies of the lease documents and monthly income statements to verify the passing rent receivable and other important terms affecting the gross and net rent. Key information regarding tenancies includes:

- responsibility for repairs and running costs;
- maintenance charges (i.e. responsibility and payments);
- tenant incentives (e.g. rent-free period, free parking spaces, fit-outs);
- additional income sources (e.g. profits on maintenance charges, parking charges);

- provision for vacating premises (e.g. notice requirements, penalties for leaving before lease expiry);
- provision for escalation of rent;
- landlord and tenant's improvements; and
- confirmation that the leases are not between connected parties.

Where it has not been possible to inspect copies of the lease documents and income statements, the *assumptions* made should be stated as being subject to verification.

3.6.3 For retail stores, the rent payable may be a function of the revenue earned by the tenant from business operations in the premises. The valuer should request the monthly income statement to verify the rent receivable.

3.7 Measurement

3.7.1 Properties are usually measured in India on the basis of super built-up-area (SBuA), which is the leasable/saleable area that consists of the carpet area and a proportionate share of common areas such as basement, lobbies, staircases and walls. The developer refers to this proportion as 'loading'. 'Efficiency' is thus defined as the percentage of carpet area to the SBuA and has a considerable impact on the rental and capital value.

3.7.2 Carpet area is defined as the actual usable area within the walls of each floor of the building that may be carpeted by the occupier. It therefore comprises the SBuA less the area covered by the walls, common areas, staircases and plant rooms.

3.7.3 Many banks require the valuer to measure the interior and external components of the property. The valuer is advised to include the carpet area and SBuA in the report, and should comment on the efficiency of the subject property in relation to that of comparable and current market transactions. In the event that the valuer is not able to verify the carpet area after reasonable research, this should be reported.

3.7.4 Consideration should also be given to measuring the building in accordance with the method appropriate for the type of property as specified in the RICS *guidance note, Code of Measuring Practice*, 6th edition (2007). This is likely to be a requirement of international client companies.

3.8 Urban development and planning

(a) Existing property

3.8.1 The value of a property can only be attributed to the legal portion of the development. The authorised and unauthorised status of the property should be defined in the report, for example, if there is unauthorised commercial activity within a residential area. Due care should be taken to ascertain the applicable zoning and development guidelines.

3.8.2 It is commonplace in India for construction plans to differ from the layout plan approved by the statutory authorities, with a tendency to build more than

permitted. A copy of the approved drawings/layout should be obtained, variations should be noted and allowance made for any apparent deviation between these and the actual construction should be reported.

3.8.3 In certain belts of cities and smaller towns, small firms and self-employed professionals operate out of residential complexes. The master plan and applicable rules to ascertain if commercial or mixed use is permissible at the subject location should be inspected, with any deviations assessed and reported.

(b) Property for development

3.8.4 The land value of a property for development will be related to the extent to which development is permissible. Floor area ratio (FAR) and floor space index (FSI) are the common terms used to express the allowed density.

3.8.5 In certain states (for example, Maharashtra), additional transfers of development rights (TDR) may be purchased and transferred to the property on payment of charges to the local authority. Reasonable efforts should be made to determine the total area that may be developed after utilisation of this provision and to factor in the associated costs/value. The cost associated with the TDR is influenced by demand and supply, and hence is subject to volatility. The most recent rate, as appropriate, on the property from the relevant government authority should be established and applied.

3.8.6 Fees for change of land use (CLU) can vary substantially from one state jurisdiction to another. Land use charges can also vary between two adjacent land parcels. Indian government authorities post the necessary information on their websites, but those sites may not be updated regularly and are not always a dependable source.

3.8.7 In addition to CLU, additional licensing fees and significant development charges can also be levied against vacant land parcels. Such charges need to be accounted for when valuing vacant land.

3.8.8 When valuing development properties for secured lending purposes, reference should be made to the India GN 3, Development land in India.

3.9 Partially constructed properties

3.9.1 Banks typically ask for a progress report on a property under construction and may require an indication of the percentage completion of the project. In addition to any specific requirements the valuer may include comments on:

- **Construction cost estimate:** For self-constructed units, the valuer is expected to obtain information from the owner and report the actual cost incurred for all improvements made.
- **Interior shell completion:** Commercial properties may be rented or sold as bare/base shell (unfinished interior); warm shell (finished interior), with a heating, ventilating and cooling (HVAC) system, drop ceilings, plumbing and restrooms, interior lighting, interior walls and a concrete floor; or as furnished space, with false ceiling, painted walls, furniture and fixtures, seating units and finishing. This will have a direct impact on the rent and price, so the degree of the fit-out during the *inspection* stage should be established and referred to in the report.

4 Valuation methodology

4.1 The following three methods of valuation are commonly used in India:

- **Direct sales comparison method:** This method is used for the valuation of residential property and, where direct comparison data is available, commercial property and development sites. It is also used in assessing values for the component elements (rental value, yield, etc.) of the income (investment) method.
- **Income (investment) method:** This is used for a valuation based on a current and/or estimated future investment income. The method may either directly capitalise rental income using an earnings multiplier or yield, or may arrive at a value via a discounted cash flow (DCF) approach.
- **Cost approach:** This method produces a figure by adding to the site value the current cost of rebuilding a property, which is discounted to allow for the age and depreciation of the structure, to the current value of the undeveloped site.

4.2 Only the first two methods should be used when valuing for secured lending purposes. The cost approach does not produce a figure that relates to the sales price achievable in the event of a default by the borrower. Therefore, it is not relevant to a bank except as an indication of the replacement cost for insurance purposes.

4.3 Where markets are limited, other forms of valuation have emerged in India and these are outlined in India GN 2 appendix 3.

4.4 Further information on each of these methods is given in the RICS publication, *Valuation methods* (2011).

5 Reporting

5.1 Reporting requirements for all types of valuation carried out in accordance with the *valuation standards* are contained in VS 6.

5.2 Individual lenders will have their own reporting criteria, but the minimum requirements of any valuation report carried out in accordance with the *valuation standards* are summarised in Appendix 6, Reporting.

India GN 2 appendix 1: Indian market background

1.1 The Indian property market in its present form is new, rapidly developing and of growing international significance. The office market, which provided around 40 million sq ft of space 10 years ago, is now in excess of 260 million sq ft, with an annual growth rate of 30–40 million sq ft. In the retail market, developments have been equally rapid, with nearly all of the country's 250 shopping malls having been built since 2000.

1.2 Despite this rapid growth, these markets are still small given the size of the country and its rapidly developing economy. Thus, while there has been a decline in values across all market sectors in response to global economic conditions since 2007, the potential for expansion of the market remains very significant.

1.3 Along with its rapid growth, a further feature of the Indian economy since 2000 has been its increasing international importance. Although expansion of the property market has until recently been led by local developers and investors, the opening up of the Indian economy and lifting of restrictions on investment by overseas investors have encouraged international interest in Indian real estate.

1.4 An effective and transparent real estate market, for both occupation and investment, is essential to the functioning of any modern economy, and such a market requires reliable professional advice backed by accurate data. This is particularly important to banks and other organisations providing secured lending to the real estate sector. Secured lending is a source of finance that is an essential fuel without which the markets would not function. Banks rely on the quality of valuation advice when making loan decisions. The continuing strength and growth of the Indian real estate market is therefore reliant on a valuation profession that operates in accordance with internationally accepted ethical and professional standards.

India GN 2 appendix 2: Reserve Bank of India guidelines on commercial real estate exposure

1 Definition of commercial real estate

1.1 On 7 January 2009 RBI re-issued guidelines (DBOD. BP. No. 502 / 08.12.015/ 2008-09) on definition of commercial real estate exposure in line with the income-producing real estate (IPRE) defined under paragraph 226 of Basel II framework.

1.2 Briefly, commercial real estate (CRE) is property where the prospects for repayment depend primarily on the cash flows generated, such as office buildings to let, retail space, hotels, warehouse space and multi-family residential buildings (see <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/RSDARE070709.pdf> for further information).

1.3 If the repayment primarily depends on other factors, such as operating profit from business operations, quality of goods and services, tourist arrivals, etc., the exposure would not be counted as CRE. Hence, loans extended for construction of a cinema theatre, amusement park, hotel and hospital, cold storage, educational institution, restaurant, gymnasium, etc., to entrepreneurs who run these ventures themselves are not classified as CRE, since the fluctuation in real estate prices is not directly correlated to the cash flows generated.

1.4 These guidelines are also applicable to cases where the exposure is not directly linked to the creation or acquisition of CRE, but the repayment would come from the cash flows generated by CRE. Illustratively, such cases may include: extension of guarantees on behalf of companies engaged in CRE activities; exposures on an account of derivative transactions undertaken with real estate companies; corporate loans extended to real estate companies; and investment made in the equity and debt instruments of real estate companies. In such cases, the risk weight applicable would be that for CRE exposure even if the borrower has an excellent credit.

2 Impact on cost of debt

2.1 With the adoption of Basel II, since April 2009 the capital adequacy percentage is evaluated on case-by-case basis as per the risk weight assigned to the respective assets.

2.2 Classification under CRE implies that the cost of capital borrowed is higher for CRE assets as compared to infrastructure and most other sectors by 100 to 200 basis points. The valuer is advised to keep up to date with these guidelines, which are subject to modifications.

3 Exposures not covered under commercial real estate

3.1 Certain types of real estate exposure are not covered under CRE, including:

- financing of renovation of self-owned company premises; and
- infrastructure lending.

3.2 RBI defines infrastructure lending as any credit facility extended by lenders, that is, a bank, financial institution or non-banking financial company (NBFC), to a borrower engaged in an infrastructure facility. This is defined as: developing, operating or/and maintaining a project in sectors like roads, highways, railways, waterways, inland ports, water supply, telecommunication, power, agro-processing, hospitals, special economic zones (SEZs) and industrial parks, educational institutions, oil pipelines, etc.

India GN 2 appendix 3: Indian valuation approaches with limited market evidence

1 Estimation of stabilised net operating income

1.1 Since commercial real estate incomes are typically driven by lease rent revenues, an estimation of net operating income (NOI) through observable data is a challenge in markets that lack transparency. Stabilised NOI is an *assumption* of how a subject property should perform under 'normal' market conditions based on the performance of similar properties.

1.2 Characteristics to consider while using comparables are as follows:

- physical size;
- location attributes;
- level of risk associated (e.g. tenant credit ratings, up/down-side potential); and
- non-recurring costs (e.g. leasing commissions, tenant improvement allowances, replacement reserves and lease turnover vacancy).

2 Estimation of market capitalisation rate (cap rate)

2.1 The estimation of the market capitalisation rate (cap rate) is to property as what the price earnings ratio is to stocks. The rate should be based on the comparable most similar to the property being valued, not an average of all the cap rates of the comparables. Purchasers expecting future NOIs to increase (or decrease) for any reason should pay prices reflecting those expectations. Hence, investor sentiment has a key influence on market-derived cap rates. Such an opinion may be biased and may weigh too heavily on historical conditions (growth curves), often resulting in overpricing real estate. Either or both of the following alternative methods to estimated cap rates may be considered: investor surveys and/or band of investment.

2.2 Investor surveys use surveys to supplement cap rate data derived directly from transactions, or when no other direct data are available. Since in India there is a lack of published surveys that map investor expectations on a large scale, the valuer is advised to carry out such investor surveys on a periodic basis to reflect investor expectations. The survey should ask whether any of the respondents recently acquired properties at the cap rates reported. In the absence of that information, the *assumption* must be made that the low end of the reported cap rate range (not the average of the range) is the point at which property acquisitions are actually occurring.

2.3 Most commercial properties are purchased with debt and equity capital, hence the overall cap rate must satisfy the market return requirements of both investment positions. The band of investment calculates weighted average returns to debt and equity based on market information for each component. Primary inputs are the annual 'mortgage constant' and the annual 'equity dividend rate'. The survey technique is applicable only where sufficient market data are available to extract accurate equity dividend rates. When market data are scarce or less reliable, band of investment should only be used as a test against cap rates derived using comparables.

India GN 3 Development land in India

1 Introduction

1.1 This *guidance note* on development land has been written specifically with regard to practice in India.

1.2 It discusses the approach to the valuation of property where the proposed development is a cleared or greenfield site, or a site that is to be redeveloped by removing all, or substantially all, of the existing buildings and constructing new buildings. These scenarios are referred as 'development land' throughout this *guidance note*.

1.3 A development scheme may range from a single dwelling to a large commercial/mixed use development. The aim of this *guidance note* is to assist the valuer in more complex cases by providing a framework within which a consistent approach to the valuation of development land can be adopted. Although there may be differences between, for example, a valuation prepared for a proposed acquisition or sale and an appraisal by a developer in connection with its own business model and secured lending (see India GN 2, Valuations for secured lending), the principles are considered to be the same.

1.4 This *guidance note* deals with the principles underlying the valuation approach used specifically for development land. It does not advise the valuer on how to undertake this type of valuation, as that is a matter of professional expertise. However, by following these principles the valuer may have confidence that the significant factors relevant to this type of valuation have been considered.

1.5 This guidance does not apply to redevelopment based on a refurbishment of existing buildings with limited demolition, for instance, the conversion of a multi-storey commercial property to a property for residential use where the original structure is retained. However, it may be of assistance in such cases even though it does not specifically relate to valuations for land in the course of development, because the principles are similar.

1.6 The valuer may adopt either or both of the following approaches to the valuation of development land:

- comparison with the sale price of land for comparable development; or
- assessment of the value of the scheme as completed, and deduction of the costs of development (including developer's profit) to arrive at the land value (known as the residual method).

1.7 In practice it is likely that a valuation will utilise both approaches, and the degree to which either (or both) is relevant will depend on the nature of the development being considered and the complexity of the issues.

1.8 Valuation using the comparison method is essentially objective, as it is based on an analysis of the price achieved for sites with broadly similar development characteristics. The residual method, in contrast, relies on an approach that is a combination of comparison and cost, and it requires the valuer to make a number of *assumptions*, any of which can affect the outcome to varying degrees.

1.9 Development land valuations are site-specific and unique. These valuations can be very complex and can relate to specialised markets, thus they require a high level of expertise. Valuers are reminded that VS 1.6, Knowledge and skills, states that they must possess the skills and knowledge to undertake the valuation competently, and recognise when assistance may be needed from other professionals.

1.10 While accepting instructions, the valuer must comply with VS 2, Agreement of terms of engagement.

1.11 To reflect the approach to this type of valuation, this *guidance note* covers the following topics:

- purpose and *basis of value*;
- establishing the facts;
- joint ventures/joint development;
- assessing the development potential;
- valuation using the comparison method;
- valuation using the residual method;
- the residual method;
- assessing the land value; and
- reporting the valuation.

2 Purpose and basis of value

2.1 A valuation of property suitable for development or redevelopment may be required for many reasons, such as for advice on loan security, acquisition, sale, valuation of options, capital taxes, planning purposes and appraisals.

2.2 In India, valuation of development land, either as a standalone land parcel or as part of a land bank, may be required for any of the following purposes:

- private transactions in the form of full or partial acquisition or sale;
- mortgaging for development financing or any other credit facility;
- public listing purposes; or
- and *third-party* financial reporting purposes.

2.3 The *bases of value* that may be used for valuation of development land are as follows:

- *Market Value* (see VS 3.2);
- *investment value*, or *worth* (see VS 3.4); or
- *fair value* (see VS 3.5).

2.4 Private transactions of development land leading to full or partial acquisition/sale most often occur between entities in the business of real estate development or investment. Those transactions may enable them to generate additional benefits from the land, making the value specific to them and different from a *Market Value* expected in a hypothetical exchange. In such circumstances, *investment value* may be used as the basis of valuation, which is different from the *Market Value* and needs to be clearly emphasised by the valuer when preparing the valuation report.

2.5 Similarly for the purpose of and *third-party* reporting for development land by these types of entity, *investment value* (in accordance with VS 3.4) may be used to reflect the benefits received by holding the asset.

2.6 As mentioned in VS 3.4, whenever any 'entity specific' criteria or parameter is used for assessing the *investment value*, it should be highlighted by the valuer in the report, along with disclosure that the *basis of value* in the report is not *Market Value*.

2.7 Where the valuer is advising on any existing or potential transaction related to development land, *fair value* (as defined in VS 3.5) may be adopted. In such cases, the parties involved in the transaction may be negotiating at arm's length, but the subject land parcel may not necessarily be exposed in the wider market. In addition, 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. Since an estimate of *fair value* is likely to be based on *assumptions*, criteria and parameters that differ from those generally made while assessing *Market Value*, they should be highlighted by the valuer, and disclosure that the value reported is not the *Market Value* should be included.

2.8 In the case of mortgaging for development financing or any other type of credit facility, the most suitable basis is *Market Value*, as the lender will most likely be interested in recovering the debt capital along with accumulated interest through disposal of the property, rather than generating financial returns from its development.

2.9 Valuation of development land for public listing entails sale of financial instruments that derive their value from the land. *Market Value* is the most appropriate basis for estimating value of the development land.

3 Establishing the facts

3.1 To judge the certainty of the valuation outcome and the processes involved, it is essential that the valuer has an awareness of the characteristics of the existing site and adequate knowledge of each development component. The level of detail that is appropriate when assessing development potential varies according to the purpose and the basis of the valuation, and requires the valuer's professional judgment for each case.

3.2 For a residual valuation (see section 8), the level of information available depends on the stage at which the valuation is being prepared. For example, a valuation in advance of an acquisition is based on less certain estimates than if the land is held while planning is progressing, or the valuation is at a date when the redevelopment commences. It may therefore be necessary to review the valuation as more detailed information becomes available.

3.3 Inspection and site specific information

3.3.1 Physical *inspection* of the site, and related enquiries, will reveal site-specific information, which may include the following list, though it is not intended to be exhaustive or to apply to every case:

- the nature of the ownership of the interest in the land – which is relevant in certain areas of India where ownership by an individual may actually be a long leasehold interest;
- extent of the site – in order to ascertain frontage, width and depth, gross and developable areas;
- shape of the site and ground contours – ideally in the form of a topographical survey;
- history of previous, and risk of future, flooding;
- sizes of any existing buildings – where there is not a local practice on the measurement of buildings, it is recommended that measurements are taken in accordance with the RICS *Code of Measuring Practice* (2007);
- existing building height and that of adjoining properties;
- efficiency of existing building(s) (if to be retained);
- any matters that may result in excessive or unusual costs (e.g. constrained site conditions, or poor or limited access), from development and occupational perspectives;
- party wall, boundary and rights of light issues;
- geotechnical conditions;
- evidence of, or potential for, contamination;
- availability and capacity of infrastructure (e.g. roads, public transport, mains drainage, water, gas, electricity and telephony);
- evidence of other head or occupational interests in the property, whether actual or implied by law;
- physical evidence of the existence of rights of way, easements, encumbrances, overhead power lines, open water courses, mineral workings, tunnels, filling, tipping, etc. – where there have been preliminary legal investigations, information may be provided by the client concerning details of such easements that are not apparent upon *inspection*;
- the presence of archaeological features – which may be evident, or there may be a high probability of their presence due to the site location (e.g. close to city centres);
- evidence of waste management obligations and whether those obligations have been fulfilled; and
- water or mineral extraction rights that may be available.

3.3.2 Valuers are reminded that sites for potential development may contain many hazards. The RICS publication, *Surveying safely* (2006), is written specifically for the UK, but its principles will be applicable in India.

Existing planning matters

3.3.3 In India, urban planning is the domain of state governments, and the urban planning framework differs between each state and each urban area. The extent of the enquiries that are necessary and appropriate varies in each case, but the following matters may require investigation:

- for any urban area, the applicable land use and master plans, as well as norms for development control and related urban planning as prepared by the relevant town planning department or development authorities, should be referred;
- the existence of a current planning permission, which may be in principle partial or full, and may include conditions or reserved matters;
- the establishment of whether any time-limited permission or development right is still valid or, if close to expiry, whether it could be extended or something similar would be granted;
- regulations that specify the extent to which development of the site might be permissible without the need for a licence, planning application or consent;
- the permitted use of existing buildings (if to be retained), or the possibility of identifying an established use;
- legally binding agreements that have been, or are to be, documented in order to secure the grant of licence, planning or development permission;
- any special controls that may apply to the site or buildings included (e.g. conservation area designation, green belt, tree preservation orders, listed buildings);
- requirements to protect or enhance environmentally sensitive features, such as aquifers or water courses, and to comply with the relevant environmental protection legislation; and
- any requirements for view corridors, sight lines, set backs or buffer zones.

3.3.4 If it is not possible for any of the matters listed to be undertaken by the valuer, the valuer should request the information from the client and check its accuracy. If the client is not forthcoming with the information, then appropriate disclosures and *assumptions* need to be made in the valuation report.

4 Joint ventures/joint development

4.1 For joint ventures, the valuer will usually provide only the *Market Value* of the land. Unless in possession of the required expertise, the valuer will not usually value any shareholding in the scheme.

4.2 If the valuer is asked to value a share in the property, full information on the legal interest has to be obtained and appropriate disclosures of them must be made in the valuation report.

4.3 In many cases, the developer enters into a joint development contract with the landowner, wherein the developer is entitled to financial benefits (including a management fee and profits) at pre-determined formulae, in return for successful fulfilment of agreed obligations on behalf of the developer. The valuation of a joint development contract will therefore involve assessing the value of the right to

receive a financial benefit at a future date that is contingent upon performance, and the fulfilment 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 likely reward.

5 Assessing the development potential

5.1 Where there is a reasonable prospect of a more optimal land use than the existing land use, having regard to the applicable planning norms, the valuer may need to establish the permissions that would need to be obtained and the associated licenses and approvals that would be required. This includes the availability of appropriately zoned land in the relevant master/land use plan and the concomitant development control norms, while recognising that they heavily influence future additions to the supply of a particular type of development/real estate product.

5.2 Emerging consultative planning policies may also be relevant, including national or regional guidance that may be taken into account while deciding planning approvals and licences. In the longer term, they may also influence the supply of competing space or affect the value of the envisaged development upon completion.

5.3 An accurate assessment of the form and extent to which the physical development can be accommodated depends essentially on the characteristics and the surrounding area of the site, as well as the likelihood of obtaining approvals. In more complex cases, this assessment should be undertaken in consultation with appointed project consultants, such as architects, quantity surveyors, and environmental and planning consultants.

5.4 Matters that may be considered include:

- the period estimated to complete the new buildings;
- achieving a high efficiency ratio (i.e. floor space index, built up area and leasable or saleable area), which may be affected by design considerations without compromising quality;
- environmental issues that may have a material bearing on the success of the project (sufficient enquiries need to be made to establish whether the presence of on-site or neighbouring environmental features influence the development process, the density or even the viability of the scheme); and
- the extent to which the planning approvals and development control norms govern energy efficiency, water conservation efforts and similar environmental initiatives.

5.5 The valuer should liaise closely with both the appropriate planning authorities and the client to ensure that the appraisal fully reflects the various aspects of the proposed development.

5.6 In considering the development potential, the valuer should establish the potential demand for the optimum possible alternative forms of development. Clearly, it would not be appropriate to consider the construction of a high-specification office block in an area where there is limited or no demand for this type of property. Matters to be considered may include, but not exclusively, the following:

- an owner-occupier's preferences for particular design features, building layouts and specifications (i.e. the degree of specialisation and its impact on marketability);
- investors' requirements;
- the location;
- access and the availability of transport routes;
- car parking facilities;
- amenities attractive to tenants and/or purchasers;
- the scale of the development in terms of sale or leasable packages;
- the form of the development; and
- market supply, including actual or proposed competing developments.

6 Valuing using the comparison method

6.1 Valuation by comparison is only reliable if evidence of sales can be found and analysed on a common unit basis (such as site area), developable area or habitable room. Although comparable sales can be analysed in unit terms, there are many other factors that determine the price paid, and hence unit comparison may not be the most significant basis. In addition, enquiries may also reveal recent marketing, or even transactions, of the site. Even where reliable information is not available, the comparison method can provide a useful check of a valuation prepared using the residual method.

6.2 Typically, comparison may be appropriate where there is an active market, a relatively straightforward form of development is proposed and it is likely that the density, form and unit cost of the development will be similar. Less frequently, it may be possible to compare larger sites for developments on this basis.

6.3 In comparing sites the following factors may be relevant:

- values may differ considerably within a small geographical area;
- since the condition of the site and associated remediation costs are very site-specific, they may differ significantly between greenfield and brownfield sites, as well as between brownfield sites;
- site and construction costs (e.g. in terms of infrastructure and service requirements) generally differ;
- types of development will vary and may reflect a requirement to provide certain mandatory components as per development norms;
- in the case of residential developments, in certain parts of the country the density reached there can also affect the price;
- the price may be affected by planning obligations; and
- in a rapidly changing market, the date of the sale of the comparable is relevant.

6.4 Generally, high density or complex developments and existing buildings with development potential do not easily lend themselves to valuation by comparison. The differences from site to site (for example, in terms of development potential or construction cost) may be sufficient to make the analysis of transactions

problematic. The higher the number of variables and adjustments for *assumptions*, the less useful the comparison will be. Comparison is rarely appropriate where construction has begun.

6.5 Where the comparative method is used, standard valuation techniques are adopted. However, some of the elements of a residual valuation may also be relevant to a valuation by comparison.

Indian context

6.6 The real estate market in India has traditionally been fragmented and disorganised, especially the land market, with lack of any reliable database available for land transactions. These pose severe constraints with regard to availability of credible information on transaction data.

7 Valuing using the residual method

7.1 Where the nature of the development is such that there are no (or limited) transactions available for the comparison method, the residual method provides an alternative valuation approach. However, even limited analysis of comparable sales can provide a useful check as to the reasonableness of a residual valuation.

7.2 The residual method requires the input of a large amount of data, which are rarely absolute or precise, coupled with a large number of *assumptions* made. Small changes in any of the inputs can cumulatively lead to a large change in the resultant land value. Therefore it may be appropriate to present a sensitivity analysis to show the effect on the land value of the differing inputs. Some of these inputs can be assessed with reasonable objectivity, but others present great difficulty. For example, the profit margin or return required varies depending on whether the client is a developer, a contractor, an owner-occupier, an investor or a lender, as well as with the passage of time and the risks associated with the development.

7.3 The aim is to assist the client in assessing the likely land value based on present and future market trends, and the likely shifts in supply and demand. Wherever possible, the treatment and presentation of these issues should be discussed with the client.

7.4 The client's instruction may ask for advice taking into account the client's specific circumstances, for instance, a recommendation on how much to bid for a site based on the construction costs that can be delivered by the client as a contractor. Such opinions may be a calculation of *worth* (see VS 3.4 and the reporting requirements in the commentary) but will not represent *Market Value*.

Use of discounted cash flow methods

7.5 Discounted cash flow (DCF) is a useful method to adopt in scenarios where the envisaged development is likely to be prolonged, with capital expenditures stretching over years and the income generation taking place even later. The DCF method addresses the issue of time value of money by discounting the sum of all future cash flows – both incoming and outgoing – and arriving at the net present value (NPV), which can be taken as the *Market Value* of the subject property. For development land, the cash outflows would essentially comprise the building costs,

planning and other regulatory levies, taxes and other professional fees. The inflows would essentially be from sale or lease of the developed property as envisaged in the development plan.

7.6 While estimating the *Market Value* using DCF, care must be taken to use various parameters related to cost, phasing, income, etc., based on market evidence, otherwise the result cannot be termed *Market Value* but would instead be the *investment value*, or *worth*. Further guidance on the application of the DCF method is in the GN 6, Discounted cash flow for commercial property investments.

8 The residual method

8.1 Residual valuation method

8.1.1 Having established the development potential, a residual valuation can be expressed as a simple equation:

(value of completed development) – (development costs + developer's profit) = land value

Each element of this equation is discussed in the following paragraphs.

8.2 Value of completed development

8.2.1 The value to be adopted is the *Market Value* of the proposed development assessed in the prevailing market conditions on the *special assumption* that the development is complete as at the *date of valuation*. This is widely referred to as the gross development value (GDV).

8.2.2 For some developments, particularly residential, the approach may be to adopt the total of the values of the individual properties. In other cases, an additional *special assumption* may be that the completed development is let and income-producing rather than available for sale or letting.

8.2.3 As the GDV does not incorporate an allowance for purchaser's costs, the net proceeds are more often aligned to the net development value, which reflects the transaction costs that would be incurred if the completed development was sold again on the *date of valuation*.

8.2.4 The finance costs, notional or actual, are included in the residual value calculation, so there is no need to adjust the GDV to reflect these.

8.3 Development costs

Planning permissions and associated matters

8.3.1 Where there is no existing planning permission, approval or licence for the project, it is necessary to allow for the costs of obtaining that permission. For development that may be contentious, allowances may be made for the potential additional costs, including delays due to appeals and/or inquiries (these include fees and additional holding costs, and may extend to creating models, lobbying,

etc.). This consideration would not normally include any deferment of the scheme as a whole due to the contentious nature of the development, as such a matter would instead be properly reflected in the final assessment of the land value.

8.3.2 The impact of legally binding agreements linked with the grant of planning permission, approval or licence has to be considered, as it may come with a commitment to fulfil certain conditions. These could be direct monetary terms, such as cash payments, or development obligations that are usually (but not always) deliverable on-site, such as the provision of community facilities or providing enhanced public transport. In addition, the timing of the payments, or the fulfilment of development obligations, may be relevant.

8.3.3 Various matters related to statutory and regulatory obligations may have to be considered. Such matters, which could incur significant costs, may include:

- building with archaeological significance and associated negotiations with Archaeological Survey of India, the state's archaeological department, Waqf Board, Delhi Urban Arts Commission, or similar bodies;
- the accommodation of archaeological surveys or digs;
- environmental protection during demolition and construction; and/or
- obtaining necessary approvals under building bye-laws.

Acquisition and pre-development costs

8.3.4 These include agents' fees, legal costs and stamp duty land tax, if any, that would be incurred on the acquisition of the land prior to the commencement of the development.

8.3.5 It is necessary to consider the costs to be incurred before the main construction activity can proceed. For example, the cost of meeting any environmental issues must be addressed. While this can relate to any remedial works it can also reflect important conservation or flood protection requirements. Such costs have to be provided by an appropriate expert. In addition there may be an obligation to remove contamination, along with the consequential waste management of that, and special environmental provisions to abate noise or control emissions, if applicable. There may be ground improvement works needed before the main construction period begins to make the site safe for development (liaison with a civil and/or structural engineer may be necessary). Any archaeological investigation costs may be borne before the main contract is let, and the time to undertake such work and its cost needs to be understood.

8.3.6 Other costs to consider before main construction activity may include the diversion of essential services, highway works and other off-site infrastructure costs, the creation of the site establishment and the erection of hoardings, and compliance with appropriate health and safety regulations during the course of the development. There may also be issues surrounding sustainability that may have a direct bearing on the site, which should be identified by the relevant departments involved in pollution control and environmental protection.

8.3.7 If appropriate, it may be necessary to estimate the costs incurred in securing vacant possession, acquiring necessary interests in the subject site or adjacent property, and any extinguishing easements or removing any restrictive covenants,

rights of light compensation or party wall agreements. Realistic allowances have to be made, reflecting that the other parties expect to share in the development value generated.

8.3.8 The letting out of advertising space on hoardings or the securing of short-term tenancies (for example, surface car parking) can help to offset finance costs before and during the development phase.

Phasing of the development

8.3.8 Larger schemes are likely to be phased over time. The phasing of the infrastructure provision or distinct elements of a complex development site may be due to planning requirements. For example, highway improvements or a car parking provision may be completed prior to occupancy to maximise cost savings in labour or materials. These are reflected in all developers' cash flows when they formulate their bids and should likewise be reflected in any valuation of such property. The valuation should also note the deferment of some costs (discussed in the remainder of this section) to a date when it might be reasonable to expect them to be incurred. Similarly, not all receipts occur simultaneously.

8.3.9 In many cases where individual buildings or units are sold, particularly concerning residential properties, the sales may start before the development is completed and may be phased over a long period of time. In these circumstances the income is to be recognised in the cash flow at the appropriate time, and the incidence of the relevant costs must reflect the actual timing of such payments.

Building costs

8.3.10 A reasonably accurate estimation, at the *valuation date*, of the building costs of the development is a major component in a residual valuation. For most schemes, except for perhaps the most straightforward, the costs should be estimated with the assistance of an appropriately qualified expert. Detailed costings should be based on the form of measurement adopted locally (for instance, carpet area or super built up area). In the absence of any local market practice, measurements should be based on the gross area (GIA) as defined in the RICS *Code of Measuring Practice*. Where GIA is adopted, the valuer is advised to check that calculations provided by other professionals are also on this basis. If there is a lack of clarity on the GIA, appropriate benchmarks should be taken based on the area to be developed under applicable floor space index, or the envisaged physical built up area, in accordance with the *National Building Code of India* (2005).

8.3.11 The residual method is very sensitive to variations in the estimated costs, and the accuracy to which costs can be assessed may vary greatly according to the specific site characteristics; the requirement or plan to retain specific structures; any unusual building specifications; and the extent to which a new building has to reflect relevant sustainability policies. Therefore guidelines, such as the *National Building Code of India*, are considered to be only useful aids and undue reliance on them can compromise the accuracy of the valuation.

8.3.12 The choice of procurement route imposes differing responsibilities on the parties and is a key consideration in determining the building costs. Reference is often made to a fixed price contract, which does allow for inflation, but is only fixed

to the extent of the works outlined in the contract. Therefore a contractor can amend the pricing if any variations to the specification are made, or unforeseen events occur.

8.3.13 It is essential that the valuer understands which route has been, or is likely to be, chosen. The suitability for the particular development and the implications of that choice on the relevant elements of the residual calculation may require recourse to other surveying disciplines.

8.3.14 In all cases the inclusion of a contingency allowance to prepare for the unexpected is essential. The quantum, which is usually reflected as a percentage of the building contract sum, is dependent upon the nature of the development, the procurement method and the perceived accuracy of the information obtained.

Fees and expenses

8.3.15 The incidence of fees and expenses can vary significantly according to the size and complexity of the development. The types that may need consideration are discussed in the following paragraphs.

8.3.16 Professional consultants may be hired to design, cost and project manage the development. The development team normally includes an environmental and/or planning consultant, an architect, a quantity surveyor and a civil and/or structural engineer. Additional specialist services may also be supplied as appropriate by mechanical and electrical engineers, landscape architects, traffic engineers, acoustic consultants, project managers and other disciplines, depending on the nature of the development.

8.3.17 Fees may be incurred in negotiating or conforming to statutory (for example, Building Regulations) or planning agreements, and in complying with the relevant health and safety regulations during the course of the development. In addition, legal advice and representation at any stage of the project will incur fees.

8.3.18 There may be lettings and sales expenses where the development is not pre-sold, or fully pre-let, as a single unit this item includes incentives, promotion costs and agents commissions. The costs of creating a show unit in a residential development may also be justified and will need to be considered.

8.3.19 Rent free periods, whether as an incentive or recognising the tenants fitting out period, are another expense to consider. These may be reflected in the valuation as either:

- continuing interest charges on the land and development costs until rent commencement (this approach is usually favoured by the financing arrangers); or
- the costs of the completed development (this approach is usually favoured by investors because there is an *assumption* that market conditions will not change).

8.3.20 Finally, there may be costs related to the raising of development finance (including possibly the lenders monitoring surveyor and legal fees). In some cases, the prospective tenant/purchaser may incur fees through monitoring the development, which may have to be reflected as an expense where they would normally be incurred by the developer.

Interest or finance costs

8.3.21 Interest is incurred on land and development costs. It is either paid when it is due, or deferred (rolled up) throughout the projected programme during the pre-contract, contract and post-contract stages. An allowance is to be made to reflect the opportunity cost of capital, even if the developer is funding the project ly, on the *assumption* that the completed fully let and income-producing development will be sold, or long-term finance will be obtained on its transfer to the developer's investment portfolio. This allowance is also included where the development is to be owner-occupied.

8.3.22 Interest is usually treated as a development cost until the assumed letting date of the last unit, unless a forward sale agreement dictates otherwise. For residential developments, the sales of individual units may occur at various stages during the development, and appropriate *assumptions* have to be made regarding cash flow, both inward and outward. The rate of interest to be adopted generally reflects the levels accepted in the market for the type of scheme involved.

8.3.23 The approximate timings for the pre-construction, principal construction and post-construction periods have to be determined. The valuer is recommended to liaise with the client, appointed professionals or colleagues with relevant experience to assess an appropriate, realistic time frame for each of the phases.

8.3.24 In applying interest, the following two approaches are commonly used:

- **Straight line:** this assumes that the preliminary costs are incurred at the *valuation date*, and the principal development costs are incurred in equal tranches, and at regular and equal intervals throughout the development. The post-development costs are assumed to be incurred at the start of that period.
- **S-curve:** depending on the type of development, the weighting of the build costs may be incurred early in a scheme (e.g. in industrial development), or at a later stage (e.g. hotels and high value residential development). The purpose of an S-curve is to reflect more accurately the incidence of the costs in a particular scheme. This approach is sophisticated and specialised, hence if it is used without the necessary expertise, it is as likely to produce less accurate values.

Holding costs

8.3.25 These are the costs (excluding interest) in holding the completed building until the assumed date of the final letting or sale, including such items as insurance, security, cleaning, property tax and fuel.

Tax relief and grants

8.3.26 In some areas and for certain properties, special allowances or grants may be available to the developer. These may relate to the cost of remediation of contaminated land, promotion of job creation or assistance to ensure that a scheme proceeds. The availability of such funds needs to be established with the relevant government office, and the possibility of their availability being changed, or withdrawn at short notice, should be recognised.

8.3.27 Capital allowances might be available for the cost of plant & equipment and for certain buildings. They would have to be considered as an expense of the business being carried out by the property owner, whether the latter is an owner-occupier or an investor. They are not available to developers, unless the property is to be retained as an investment.

8.3.28 The *worth* of capital allowances cannot be assessed via a formula as they are dependent on the particular circumstances of the property owner. They are not usually explicitly included in development appraisals, but their potential availability may be reflected in the price offered by certain clients.

Value added tax

8.3.29 The decision as to the inclusion of VAT in the valuation is best resolved through a discussion with the client. However, in the absence of explicit instructions, the valuer may consider using current practice on the election to tax for the location and type of property concerned. For more complex developments it may be necessary to explicitly include the occurrence of both payments and recoveries of VAT. Any *assumptions* made are to be stated in the report.

8.4 Developer's profit

8.4.1 The nature of the development and the prevailing practice in the market for this sector help to determine the selection of the profit margin, or rate of return. The percentage to be adopted varies for each case.

8.4.2 The valuer can usually assume that the developer seeks a capital profit expressed as a percentage of the total development cost (including interest), or the GDV. The former approach is more common, while the latter stems from the traditional financing of commercial developments where the completed property is sold to a long-term investor. Although the valuer has to exercise judgment on the figure to be incorporated, it may be helpful to obtain the client's views.

8.4.3 There are, however, other criteria that are sometimes adopted. They are outlined in the following paragraphs.

Initial yield on cost

8.4.4 The net rental return calculated as the initial full annual rental on completion of letting expressed as a percentage of the total development cost. This criterion may be significant in establishing whether the developer could service a long-term mortgage loan, or for evaluating the effect of the development scheme on the profit and loss account of the company.

Cash-on-cash (or equity yield)

8.4.5 The capital uplift or (more usually) net income (after interest charges on any long-term mortgage loan), expressed as a percentage of the long-term equity finance provided by the developer.

Interest on capital employed

8.4.6 A technique that has regard to the rate of return on actual costs expended, calculated net of interest and corporation tax.

DCF method

8.4.7 A method where the income stream is projected with explicit *assumptions* about rental growth, and discounted back to a NPV using an appropriate discount rate. The scheme is deemed viable if NPV exceeds the total development costs. The discount rate includes an allowance (profit margin) for the management requirements and risks of investing in a development project rather than an existing, fully let property, which is based on market evidence and not specific to the developer in question. This approach is particularly appropriate for large, phased schemes. (For detailed guidance, see GN 6.)

Equated yield, or rate of return

8.4.8 A variant of DCF in which the yield is defined as the discount rate that equates NPV with total development cost (see GN 6).

Amount of cover

8.4.9 The extent to which the rent or sale price can be reduced, or the letting or sale period extended (often expressed as a number of months of rolled-up interest, or loss of rent), without suffering an overall loss on the scheme.

8.4.10 The appropriate level of profit to be assumed in the appraisal cannot be specified in this *guidance note*, as market requirements vary from project to project. Evidence may be deduced, though with difficulty, by analysing transactions, but it is better obtained from the valuer's knowledge of the market or developer's requirements.

8.4.11 In any event, the appropriate profit to be expected from a particular development may be influenced by a number of factors, which might lead to the departure from the market norm. High among these are the certainty of the information available to the valuer and the general risk profile (for example, whether the interest rate is fixed, or if the scheme is pre-let or pre-sold). The scale of development, the amount of financial exposure and the timescale are also relevant.

9 Assessing the land value

9.1 Where a comparative approach has been followed, the land value is determined at an early stage. However, the valuer may wish to evaluate the result against a simplified residual valuation, or consider if any factors explicit within a residual valuation (such as specific planning or site characteristics) have not been appropriately reflected in the adjustments that the valuer has made to the comparables.

9.2 Where a residual method (including DCF) has been followed, the valuer draws together the various elements and, after establishing the completed value by deducting the various costs, determines the residual land value.

9.3 The residual value is not necessarily the same as the value of the land as it has to be considered in the context of the valuation as a whole. The matters discussed in the following paragraphs may have an impact on the residual value and need to be addressed before the final conclusion is reached.

9.4 Some elements of the calculations may be very sensitive to adjustments and, although these may be reflected in the cost calculations, such sensitivities may also be reflected in an adjustment to the residual value. A sensitivity analysis, for instance a Monte Carlo simulation, may be undertaken and the results incorporated into the report.

9.5 If at all possible, an attempt should be made to compare the result with existing market evidence because the residual method sometimes produces theoretical results that are not in line with prices being achieved in the market. For example, in a large, phased scheme (such as a major residential development) cash flow constraints may prevent the theoretical value from being realised (that is, there may be a quantum discount that applies in the market). Similarly, in some circumstances, for instance where site remediation costs are very high, the residual appraisal may produce a negative figure, yet many of these sites with this figure still find buyers. However, this does not negate the requirement in VS 6.8 that negative values should be reported if appropriate.

9.6 The client may request the valuer to identify any hope value that may be reflected in the valuation. Hope value is the popular term for the element of the difference between the value of the land assuming it is restricted to its existing use, and the value with an enhanced (actual or assumed) approval that is reflected in the *Market Value*. The existing use value is based on comparables and the valuer's experience and knowledge of the market. Where the valuation is for secured lending (see India GN 2) the valuer may be requested to identify the hope value as a separate figure.

10 Reporting the valuation

10.1 The precise nature of the report depends on the instructions given and its purpose, but the requirements of VS 6.1 must be fulfilled. In particular:

- the basis of valuation must be clearly stated, and where a basis other than *Market Value* is adopted, the reasons for this must be fully explained (VS 6.1 (f));
- all *assumptions* made must be stated and, where appropriate, the effect of those *assumptions* where they are material must be commented on (VS 6.1 (k)); and
- the statement requiring comment on the valuation approach must be included, as it is particularly important in these valuations (VS 6.1 (q)).

10.2 Should the land have a negative value, even if it is not to be developed the negative value must be reported in accordance with VS 6.8.

10.3 Where a sensitivity analysis is provided, it is acceptable to report a range of values. For a residual valuation of a large multi-phased project, highlighting in the report the key project risks and their potential impact on the project revenues and resultant cash flows is recommended. However, for some purposes (such as for *financial statements*), a single figure must be reported with appropriate comments about its certainty (see GN 1, Valuation certainty).

India GN 4 Valuation for taxation purposes in India

1 Introduction

1.1 This *guidance note* outlines the recommended practices for valuing real estate assets for taxation purposes in India. It endeavours to integrate the core principles defined in the global *valuation standards* within an Indian context.

1.2 Valuations for wealth tax (WT) and capital gains tax (CGT) purposes are based on statutory definition and rules formed, which are very different from the standard valuation definition accepted in the market. Nevertheless, the governing Acts for these taxes provide for use of fair market value, subject to certain conditions.

1.3 According to the *Wealth Tax Act 1957* and rules formed from it, a valuation can only be carried out in the prescribed format and by a registered valuer as described in Section 2 (oaa), Section 34AB and Rule 8A. A registered valuer is a person recognised by the Chief Commissioner, or Director General, who will make an impartial and true valuation in the prescribed form and not undertake the valuation of any asset in which that person has a direct or indirect interest. For full details, see Section 34AB of the *Wealth Tax Act 1957*.

1.4 The differences between statutory valuation definitions have been interpreted by the local tribunal and higher courts. The valuer should be aware of the differences to prevent the valuations from being challenged by tax authorities as being made on an incorrect basis.

1.5 This *guidance note* deals with the statutory definition of property value for WT tax and fair market value for WT and CGT.

1.6 'Fair market value' used for WT and CGT is defined as the price that the asset would ordinarily fetch on sale in the open market on the relevant date. Although the definition is different from *Market Value* (see VS 3.2), it is an accepted practice for the valuer to report *Market Value* with regard to the statutory *assumptions*.

1.7 WT and CGT are complex and *members* should take care to understand the background to the event triggering a potential tax liability before proceeding.

1.8 This guidance is based on interpretations arising from cases that have been determined by the local tribunal or higher courts, on appeals made by taxpayers against tax assessments based on the value of property.

2 Taxpayer liability

2.1 WT and CGT are included in self-assessment procedures for which the taxpayer is responsible for calculating the appropriate amount of tax based on the valuation provided by a registered valuer.

2.2 The valuations used by the taxpayer in these tax computations are subject to checks by the assessing officer (AO) on behalf of the revenue department. Therefore, the taxpayer must ensure that any valuation used in the tax calculations has followed the statutory requirements using best practices.

2.3 If following discussion with the AO a different valuation is agreed or determined that results in a materially higher tax incidence, a taxpayer could face a claim for interest and, in some cases, additional penalties. In a situation where the taxpayer has paid more tax than the actual tax incidence, the revenue department may pay interest but at a lower rate. In either case, the taxpayer is worse off because the interest rates are less favourable than commercial rates.

3 Basis of valuation

3.1 Capital gains tax

3.1.1 The *basis of value* for CGT is fair market value as defined in Section 2 (22B) of *Income Tax Act* 1961. This is the price that the capital asset would obtain in the open market on the relevant date. Where this price cannot be determined, it may be established by abiding by the rules of the Act.

3.1.2 For the purpose of calculating CGT, capital asset means land, buildings and any rights on such immovable property as defined under the *Transfer of Property Act* 1882. The surrender of tenancy is also considered as transfer of immovable property, and the entire amount received by the tenant, reduced by any incidental expenses, is subject to CGT provisions. Any immovable property, if held as 'stock in trade' of a business on sale, is not considered to be a capital asset. There are specific requirements with regard to the definition of agricultural land. The definition of capital asset as per *Income Tax Act* 1961 can be viewed on the official website of Income Tax Department of India (www.incometaxindia.gov.in). *Members* are advised to take representation from their client's tax advisers on the applicability of the provision of CGT.

3.1.3 Capital gain is profit derived on sale/transfer of real estate. It is classified as short term and long term, depending on the period of holding such assets from date of purchase/acquisition.

3.1.4 Capital gain is equal to the difference of the sale value of the property and is either:

- (a) where the property is purchased or acquired after 1 April 1981 – the cost of acquisition
- (b) the fair market value as on 1 April 1981 if the property is purchased or acquired prior to that date.

The valuer is concerned only with (b), where the property is purchased or acquired before 1 April 1981, if the calculation of fair market value as on 1 April 1981 is required.

3.1.5 The Act states that the *valuation date* is 1 April 1981, but as an accepted practice, the valuer may take transactions that are close to 1 April 1981 and adjust for any timing gap. Typically, such data can be obtained from a registrar of properties from old records.

3.1.6 As mentioned in the introduction, the definition of fair market value is very similar to *Market Value*, and *members* may value the asset by adopting the *Market Value* definition.

3.2 Wealth tax

3.2.1 WT is levied on the net wealth of the assessee. Net wealth includes the aggregate value of all the assets, as defined, calculated on the *valuation date* in accordance with the provisions of the *Wealth Tax Act* 1957. The full text of the Act is available at www.incometaxindia.gov.in. Briefly the valuation methodology is prescribed in section 7 and is further explained in Schedule III. The Act provides two *bases of value*:

- statutory value (Schedule III, Part B, Rule 3 to 7), which takes into account various aspects such as maintainable rent, unbuilt area, unexpired lease terms; and
- fair market value (Schedule III, Part H, Rule 20 – applicable at certain exceptions), which defines value as the price an asset would obtain if sold in the open market on the *valuation date* (see paragraph 1.7).

3.2.2 WT is charged as a percentage on net wealth owned by a taxpayer at the end of financial year.

3.2.3 Net wealth is defined as the difference between:

- the aggregate value, calculated in accordance with the provisions of the *Wealth Tax Act*, of all the assets belonging to the assessee on the *valuation date*, including assets required to be included in the taxpayer's net wealth as on that date under this Act; and
- the aggregate value of all the debts owed by the assessee on the *valuation date* which have been incurred in relation to the assets.

3.2.4 The *valuation date* for the purpose of WT is 31 March of the previous year as defined in section 3 of the *Income Tax Act*.

3.2.5 Various provisions are given in the Act regarding inclusion of assets in the required calculations. *Members* should consult with their client's tax adviser for exact treatment of the asset (whether it needs to be included or excluded from the calculation of net wealth) with regard to the *Wealth Tax Act*.

3.2.6 The valuation methodology is prescribed in section 7 of the Act. For an owned and completely self-occupied residential house (note the term 'house' has a specific definition in the Act and can include certain commercial property), the Act requires the value to be determined in the manner stated in Schedule III (statutory value). The *valuation date* would be either the date on which the assessee became the owner of the house, or 31 March 1971, whichever is more current. For other assets, the value is determined in the manner set out in Schedule III.

3.2.7 As per Rule 8 of Schedule III, in any of following cases, the valuation has to be on the basis of fair market value as per Rule 20:

- (a) when the assessing officer is of the opinion that it is not practicable to apply the Schedule III methodology;
- (b) where the difference between the un-built area and the specified area of the property exceeds 20% of the aggregate area; or

- (c) where unexpired lease terms is less than 15 years.

The valuer should check which conditions apply before undertaking valuation to ensure the correct valuation method is used.

3.2.8 The registered valuer needs to report the valuation in the prescribed format (in accordance with Rule 8D of the Act).

3.2.9 It has been clarified in the rules that any restrictive terms on transfer should be ignored for the purposes of a valuation on the basis of fair market value.

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. Although some of these publications are specifically related to practice in the UK their principles may be relevant in India.

Practice standard (mandatory)

Surveyors acting as expert witnesses, 3rd edition (2008)

Guidance notes

Asbestos and its implications for members and their clients, 2nd edition (2009)

Boundaries, 2nd edition (2009)

Contamination, the environment and sustainability: implications for chartered surveyors and their clients, 3rd edition (2010)

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 5: *Rural Property Valuation* (2007)

VIP 12: *Valuation of development land* (2008)

VIP 13: *Sustainability and commercial property valuation* (2009)

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