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INTERNATIONAL VALUATION
STANDARDS COUNCIL

EXPOSURE DRAFT

Proposed Guidance Note

The Valuation of Investment Property under Construction

Comments to be received by 31 October 2009





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PROPOSED GUIDANCE NOTE

The Valuation of Investment Property under Construction

published August 2009

This Guidance Note is published by the International Valuation Standards Board which is the independent standard-setting body of the International Valuation Standards Council.

Comments on this Exposure Draft are invited before 31 October 2009. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to CommentLetters@ivsc.org, or by post to the **International Valuation Standards Board, 41 Moorgate, LONDON EC2R 6PP, United Kingdom**.

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The Valuation of Investment Property under Construction

Notes for Respondents

In May 2008 the IASB approved changes that brought investment property under construction into the scope of IAS 40 *Investment Property*. For periods beginning on or after 1 January 2009 entities reporting under IFRS have been required to account for investment property under construction as investment property.

This means that any entities that measure completed investment property at fair value also need to measure any investment property that is under construction on the date of the financial statement at fair value, subject only to the value being reliably determinable. Even if an entity measures its investment property using the cost model (the other measurement option available in IAS 40) it still needs to provide a fair value estimate of the partially completed property, since IAS 40 requires the disclosure of the fair value of investment property when the cost model for accounting is applied.

Following evidence of diversity in the approaches that entities or their advisors were proposing to adopt in implementing this requirement, the International Valuation Standards Board (the "Board") issued an Interim Position Statement in January 2009 giving its preliminary view of the valuation principles that should be adopted where partially completed investment property was required to be valued under IAS 40. Following publication of this interim statement, the Board established a working group to consider the issues in more detail and develop a draft for exposure. As a result of these further deliberations the Board has considered it prudent to extend the scope of the new Guidance Note to include all valuations of investment property under construction, and not confine the scope just to valuations required under IAS 40.

There follow some questions to which the Board is particularly interested in receiving a response based on its internal deliberations. However, Respondents do not have to answer all of these, and are welcome to make any other comments on the Exposure Draft. Where Respondents disagree with a position taken by the Board, or feel that additional or alternative guidance should be provided, it would assist if reasons can be provided.

Questions for Respondents

1) Scope of Guidance Note

The Interim Position Statement dealt exclusively with valuations of investment property under construction carried out under IAS 40. During its deliberations, the Board has decided the scope should be extended to the valuation of investment property under construction for any purpose, but not to other types of property. The reasons for this were:

- a) Broadening the scope of the guidance enables the generic principles to be distinguished from those that are specific to a particular application such as IAS 40.
- b) It is important that the distinction between accounting and valuation standards is maintained. It is the role of the IVSB to develop standards for valuation generally; while this includes guidance on applying generally accepted valuation principles where the valuations are required for use in financial statements prepared under IFRS, it should not extend to developing those principles exclusively for IFRS.
- c) Although many of the principles discussed will also apply in the valuation of other types of real estate that is under construction, the project was originally conceived to address diversity of practice in the valuation of investment property under IAS 40. The Board rejected the idea of widening the scope of the Exposure Draft to include other classes of property under construction or investment property generally because it was felt that this could lead to a loss of focus on the original issue and increase complexity.

Do respondents agree that it is appropriate that the Exposure Draft extends to include the valuation of investment property under construction for all purposes but not to other types of property under construction?

2) Valuation Approaches

Paragraph 2.3 states that as directly comparable sales evidence is unlikely to be found for investment property under construction, the value has to be estimated using one or more alternative market based approaches. It does not stipulate a particular approach but suggests some that may be appropriate. Some argue the need to be more specific on this point by explicitly identifying acceptable and unacceptable approaches. Others stress the need to focus on underlying principles and that the stated purpose of the Guidance Note excludes the provision of instruction on how to value and detailed discussion on the merits of different valuation techniques.

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Another problem with identifying specific valuation approaches and methods is that different terms are used to describe the same method in different markets.

Do respondents consider that the level of detail on the types of valuation approaches that may be appropriate is sufficient to eliminate significant differences in practice or do they consider that it would be appropriate to expressly identify approaches that would be acceptable or unacceptable by name? If respondents agree with the latter, it would be helpful if examples of named approaches that it is considered should be expressly referenced could be provided.

3 Current versus Prospective Values

Paragraph 3.2 provides that the valuation input to reflect the completed project may either be based on the current value assuming it is already completed or a prospective value based on an estimate of the value at the time completion is anticipated. It goes on to state that the correct approach is the one that most closely reflects practice in the relevant market on the date of valuation. Paragraph 3.4 provides that the costs required to complete may be based on either current costs or projected costs. The need to identify and reflect the different risks associated with these alternative approaches is identified in paragraph 3.7.

The Board is interested in learning the extent to which the two approaches to estimating the value and cost inputs to the valuation of a part completed project are used in different markets. It would therefore be helpful if respondents could indicate the market or markets in which they operate and the approach that is generally used.

4 Finance Costs and Risk

Paragraphs 3.5 and 3.7 respectively consider the need to reflect finance costs and the return that a buyer of the property under construction would require. Although one deals with the risk return that would be required by a lender and the other to the risk return that would be required by a borrower, some consider that because finance costs will also reflect project risk there is a danger of double counting. Accordingly, a cautionary note to this effect has been included at the end of 3.5.

a) Do respondents consider that there is scope for confusion between finance risk as reflected in the interest rate charged to the developer and the return that the developer requires to reflect total development risks

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(which may include fluctuations in the cost of finance)? If so, is the cautionary note adequate or is more detail required on this point?

It has also been suggested that a distinction should be made between the costs of finance up until practical completion of building work and cost of finance during any subsequent holding period before the building is leased.

b) Do respondents agree that the guidance note should expressly refer to the potential for different interest rates at various stages before the investment reaches its normal income generating potential?

5 Valuation Reliability

IAS 40 provides that investment property under construction should be carried at cost if the entity determines that its fair value is not reliably determinable. The Interim Position Statement included a paragraph indicating that the Board was of the view that because investment property was held for income or capital appreciation, the cash flows associated with the completion of the project could normally be readily identifiable and capable of reliable estimation. The implication was that it would only be in exceptional cases that the value could not be reliably determined. On reflection the Board has excluded this comment from the Exposure Draft, on the grounds that it is not the role of these standards to direct how entities or their advisors interpret IAS 40.

Do respondents agree that it is outside the scope of this guidance note to consider whether a valuation can be reliably determined for the purpose of IAS 40?

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International Valuation Guidance Note ##

Valuation of Investment Property under Construction

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1. Introduction and Scope

- 1.1. The International Valuation Standards Board (the "Board") issues Guidance Notes (GNs) to guide experienced valuers on the application of the fundamental principles of the International Valuation Standards (IVS) to a specific asset type or for a specific valuation purpose. A GN is also intended to provide information to those who commission or rely on valuations and their professional advisors on the generally recognised principles that a valuer should follow and on the principal techniques and methods that may be used. Because of the range of asset types and of purposes for which valuations are required, a GN cannot provide specific guidance for every valuation situation and departure from the principles described may be justified in certain situations. A GN does not provide instruction on how to value nor detailed discussion on the merits of different valuation techniques.
- 1.2. The objective of this GN is to provide guidance on internationally recognised principles that should be applied when the objective is to estimate the market value of investment property that is under construction on the valuation date. Many of these principles are similar to those that apply to the valuation of other types of asset; this guidance should therefore be read in conjunction with the International Valuation

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Standards, and in particular IVS 1 *'Market Value Basis of Valuation'*, IVS 2, *'Bases other than Market Value'*, and IVS 3, *'Valuation Reporting'*.

- 1.3. Valuations of partially completed investment property are required for different purposes including:
- acquisitions, mergers and sales of businesses or parts of businesses,
 - loan security,
 - litigation, and
 - financial reporting.

2. Valuation Approach

- 2.1. This Guidance Note examines the principles that should be observed in estimating the market value of investment property under construction. Market value is discussed in detail in IVS 1 but in summary the objective is to estimate the price that would be paid and received in a hypothetical exchange of the partially completed property in the market as of the date of valuation.
- 2.2. In practice, few investment properties are transferred between market participants in a partially completed state, except as either part of a transfer of the owning entity or where the seller is either insolvent or facing insolvency and therefore unable to complete the project. Even in the unlikely event of there being evidence of a transfer of another partially completed investment property close to the valuation date, the degree to which work has been completed would almost certainly differ, even if the properties were otherwise similar.
- 2.3. In the absence of directly comparable sales evidence, the value has to be estimated using one or more market-based valuation approaches. Such approaches may use information from a variety of sources, including:
- 2.3.1. sales evidence of similar properties in different locations or in a different condition with adjustments made to account for such differences;
 - 2.3.2. sales evidence of comparable properties transacted in different economic conditions with adjustments made to account for such differences;

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- 2.3.3. discounted cash flow projections supported by comparable market data on construction costs, lease terms, operating costs, growth assumptions, discount rates and other key inputs.
- 2.4. It is inappropriate to estimate the market value of a partially completed investment property solely by reference to the project plan or feasibility study produced at the commencement of the project. Once the project has commenced, this is not a reliable tool for measuring value as the inputs will be historic. An approach based on estimating the percentage of the project that has been completed prior to the valuation date is therefore unlikely to be relevant in determining the current market value.
- 2.5. The market value of a partially complete investment property will reflect the expectations of market participants of the value of the property when complete, less deductions for the costs required to complete the project and an appropriate adjustment for risk. The valuation and all key assumptions used in the valuation should reflect market conditions at the valuation date.
- 2.6. If the time required from the valuation date to complete construction of a new investment property is such that the anticipated cash flows will occur over a period of time, and if the time cost of money is likely to be a significant factor, it would be appropriate to use a valuation method that reflects the probable timing of those cash flows.

3. Valuation Inputs

- 3.1. The following inputs will normally be required in order to reliably estimate the value of an investment property under construction:
- 3.2. **Completed building:** This may be either the value on the assumption that the project had been already completed on the date of valuation or the prospective value on the date completion is anticipated. The more appropriate of these alternatives will be the one prevailing in the market for the class of property on the valuation date. The type of input used and the reasons for it should be disclosed in the valuation report.
- 3.2.1. The value of an investment property as if complete on the date of valuation will reflect the concurrent market value of existing investment property of a

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similar type and specification to the proposed project once it has been completed and leased.

3.2.2. The prospective value of an investment property will reflect the reasonable expectation of market participants of the value on the date that the property is anticipated to be completed and leased.

- 3.3. **Leasing:** If lessees for the property after completion have still to be identified, allowance will need to be taken of the time and costs (inclusive of incentives and fees) that it would be realistic to allow for the maximum potential income or capital to be generated from the project in current market conditions. If there are leasing agreements in place that are conditional on the project, or a relevant part, being completed, these should normally be reflected..
- 3.4. **Construction Costs:** The benefit of any work carried out prior to the valuation date will be reflected in the current value, but will not determine that value. Consequently previous payments under the actual building contract prior to the valuation date are not relevant to current value. In contrast, the sums remaining to be paid under any binding construction contract in existence at the valuation date are often the best evidence of the construction costs required to complete. However, if there is a material risk that the contract may not be fulfilled, for example due to a dispute or insolvency of one of the parties, it may be more appropriate to reflect the cost of engaging a new contractor to complete the outstanding work. If there is no fixed price contract in place then it may be appropriate to use prospective cost, ie reflecting the reasonable expectation of market participants on the valuation date of costs on the dates when they are likely to be incurred.
- 3.5. **Finance costs:** The cost of providing finance to cover the remaining costs of construction, and of any period following completion until the property has achieved its full income potential. As the risks during construction may differ substantially from the risks following completion of construction, the finance cost during each period should be considered separately. Even if the entity is self funding the project, appropriate market rates of interest should be allowed to reflect those which would be obtainable by a typical buyer of the property in the market at the date of valuation. These rates should generally be considered concurrently with any discount rates used to ensure that the same risk is not accounted for twice.

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- 3.6. **Other Costs:** These will include legal and professional costs that would be reasonably incurred by a buyer in completing the construction and in letting the investment property. Except where there are leasing agreements in place, allowance will also need to be made for the reasonable costs of marketing. However, any costs that would be incurred in an actual transfer of the property on the date of valuation should be ignored.
- 3.7. **Risk:** All significant risks should be identified and evaluated. Typical risks associated with any partially completed construction project will include variations in construction cost, finance costs and the construction programme. Additional risks associated with investment property under construction include fluctuations in the value of the completed project between inception and completion, and the time that will be required to secure lessees and a stabilised income. The risks associated with generating income from the property after completion should be identified and evaluated separately from the risks associated with completing construction. If the valuation inputs are based on current values and costs the risk of movement between the valuation date and the anticipated completion date should be evaluated. If prospective values and costs have been used, the risk of those projections proving to be inaccurate should be evaluated.
- 3.8. **Investor's Return:** Allowance should be made for the return that would be required by a buyer of the partially completed investment project in the market place. This should reflect the risks associated with the completion of the construction programme and in achieving the anticipated income or capital appreciation on the date of valuation, (see paragraph 3.7). The buyer's return can be expressed as a target profit, either a lump sum or a percentage return on cost or value. Alternatively, if a discounted cash flow approach is used to produce the valuation it may be the minimum rate of return that would be required by a typical buyer in the market. The profit anticipated by the entity at the commencement of the development project is irrelevant to the valuation of its interest in the project once construction has commenced. The valuation should reflect those risks remaining at the valuation date and the discount or return that a buyer of the partially completed project would require for bringing it to a successful conclusion.

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- 3.9. Other considerations:** In situations where there has been a change in the market since a project was originally conceived, the project under construction may no longer represent the highest and best use of the land. In such cases the costs to complete the project originally proposed may be irrelevant as a buyer in the market would either demolish any partially completed structures or adapt them for an alternative project. In such cases, the value of the investment property under construction would need to reflect the current value of the alternative project and the costs and risks associated with completing that project.

4. Special Considerations under IAS 40

- 4.1. IAS 40 (paragraph 38) provides that the fair value of investment property shall reflect market conditions at the end of the reporting period. Paragraph 39 further provides that the value is time-specific as of a given date. As indicated in IVA 1 Valuations for Financial Reporting, the IVSB considers that the explanatory provisions in IAS 40 on the application of fair value¹ mean that, for financial reporting purposes, it is indistinguishable from Market Value
- 4.2. Financial statements are produced on the assumption that the entity is a going concern unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so (IAS 1 paragraph 25). It is therefore normally appropriate to assume that any contracts, for example for the construction or letting of the property on completion, would pass to the buyer in the hypothetical exchange, even if those contracts may not be assignable in an actual exchange. An exception would be if there was evidence of a higher than normal risk of default by a contracted party on the date of valuation.

5. Special Considerations for Secured Lending Valuations

- 5.1. A valuation of a partially complete investment property for secured lending produced in accordance with these standards (IVA2 Valuations for Secured Lending Purposes) will have Market Value as its objective. However, many contracts are either void or voidable in the event of one of the parties becoming subject to formal insolvency proceedings. Therefore an assumption that a buyer of the partially completed project

¹ The provisions in IAS 40 cited in this draft may be superseded by the IASB's proposed new Fair Value standard during the development of this IVSB guidance. However, the IASB Exposure Draft "Fair Value Measurement" published in May 2009 reinforces the need for fair value measurements generally under IFRS to be based on the same objectives and principles as Market Value as defined in IVS.

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may have the benefit of existing building contracts and any associated warranties and guarantees may be inappropriate in valuations for this purpose. Likewise, care should be taken in assuming that any agreement for lease entered into by a borrower would be transferable to a buyer.

6. Reporting

- 6.1. In addition to the provisions of IVS 3 *Valuation Reporting* the valuation report should state clearly in a heading that the project is under construction, include a description of the project, the stage of development reached, the valuation method or methods used, the key inputs to the valuation and the assumptions made in determining those inputs. In particular, the report should identify and where possible quantify the remaining risks and costs associated with the project and how these have been reflected in the valuation. In quantifying such risks, distinction should be made between risks in respect of generating rental income and construction risks.

Effective Date #####