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30 April 2014

Dear IVSC Members

IVSC Exposure Draft: *"Development Property"*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the International Valuation Standards Council (IVSC) issuing an Exposure Draft (ED) on *Development Property.*

We include, in the attached appendix, our responses to the specific questions raised in the exposure draft.

Should you wish to discuss the contents of this letter with us further information, please contact Sven Schieszl (sven.schieszl@de.ey.com) or Philipp Lindenmayer (philipp.lindenmayer@de.ey.com).

Yours faithfully

Ernst & Young

Appendix: Responses to the specific questions in the Exposure Draft "D*evelopment Propertiy"* (issued January 2014)

It is proposed that the specific requirements for valuations of investment property under construction for financial reporting under IFRS be referenced in the guidance on IFRS requirements in IVS 300 *Valuations for Financial Reporting*, rather than being in a separate standard. The Board considers it more logical to include all the requirements in the IVSs for valuations used in financial reporting and guidance on the requirements under IFRS in the same standard. If this is done the current IVS 233 would be withdrawn.

1. Do you agree with the Board's proposal to move all material in the standards specific to financial reporting to IVS 300?

Yes. We believe this would be an improvement.

This Exposure Draft is of a proposed Technical Information Paper (TIP) that will retain the guidance in the current IVS 233 *Investment Property under Construction* if the latter is withdrawn. The guidance in this proposed TIP is designed to be more broadly applicable to all development property rather than to the specific case of valuations of investment property under construction under IAS 40. The Board considers that similar valuation considerations and methods are applicable to all types of real property under construction, not just investment property.

2. Do you agree with the Board's view that the valuation techniques described in the commentary to the current IVS 233 are applicable to all types of development property, not just investment property as defined in IFRS?

We generally agree that the guidance should be broadly applicable to all development property.

The intended purpose of the proposed new TIP will be to provide guidance to support the application of the principles in IVS 230 Real Property Interests to development property. Paragraphs 1-4 set out the scope of the proposed guidance.

3. Do you agree with the scope as described? If not, please explain any additional matters that you believe should be added to the scope or matters currently included that you believe should be excluded.

Following the reasoning in paragraph 27 there might be changes in the market that lead to a conclusion that the current use of a property no longer represents the highest and best (for example, properties that are obsolete and/or permanently vacant). Such properties may be appropriately considered within this TIP.

Paragraph 7 provides a non-exhaustive list of matters that typically need to be considered when undertaking a valuation of development property.

4. Please indicate if there are any items on this list with which you disagree or any additional matters you believe should be included.

We generally agree with the matters listed in paragraph 7. However, in our view, its relevance to a valuation may depend on the applicable bases of value. We would encourage the IVSC to address this in either in paragraph 6 or paragraph 7. For example, if the basis of value were market value (or fair value, as defined in IFRS 13 *Fair Value Measurement (*IFRS 13 Fair value)), the relevance of the private contract would depend on whether it transferred to a potential purchaser or otherwise remain in place after transfer.

Furthermore, we encourage the IVSC to list potential encumbrances or characteristics that are contained within title deeds that may have a significant impact on the valuation (e.g., pre-emption rights or easements).

Understanding of the legal permissions or zoning may be improved by clarifying that the permitted usage and construction limitations (e.g., maximum height, floor space ratio, etc.) influence the value of development properties, especially in connection with redevelopments the permitted usage is worth investigating.

Paragraph 15 suggests that all three valuation approaches identified in the IVS Framework can be applied to development property.

5. Do you agree? If not, please explain why.

Yes. The approaches described may be relevant, depending on the specific facts and circumstances.

However, due to the lack of transactions of comparable development properties already undergoing construction works, the market approach would only seem applicable to plots of land. If it understood that plots of land for development should be valued using this TIP rather than another paper, then we agree with the inclusion of the market approach in this paper.

Paragraph 20 introduces the “Residual method”. Paragraphs 21 and 22 explain the sensitivity of the residual value due to small changes in the inputs.

6. Do you consider the caution provided here is sufficiently detailed or do you consider further guidance is required?

We agree with the discussion in paragraph 20. However, we would encourage the IVSC to provide similar guidance in paragraphs 13 and 14 to emphasise the importance of selecting one or more valuation techniques that are appropriate in the circumstances and will provide relevant and reliable information.

Paragraph 24 lists typical inputs into a cash flow forecast for a development property. This list is almost identical to that appearing in the current IVS 233.

7. Do you consider that there are any typical inputs that are not referenced but should be included or items included that would not typically be used? If yes, please identify the input and the reasons for inclusion or exclusion?

The following comments are included in respect of the inputs listed in paragraph 24:

- We would encourage the IVSC to state whose perspective the valuer should consider in relation to the inputs listed in paragraph 24, which may vary depending on the applicable basis of value. For example, sub-paragraph (b) refers to lease agreements. When leases that have been entered into are entity-specific and contain terms that may not be consistent with what market participants generally would receive, such as for anchor tenants, rent-free periods, special fixtures and fittings, discounts, etc.. a market-based approach (including IFRS 13 Fair Value) may require these inputs to be adjusted to reflect market conditions. In relation to lease agreements, whether letting fees for a real estate agent, tenant improvement costs, etc., should be taken into account in connection with lease assumptions should be clarified.
- Construction contracts – In our view, the payment mechanism in a construction contract may not necessarily be a reflection of the stage of completion of the construction contract. However, as currently drafted, the second sentence suggests that past payments should be ignored while the third sentence suggests that future payments are relevant. We would encourage further clarification.
  It should also be considered that contractual costs may include special requirements that reflect the specific requirements of already known users and do not necessarily align with common requirements of third-party market participants.
- Finance costs – We would encourage the IVSC to provide additional guidance on the inclusion of finance costs in a valuation of development property. For example, it is not clear:
    - Whether the impact of finance costs would vary depending on the relevant basis of value
    - How the IVSC views the interaction between consideration of such funding throughout the remaining construction period and the selection of an appropriate discount rate(s)
    - How a valuer would ensure assumptions are consistent with the asset being measured, rather than an entire business
    - What a valuer would be expected to consider when determining the appropriate credit risk for market participants for the loan profile

Paragraph 25 indicates common sources or methods for determining the appropriate discount rate. More detailed guidance is provided in TIP 1.

8. Do you consider that there are any other methods for determining the interest rate that should be included? If so, please explain these.

We would encourage the IVSC to provide additional guidance on how to incorporate risks into the discount rate or cross-refer to other valuation standards or TIPs where such guidance is provided.

In addition, we acknowledge that, when using an income approach (e.g., discounted cash flow technique) to value a development property, the weighted average cost of capital (WACC) as a basis for developing a discount rate is commonly used. However, WACC is usually derived from company data, which includes diversification of investments etc. In order to derive a discount rate for a single asset, adjustments would be needed. It is not clear how a valuer would ensure assumptions are consistent with the asset being measured, rather than an entire business. It is also unclear how rates derived from transactions of similar development properties will be suitable due to the lack of comparability of development properties.

We also note that some IFRSs require a pre-tax discount rate be used (e.g., IAS 36 *Impairment of Assets*). We believe it would be helpful to address challenges and provide guidance to assist valuers in determining an appropriate discount rate (and adjusting cash flows) in those instances, either in this TIP or by cross-reference to a relevant valuation standard or TIP.

Paragraph 34 includes a list of recommended matters that should be included in a valuation report for development property where relevant and appropriate.

9. Do you agree with this list? If not, please identify any additional matters you would like to see included or matters that are included that you think should be excluded, with supporting reasons.

Referring to the last bullet point “key inputs to the valuation ….”, it might be helpful to add examples to clarify whether the IVSC has a view as to the required level of detail or whether valuers should use their judgement in determining the appropriate level of detail. For example, if there is an office development property with several planned letting units it might be unclear whether an overall rent level assumption or the rent level assumption per unit should be stated within the valuation.

In relation to the risk statement, we believe the appraiser should also make a statement about the expected duration until completion and potential risks with regard to a possible extension (e.g., due to overrunning the anticipated or agreed construction period).

Paragraph 36 suggests that it may be advisable to include a sensitivity analysis if the valuation is very sensitive to changes in key inputs. This is in order to illustrate the risk of the value changing if, say, market conditions or construction costs were to change during the period required for completion.

10. Do you agree that this type of disclosure is helpful and should be encouraged wherever appropriate?

We agree that this type of disclosure would be helpful. In our view, the sensitivity of underlying assumptions is important for users in developing an understanding of the valuation. We also believe the fact that the valuation is not sensitive to certain inputs may also informative to users, depending on the specific facts and circumstances. Valuers should, therefore, use their professional judgement to determine whether such information should be disclosed.

Other comments

- In situations where a valuer presents two or more values, we would encourage the IVSC to consider requiring a valuer to give an opinion as to the most appropriate value. We believe it would be helpful for a valuer to provide additional discussion to explain the differences and which value they believe is most appropriate, in light of the relevant measurement objective (e.g., Market Value, IFRS 13 Fair Value etc.).
- Definitions - We note that, in paragraph 5 of the exposure draft, the definition of the income approach uses the term ‘capital value’. The definition of this term may not be clear to all users of the TIP. As such, we would encourage the IVSC to define this term and/or provide additional guidance.
- The first sentence in paragraph 19 of the exposure draft states, "The market value of a development property will reflect the expectations of market participants of the value of the property when complete, less deductions for the costs that they will incur to complete the project with appropriate allowances for profit and risk". In our view, this is a general statement that would be more useful earlier in the document, such as before paragraph 6.
- As there are more elements to the discount rate than just time value of money, we suggest modifying the last sentence of paragraph 19 of the exposure draft to clarify that the "appropriate discount rate to reflect the anticipated timing <u>and risk</u> of those cash flows...".
- It might be helpful to clarify the difference between the income and the residual approach due to the fact that both valuation methods contain similar items and assumptions.

- Paragraph 32 provides additional considerations for financial reporting. It assumes that: (a) a reporting entity would be a going concern; and (b) the measurement objective/basis of value is IFRS 13 Fair Value. These assumptions may not always be appropriate. We believe this paragraph needs to clarify:
    - That the measurement objective may not always be IFRS 13 Fair Value and valuers need to ensure assumptions are appropriate in light of the relevant measurement objective
    - That an entity may not always be a going concern
    - Why the IVSC believes the fact that an entity may or may not be a going concern is relevant when assuming that contracts would pass to the buyer in a hypothetical exchange