International Valuation Standards Council (IVSC)

Discussion paper

Investment Property

Response of the
Royal Institution of Chartered Surveyors (RICS)

Contact:
Lorraine Howells MRICS
RICS Associate Director Valuation Professional Group
lhowells@rics.org

Ben Elder FRICS
RICS Global Head of Valuation
belder@rics.org

Introduction

The Royal Institution of Chartered Surveyors (RICS) has noted the publication of the Discussion Paper – Investment Property – produced by the International Valuation Standards Council (IVSC) in November 2012 and welcomes the opportunity to comment.

About RICS

RICS is the global leading organisation for professionals in real estate, land, construction and related environmental issues as well as working in the personal property and business assets sectors.

Over 120,000 RICS members, who are Chartered Surveyors, exist globally and operate out of 146 countries, supported by an extensive network of regional offices located in every continent. RICS Headquarters is based in London and our international work is supported by a network of regional offices and national associations.

RICS members play a vital role throughout the entire asset life cycle – from initial inspection and measurement, development through to investment in, and the use of physical structures and other assets, as well as financial and business interests. We also provide impartial advice to governments, policymakers and non-Government organisations.

RICS is an independent professional body, which was established in 1868 and has a UK Royal Charter. It is committed to setting and upholding the highest standards of excellence and integrity, providing impartial and authoritative advice on key land and asset issues affecting businesses and society.

RICS is a regulator of both its individual members and firms enabling it to maintain the highest standards and providing the basis for unparalleled client confidence in the sector.

The general ethical principles for all RICS regulated members and firms are set out in our professional and ethical standards to which the following is an extract:

Act with integrity – Be honest and straightforward in all that you do

Always provide a high standard of service - Always ensure your client, or others to whom you have a professional responsibility, receive the best possible advice, support or performance of the terms of engagement you have agreed.

Act in a way that promotes trust in the profession - Act in a manner, both in your professional life and private life, to promote you, your firm or the organisation you work for in a professional and positive way.

Treat others with respect - Treat everyone with courtesy, politeness and respect and consider cultural sensitivities and business practices.

Take responsibility - Be accountable for all your actions - don't blame others if things go wrong, and if you suspect something isn't right, be prepared to take action.

RICS and Valuation Standards

A significant proportion of our members are involved in valuation practice on all manner of assets. The first RICS Valuation Standards was produced in 1976 and the current standards are the “RICS Valuation – Professional Standards” effective from 30th March 2012. The standards are commonly known as “the Red Book” and contain mandatory rules and best practice guidance for valuations of real estate and other assets.

RICS adopts the International Valuation Standards (IVS) 2011. The adoption of IVS in the Red book provides an implementation and practice framework for the application of IVS globally, ensuring that RICS members follow consistent methodologies throughout the world.

The Red Book is mandatory for all RICS members and regulated firms worldwide when carrying out Red Book specific valuations. It is also widely referred to by non-RICS valuers.

The global section of the Red Book comprises a broad ethical framework which can be applied to valuations of any asset type in any jurisdiction, in harmony with national legislation. They comprise a framework for the following:

- Compliance, competence, independence and ethical requirements;
- Terms of engagement;
- Valuation bases (global);
- Valuation applications;
- Investigations, inspections and verification of information; and
- Valuation reports.

More specifically the standards relating to application, competence, independence and objectivity are set out in Valuation Standards VS1.2-1.9.

The global standards are accompanied by detailed national standards.

For more information please visit http://www.ricsvaluation.org/

Detailed response to the Discussion Paper

You have requested that responses to this consultation paper are set out as answers to specifically posed questions.

Question 1

Do you think that the current definition should be retained in full or that an amendment to the definition in IVS 233 is required *?*

RICS supports the current definition of *Investment Property* as it stands, which is simple and sufficiently clear to cater for the broader needs of the global market to which it serves. The definition of *Investment Property* is currently the same as that in IAS 40, and we would be concerned that any change to it would cause confusion in the market, as we already see with the two different definitions of *Fair Value* (IVSC and IFRS).

For clarification purposes we assume that this definition also includes residential investment property under construction as well as commercial property.

As suggested in the discussion paper, IVS 233 (Investment property under construction) is important in that it stands as an anomaly among the international standards as it focuses on one type of asset in a specific situation, rather than providing valuation standards interpretation like the others. Whilst IVS 233 is listed as a Standard, its content and subject topic reads like guidance and therefore may be more appropriate sitting as a Technical Information Paper (TIP) instead. We discuss the position of IVSC Standards and TIPs in greater detail later in this response.

Question 2

If you believe it should be retained in full, what guidance should be given to valuers when valuing for the non-financial reporting purposes referred to above ?

RICS believes that the definition should be retained in full given the reasons explained above.

Additional guidance to those valuers when valuing for non-financial purposes is important, however we do not consider this needy of a separate valuation standard.

Whilst the RICS notes the stated objective of this discussion paper, it is unusually detailed and also variable in topic as well as based on asset-specific valuation issues rather than dealing with international valuation standards interpretation. Whereas IVS 233 is already asset specific, it does raise the question of whether IVSC wishes to further extend what is now an anomoly, to *Investment Property*.

RICS would invite the Professional Board - and IVSC - to consider whether this level of detail is entirely appropriate as a Valuation Standard and to provide clarity on whether they are a Standard Setter, a Guidance Issuer, or both. Perhaps a full discussion is required on the direction of IVSC.

Question 3

If you believe an alternative definition is warranted, please give reasons and suggest appropriate wording.

We do not consider an alternative definition is warranted and refer you to our answer at question 1 regarding confusion in the market when there is more than one definition.

Question 4

Have you encountered valuations that explicitly refer to intangible assets associated with either the property interest or the business in occupation ? If so, were these separately valued or not ? For what purpose was the valuation required ?

We have referred to our members on this question who have answered that some lenders expect valuers to value the components separately (including Intangible Assets) and write this into their instruction letters.

Our US members in particular mention a revision to the Standard Operating Procedures (SOP) of the Small Business Administration, which directs appraisers performing going concern appraisals to identify different categories of a firm's assets and separately value the property in each category. One SOP provision deals with "Appraisal and Business Valuation Requirements" for Commercial Real Estate,

Subpart B, Chapter 4 II(C)(1)(g), SOP 50 10 5(D) of the SOP states: "If the appraisal engagement letter asks the appraiser for a business enterprise or going concern value, the appraiser must allocate separate values to the individual components of the transaction including land, building, equipment and business (including intangible assets). When the collateral is a special purpose property, the appraiser must be experienced in the particular industry."

Another provision dealing with Business Valuation Requirements – Change of Ownership, states that "The lender may use a going concern appraisal to meet [the change of ownership valuation requirements] if the appraisal allocates separate values to the individual components of the transaction including land, building, equipment and intangible assets." (Subpart B, Chapter 4 II(C)(5) (e)(3)).

By contrast, in the UK, for trade-related property it is common in today's market for secured lending specialists to require the valuer to provide the:

1. Market Value of the property on a fully operational basis; and
2. the Market Value subject to assumptions: that the business has ceased trading; that no accounts would be available to a prospective purchaser; and that the trade fixtures and fittings have been removed.

In this instance the valuation is usually reported as an inclusive sum, clearly setting out the assets included in the valuation.

Question 5

Have you encountered valuations of investment property where you believe that the value of an intangible asset has been included in the value of the property interest but has not been expressedly identified ?

We believe that this question may be directed towards the valuation of trade-related property on assets such as hotels, theatres, care homes and others where the key attribute of the asset means that they are usually bought and sold in the market based upon trading potential.

We refer you to our response to the previous IVSC Discussion Paper on Trade-Related Property and in particular our answers to questions 10-14.

Question 6

Do you consider that the IVSC needs to provide guidance on this issue ?

No. We do not consider that IVSC needs to provide guidance on this issue.

Question 7

Which of these options do you favour or is there another option that you would suggest ?

From what we are able to ascertain, the discussion paper provides the following options:

a. Amending IVS 230 (Real Property) and 233 (Investment Property under Construction)
b. Producing a new Standard on Investment Property which may incorporate IVS 233
c. Produce a new Standard for Property under Construction that would incorporate IVS 233
d. Making no or limited changes to IVS 230 and IVS 233 but producing a new Technical Information Paper providing guidance on the relevant issues

We do not consider that there is a need for a separate standard on Investment Property nor does IVS 230 require amendment.

The rest of the question is difficult to answer given our comments already relayed in questions 1 and 2. IVS 233 stands as an anomaly in the Standards in that it deals with a asset-type in a specific situation. We therefore suggest that this would read better as a Technical Information Paper rather than add to the existing list of Standards.

We would therefore answer that (d) would be preferable, with some slight changes: make no amendment to IVS 230 but then move IVS 233 to a Technical Information Paper status. Alternatively, members of IVSC are capable of providing a framework of guidance on technical matters such as Investment Property to their own individual members as the need arises, leaving IVSC as the Standard Setter, providing high-level international valuation standards as that already set out in IVS 230 and others.

Question 8

Do you consider the provisions of IVS 230 and IVS 233 in relation to valuation methods to be sufficient ?

Yes.

IVS 230 is well written and adequately deals with Real Property Interests, talking the reader through the processes required in undertaking a valuation of real property in a logical manner. It includes the three principle valuation approaches: Market Approach, Income Approach and Cost Approach and also gives guidance on how these approaches may be applied in relation to historical property. Short of providing examples (which we do not consider appropriate within a Standard in any case), there is no need to make any amendments.

As previously mentioned IVS 233 stands as an anomaly in valuation standards in that it deals with an asset in a specific situation and deals well with the valuation inputs associated with discounted cash flow models. The Standard falls short of telling the valuer how to undertake a discounted cash flow projection but highlights the items the valuer needs to consider when undertaking this type of work. Again, we do not consider that any amendments are needed here in relation to the valuation methods mentioned, albeit we do see this asset-specific type instruction better as a TIP.

Question 9

If not, what specific aspects of valuation methodology for investment property do you think should be addressed in any future TIP ?

RICS believes that investment property is well covered by the current international valuation standards provided at present.

RICS will continue to provide additional commentary and guidance to its members within the form of the Red Book, Guidance Notes and Information Papers as and when it identifies an area worthy of additional guidance. We also forsee that other IVSC member organisations will do the same.

Question 10

Do you consider that the additional guidance to that provided in the IVS Framework (paras 33-35) is needed to apply the highest and best use concept to investment property ?

We consider that the concept of “highest and best use” is well understood in the market amongst valuers. However, where we find that there is sometimes confusion is whether this is applied to the definition of Market Value in some countries. In rare circumstances, we find that valuers will sometimes confuse Market Value with value in existing use and this may be because they immediately assume the existing use is the highest and best use, which is not necessarily the case.

In answer to this question therefore, paragraphs 33-35 explains the highest and best use concept and no additional guidance is necessarily required in this regard, however this is not where we consider the problem lies.

Question 11

Please indicate which of the above most frequently presents a problem in the valuations that you encounter and the most common methods you see being used to address the issue

The topics you have mentioned include:

a. where there are either no or limited sale transactions of a particular type of investment
b. where an investment property has not been leased since its completion
c. where, due to specific legal or practical issues, the property cannot be sold as a separate asset
d. where an investment property comprises property to be developed, defining what constitutes "completion"; and
e. how discount rates should and should not be constructed

RICS has experienced circumstances in most of those areas mentioned above but in recent years the most frequently mentioned problem has been (a). The lack of comparable evidence due limited or no sales transactions continues to cause problems in many markets. RICS provides guidance on how to translate this into valuation practice through its Guidance Note 1 on Valuation Certainty and also the RICS Information Paper on Comparable Evidence.

Question 12

If you are a valuation provider, please indicate why you prefer these methods. If you are a valuation user, please indicate if youa re confident in the result obtained by these methods.

RICS is neither a valuation provider nor a user.

Question 13

Have you encountered material inconsistency in the approach adapted to the treatment of costs or tax in valuations of investment property ? If so, please indicate the nature of the inconsistency and its consequences

Whilst RICS does not practice valuation itself, the Institution has approximately 35,000 members in its valuation professional group of which we consider a large majority of those practice valuation, even if not on a daily basis.

There are many instances where different approaches in the treatment of costs or tax in valuations can be identified. An age old example of this is the valuation of leasehold property where tax is sometimes incorporated within the sinking fund and sometimes it is not. The consequence of this will be a different multiplier, which will in turn affect the calculated capital value.

Another example where there is inconsistency within the valuation of investment property relates to whether revenue costs such as UK empty rates or more generally irrecoverable service charges exist as capital expenditure costs or a revenue deduction within the cash flow. Whilst this has no impact on the equivalent yield or capital value, manipulation of these costs affect the net initial and running yields, which can then prove difficult when analysing comparable evidence.

As mentioned in the discussion paper, properties purchased in special purchase vehicles pay advantageous property and value added tax. There have been instances in competitive situations where this has affected the purchase price where it is perceived that certain parties have greater purchase power due to the lower level of transactional tax being paid, albeit care needs to be taken as to whether the asset actually being valued is the vehicle or the property within the vehicle.

There are instances where some fair values are valuations of special purchase vehicles and others are valuations of an asset allowing full stamp duty. In countries where there are high stamp duty levels this will result in inconsistencies.

Question 14

Do you consider that the IVSC ahould attempt to set benchmarks that indicate whether inputs and valuations should include or exclude different types of tax or other costs ? If so, which specific benchmarks would you consider appropriate ?

RICS consider it would be very difficult to set a benchmark on the valuation approach which might include or exclude different types of tax or costs. There are often significant factors driving national markets which will include the overall fiscal setting and it may prove extremely difficult and unwise to attempt global guidance which is capable of translating satsfactorily into all national contexts. We can see where EPRA concerns are coming from but consistency in the application of the existing standards, coupled with perhaps some further national/European conventions or guidance seems a more sensible way forward as taxation issues are substantially about individual national contexts even for the biggest players. The focus on the "figure that would appear in the hypothetical contract of sale" (Red Book 2012 VS 3.2, commentary para 2) remains important.

Valuation is not a precise science and we do not believe it is the role of IVSC to provide mathematical examples and benchmarks on how to value. Instead we believe that IVSC should concentrate on providing Standards that encourage transparency and clarity in valuation reporting so there is no room for doubt on whether taxes or costs have been included or excluded. The valuer and/or valuation user will then able to easily analyse and compare.

Question 15

Do you consider that an opinion on where the inputs used in a valuation of investment property fall within the input hierarchy under IFRS (or any other accounting standard that contains a similar hierarchy of inputs) should be provided as part of the valuation report ?

Yes, RICS considers that the inputs should form part of the valuation report. The valuer has knowldge of the inputs that form part of the valuation assumptions and also the subjectivity adopted. They are therefore best placed to provide this opinion, which will be discused with the company and the auditors.

IFRS 13 includes a "Fair value Hierarchy", which classifies valuations according to the nature of available inputs

RICS Valuation – Professional Standards follows IVSC and we have also adopted the IFRS Fair Value definition for valuations in financial statements where IFRS is relevant. Valuation Inputs and Fair Value Hierarchy are considered a part of this adoption.

Question 16

If so, what guidance should IVSC be providing to enable valuers to comply with the requirements of IFRS 13 in relation to disclosure on inputs ?

IVSC could provide additional guidance on the application of the input hierarchy, which may provide assistance to valuers internationally. At present there appears to be indecision on which level to apply amongst valuers but where the purpose of IFRS 13 Fair Value Hierarchy is to provide a unit of account which can relate to a stand alone asset or a group of related assets there is now a need to provide a framework and consistent standard to enable them to do this.

Question 17

Do you agree that not all investment property is capable of reliable valuation ? If so, please give any additional examples to those above.

RICS considers that there are instances where it is difficult to provide reliable valuations, perhaps during times of economic uncertainty. An example of this would be during the immediate aftermath of the collapse of Lehmans Brothers in 2008.

Nevetheless, even where it is difficult to interpret a reliable valuation, this doesn't mean that the property is not worthy of valuation at all. A valuation is not a fact but an estimate and the degree of subjectivity will vary from case to case, as will the degree of certainty, that the opinion of market value will coincide with what is achieved in the market.

RICS provides a Guidance Note on Valuation certainty (GN1 within the RICS Valuation – Professional Standards) which recommends that an expression of a range of values is not good practice and in most cases the valuer should provide a single figure.

Even where it is difficult to interpret a reliable value, valuers should not treat their valuation as an admission of weakness. Indeed, where the value is considered difficult to interpret due to external factors, the weakness would be in the failure to draw attention to material uncertainty in the valuation applied.

Question 18

Please indicate the nature of guidance that you believe IVSC could usefully provide to help determination when a valuation cannot be reliably provided.

It is possible that IVSC may wish to provide guidance on uncertainty in valuations or where reliability is un-determined as a Technical Information Paper (TIP), albeit we refer you to our previous comments on where IVC wishes to position itself as a standard setter or guidance issuer, or both.