Appraisal Institute®

Professionals Providing Real Estate Solutions

March 1, 2013

International Valuation Standards Council
41 Moorgate
LONDON EC2R 6PP
United Kingdom

To Concerned Readers:

Re: Discussion Paper on Investment Property

On behalf of the 23,000 worldwide Designated members, Candidates and Affiliates of the Appraisal Institute, thank you for the opportunity to comment on the Discussion Paper on Investment Property published by the International Valuation Standards Council (IVSC). This is an important topic today given the discussions of convergence between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) relating to investment property. In December, following several years of discussion as part of lease, investment company and “investment property entity” accounting standards, FASB added to its future project list a project relating to investment property. It is likely that FASB will commence work on this project later this year, highlighting many of the issues identified in the discussion paper of U.S. accounting considerations.

General Comments

Overall, the Appraisal Institute does not believe a separate standard is necessary for investment property under construction. This area of practice falls squarely within the existing real property standard (230). We believe concerns that have been expressed by valuation services clients regarding the need for a separate standard relate more to developing an acceptable scope of services for assignments involving investment property under construction. Here, we believe that a generally consistent framework has been established by pension funds, life companies, institutional investors and some real estate investment trusts to prepare appraisal reports on investment properties, with periodic updates to those appraisals on a quarterly or annual basis. Frameworks are already firmly established in the Real Estate Information Standards published by the Pension Real Estate Association and National Council of Real Estate Investment Fiduciaries and the Global Investment Performance Standards published by the CFA Institute. We see nothing to preclude a qualified valuation professional (an MAI) from performing such assignments for investment property accounting in accordance with IVS 230.

Further, we believe that any documentation from the IVSC relating to Investment Property is best developed by the International Valuation Professional Board in the form of guidance materials, not the International Valuation Standards Board. The Investment Property issue is one that illustrates the necessity of maintaining lines of distinction between *standards,* which should relate guiding principles such as ethics, development and reporting obligations, as opposed to *guidance,* where great care should be taken to avoid mandating certain methodologies that would tie the hands of valuation professionals.

Overall, we do not believe that the existing standards require overhaul, but minor adjustment, specifically in the area of definitions found in IVS 233 relating to the unique situation of incomplete construction and clarity of the valuation product to any reader as to what was considered in the analysis.

More than anything, the Appraisal Institute urges the IVSC to support REIS, GIPS or other existing standards in application with IFRS and US GAAP valuation frameworks.

Mandatory Application of TIPs

We have taken note of the comments in relation to mandatory application of IVS and Technical Information Papers (TIPs) 1.3.1., which states:

> *The IVSC currently publishes both the International Valuation Standards (IVSs) and Technical Information Papers (TIPs). The IVSs set high level principles for the process of setting up, undertaking and reporting a valuation and are written in imperative language that makes them capable of mandatory application by those adopting the standards.*

We stress the importance of distinguishing between standards and guidance documents. "Standards" are guiding principles and they are "standard," meaning their application does not change much, if at all, with the situation. "Best practices" or guidance materials are fluid; what they are and how they are applied is highly dependent on the specific circumstances.

While the Appraisal Institute supports the development of standards that can be sufficiently enforced by government agencies and professional societies, we are strongly opposed to the mandatory application of guidance or best practice documents. Properties that are the subject of valuation assignments have such a wide range of diversity that a similarly wide latitude must be available for the valuation professional to solve the problem at hand. We urge that the IVSC remove and refrain from including any reference within a TIP that would imply or otherwise encourage mandatory adoption of guidance or best practice materials.

Valuation and the Value Definition

The valuation principles applied with investment properties are the same as other property types. Investment properties generate income streams and the valuation is based on the income capitalization and the principle of anticipation. Inherent in the principle of anticipation are the quantity, quality and timing of the income stream. For proposed construction and/or properties under construction, timing is the critical element. If market value is the goal, the body of knowledge requires a properly developed highest and best use, both as vacant and as improved. The highest and best use requires that the valuation professional address both the typical buyer for the property and the timing of any income stream. For proposed construction or properties under construction, the highest and best use and properly applied income approach account for delays in anticipated income, accordingly, in the capitalization process.

In the United States, the Uniform Standards of Professional Appraisal Practices (USPAP) addresses clarity of proposed or under construction valuations with the use of hypothetical conditions and extraordinary assumptions. Depending on the intended user and the scope of work needed to solve the client's needed information, more than one value may be required. An example might be the case of a lender on a proposed multi-tenant office building that may require a year of construction plus a second year of lease-up. The valuation may be of the vacant property as of the current date, "as is", plus the prospective value of the vacant building one year in the future under an extraordinary assumption that the improvements will be constructed as proposed within the one-year construction period, and that the market would not significantly change in that time period. This "built but as vacant" market value would account for the delayed timing in the income stream and any cost needed to obtain stabilized occupancy (I.e., the timing issue of the highest and best use). In addition, a stabilized occupancy prospective market value at the end of the lease-up period may be required under the extraordinary assumption that the market will not significantly change regarding office demand in the interim period.

The value being appraised is the critical issue and should be made clear by the valuation professional. If market value is being appraised, the highest and best use must be analyzed. But, if "use value" is being appraised, the appraisers generally will not analyze the highest and best use. Standards should require that the appraiser be clear as to what value is being appraised. If that is done, the existing body of knowledge for valuation methodology will address how timing, quality and quantity of the income stream should be considered.

Technical Comments
More technical comments relating to the specific questions posed by the Discussion Paper are presented below. We look forward to working with the IVSC to bring clarity to issues relating to the valuation of investment property.

Questions and Answers

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?

We read IVS 230 as the basic standard for real property and IVS 233 as the "needed" amendment for properties that are not yet complete. That said, one consideration missing from IVS 233 is that the value needs to clarify and specify assumptions made in the valuation regarding completion and rent-up cost. The rent-up cost should also be clear to cover all direct and indirect costs including entrepreneurial incentive to take on the risk. The Appraisal Institute believes an amendment to the definition found in IVS 233 is required if it becomes effective after this discussion.

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?

N/A – the Appraisal Institute believes that the definition requires amendment.

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

The amendment should provide clarification that investment property is an income-producing investment or a speculative appreciation investment. This is particularly critical for the properties under construction that are being addressed in the Standard under discussion.

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?

Yes. Intangible assets are valued separately in purchase price allocations, assignments involving emergence from bankruptcy, property tax, and impairment testing in various instances. Accounting Standards Codification 805 (ASC 805) in U.S. GAAP ("Business Combinations") requires all separately identifiable intangible assets and liabilities to be separately valued. Further, any entity subject to SEC regulation and preparing US GAAP financials has to value these intangible assets and liabilities upon the acquisition of property (either directly as an acquisition for investment purposes, or a corporate merger that brings with it real estate assets).

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 expressly identified?

Yes. Examples include hotels, convenience stores, restaurants, self-storage, assisted living facilities, golf courses, bowling alleys, steel mills, refineries, and entertainment venues. Furthermore, intangible assets (and liabilities) are often a component of any acquisition of investment property that includes leases to 3rd parties. For example, intangible assets (liabilities) arise from contractual obligations that are favorable (unfavorable) relative to prevailing market conditions (e.g., leasehold interests). Additional intangible assets arising from investment property with leases are attributed to foregone costs associated with securing contracts (commissions, lost rent, etc.). Entities preparing U.S. GAAP financials (publicly traded REITs, etc) explicitly recognize these intangibles as part of any acquisition of investment property.

However, in fair value reporting for real estate funds (e.g., REIS & GIPS standards), no such break-out is typically found.

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

We see no harm in the development of guidance, although we see nothing holding back the valuation profession from providing valuations of investment property today. However, any guidance developed must not be "mandatory" and should maintain maximum flexibility to allow the valuer to do the work necessary under the stated intended use.

In the U.S., FASB provides suitable, open-ended guidance on what must be recognized (the criteria for determining what must be recognized, leaving it up to the valuer to identify items that meet the criteria), but does not explicitly provide a formulaic approach on how the valuation should be undertaken. For example, in the U.S., our members witnessed a "learning curve" for the first 12-24 months after the original FAS141 pronouncement was released, but in the following years the valuation profession seems to have settled on "accepted" procedures for most intangibles (there was substantial debate in the early years).

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

The IVSC should offer TIPs as guidance materials only, and take all steps to avoid the possibility of such guidance material being made mandatory by government agencies or professional societies.

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

Some minor clarification of definition (as explained above) is in order; otherwise, the Standards appear to be sufficient. Standards should be sufficiently broad to allow the professional practitioner to apply appropriate methods and techniques to the appraisal assignment.

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

The valuation professional must account for the timing of any investment stream in addition to all costs, either expended or lost, that are incurred before the stabilized income stream may be realized. If delays are anticipated, both the costs and the present value of the delayed income stream should be accounted for in the capitalization process for present market value.

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?

For market value, Highest and Best Use must be determined as of the effective date of value. This determination requires testing for physical possibility, legal permissibility, financial feasibility, and maximum productivity. Future events are very difficult to forecast, therefore, the information needs to be based on the past, what's current, and what can be reasonably anticipated based on information available at the time the valuation assignment is completed.

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.

Valuation professionals have a myriad of techniques to infer from historical data and apply appropriate forecasting techniques to project the future of the market. To properly develop any highest and best use conclusion, the valuation professional must consider not only the use, but the users and timing of that use. The existing body of knowledge for valuation professionals contains ample techniques to address the past, present and future.

For example, using fundamental market analysis a skilled valuation professional can help clients understand the future of the particular market and how the subject property will be impacted by these future changes.

Periodic update valuations based solely on a macro-market index and a prior full analysis should be clear to the reader that it is a limited scope of work, so that it is clear and not misleading and can be weighted accordingly as to any comparison with a valuation that considers standard requirements. The periodic valuations also should carry with it a requirement of declaration of assumptions used.

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

The Appraisal Institute believes this depends on the quality of the valuation professional and the clarity of the communications with the client about the intended use of the valuation. A well trained, conscientious valuation professional will apply the appropriate techniques to help their clients make informed decisions. We prefer highly skilled, Designated valuation professionals (MAIs) who have the special skills necessary to perform a credible analysis of commercial investment property.

Any information regarding the concerns of the client should be expressed to the valuation professional prior to awarding the assignment so that the concerns may be properly addressed in the development of the scope of work.

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.

Yes. This may be a good area to develop a TIP, as some guidance and clarification in this area may be illuminating.

14 Do you consider that the IVSC should 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?

No, we believe that there is ample information available to valuation professionals in the body of knowledge and throughout the profession. Also, these may be different by region or market and should reflect how market participants apply them in their pricing decisions.

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?

It appears that what is being asked is whether or not a valuation professional should be required to specifically delineate inputs into a valuation report across a hierarchy of inputs (Levels 1, 2 and 3, if we were to use the definitions from U.S. GAAP). For example, under U.S. GAAP there are Levels 1, 2 and 3 inputs. Level 1 inputs are direct, observable inputs (like the trading price of public stock). Level 2 inputs are based on observable inputs, but have adjustments. Level 3 inputs are unobservable inputs.

From a practitioner standpoint, having input hierarchies imply that an appraisal may not be as credible if lower level inputs are used is not helpful and it illustrates a lack of understanding of the valuation process. For example, in contrast with accounting, the most reliable approach for some properties may be one that utilizes significant Level 3 inputs in accounting (the income approach, for instance, as compared to the Sales Comparison Approach, which is firmly Level 2). We strongly urge the IVSC to avoid aligning or equating valuation methods and techniques with accounting hierarchies.

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

N/A

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

No. We believe that investment property can be valued reliably by qualified real property valuation professionals. Reliability has degrees and is subject to such things as the scope of work for development of the assignment results, data availability and other variables. It is more important that the valuer be competent or become competent to complete the appraisal assignment in compliance with applicable standards. Not all valuation professionals are qualified to appraise all property types.

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

Same as #17, we believe that every investment property can be valued with some opinions more reliably. For instance, some appraisals cannot be done easily or quickly or by all

valuation professionals. However, valuation professionals have an obligation to decline work when they are not competent to appraise certain property types.

Thank you for the opportunity to comment on this important topic. If you have any questions or require any additional information, please contact Bill Garber, Director of Government and External Relations, at 202-298-5586 or bgarber@appraisalinstitute.org.

Sincerely,

Appraisal Institute