VALUATION UNCERTAINTY

RICS RESPONSE TO THE IVSC DISCUSSION PAPER PUBLISHED IN SEPTEMBER 2010

The RICS welcomes the IVSC discussion paper issued in September 2010 as an important and useful contribution to the debate about valuation uncertainty. We note that it addresses valuation uncertainty in relation to wider financial markets as well as in relation to real estate markets, and whilst the main focus of RICS valuation standards is directed towards the latter, the key principles apply to both and so we have considered this paper carefully as a whole.

We are pleased to make the following comments - to aid clarity, they are arranged in three parts:

a) General comments on the paper ;
b) Detailed comments on individual paragraphs or sections;
c) Responses to the specific questions posed.

a) General comments

Valuation uncertainty may be regarded as a function of investment uncertainty. Investors will normally use a variety of risk management tools to identify uncertainties within a predicted cash flow and then seek to measure these uncertainties in order to develop plans and pricing strategies that are focussed on minimising or, where possible, removing them. It follows that valuers should be alert to the same uncertainties as the investor in relation to the asset being considered, and be careful to address them before, and in the course of, providing valuation advice. The issue is how this is done.

Perhaps due to the breadth of the paper's subject matter, there is an implication that - for all types of valuation - standards are currently limited and this by definition leads to uncertainty. This is not absolutely true for real estate valuation where not only may international valuation standards (IVS) themselves be adopted, but also additional standards set by various professional bodies throughout the world which in turn may include or supplement national standards. This ensures discipline and commonality in process and supports transparency in outcome. It is not to say that improvements cannot be made.

Another general observation is that no distinction is made between uncertainty that arises due to an issue directly related to, or inherent in, the asset (for example in the case of real estate the rights of occupiers, or development potential), and uncertainty that impacts on the market for the asset. Such a distinction may not necessarily apply to financial instruments but if the paper is intended to cover all classes of asset, the need for differentiation in appropriate circumstances should be made clear.

b) Detailed comments on individual paragraphs or sections

Para 2

It is agreed that transparency - that is, stating assumptions, identifying comparables and explaining the valuation - is a paramount aim. Consistent with the general observation above, it is worthy of mention that for real estate the valuation standards currently in place are designed to achieve that aim. However, whilst equivalent standards may not yet extend to financial instruments we note that in the current discussion on fair value, and within the proposed new IVS (including 304.01, which is specific to financial instruments), there is a shared objective to improve levels of disclosure about the intrinsic certainty of a valuation, inter alia recognising the hierarchy of valuation methods or approaches that may be available in individual cases.

Para 4

Although we very much agree with, and endorse, the key message within this paragraph we consider that the first sentence should be articulated as "…an opinion that is derived from the consideration of the probable range of outcomes ...". The second sentence should then be similarly amended.

In the last sentence the word 'price' could be replaced with 'transaction'. This would then be consistent with the comment in the first sentence of para 5.

Para 5

It is suggested that reference to the 'normal uncertainty' inherent in any valuation could open this paragraph rather than appear half way through. This would give this important point greater emphasis.

Para 6

We think the distinction drawn here between valuation uncertainty and market risk is important and well made. But we suggest that "probability" (with its connotations of mathematical probability) is here replaced by "possibility" in the second sentence. It would also better accord with research-based findings that valuation accuracy is not infrequently demonstrated and supported by comparable transactions, or even – in some instances – by transactions in the property itself.

Para 12.1

Purely on a presentational point we would suggest that this sub-paragraph appears at the end of the list of factors rather than the beginning. Application of judgement is the final stage in the valuation process, applied to the combination of circumstances and inputs: the latter are the key (shorter term) variables requiring considered exercise of the former.

We have some concern about the rather bald statement that accuracy is dependant on 'skill and experience'. Whilst reflecting an important truth, it could nevertheless be read in ways that are unintended eg that valuations are sometimes provided by individuals without the necessary skills and experience (thus overlooking the requirement, in IVS, RICS standards and others, that the valuer must be competent in the valuation of the particular type of property - and if not competent should not accept the instruction, or should make arrangements for specialist advice) or that accuracy is necessarily enhanced purely by length of time post-qualification.

Similarly, the third sentence refers to 'independence'. An internal valuer can still be 'independent' in the exercise of his or her judgement, even though there may be a perception by some of a possibility of bias. This situation could be dealt with by better recognition of what independence means in this context and a requirement for full disclosure in the report.

A related issue on independence is the perceived interaction between the valuer and the client over a period of time leading to reduced objectivity. In the RICS standards we specifically provide that a valuer should be responsible for valuations for a limited period of time and a similar provision might be suggested here.

Para 12.2

The first sentence is agreed. However we have some difficulty with the remainder of this paragraph. Clearly the degree of uncertainty is potentially affected by the depth of investigation but we would not agree that just because a valuation is made as at 'today' it is less certain. We would, however, agree that a forecast (a term used in preference to 'a future date valuation') inevitably carries a greater inherent uncertainty, because additional assumptions have to be made that may not be borne out by events.

The second and third sentences essentially repeat in a slightly different form the opening sentence and could perhaps be shortened or deleted. And perhaps it is worth adding something about the importance of the quality, rather than simply extent, of inputs.

Para 12.3

We do not entirely agree that panic buying and selling is a manifestation of uncertainty per se, it is probably more related to volatility that has as its driver a specific uncertainty which may in practice be one step removed, as the examples to some degree illustrate. It is suggested that this distinction is made. And the examples could also help underline why in such circumstances a qualitative rather than quantitative assessment is more likely to be feasible and helpful.

Para 18

We agree with the paragraphs leading up to this conclusion – and very much endorse the final sentence. Where uncertainty is disclosed, reliance on a quantitative articulation could be very misleading – explanation, interpretation, and significance remain key, as paragraph 19 sets out.

Para 22

This paragraph relates to two separate issues. One is the degree of uncertainty in the individual valuation and the other is its significance in terms of the potential impact on the entity owning the asset, often being simply one of a number of assets. We suggest that these points are separated with the uncertainty on the valuation being incorporated into the valuation report, where required. The second point is one specific to an entity and can only be considered in the light of all information relating to that entity and would not form part of an individual valuation report but a higher level impact analysis.

Para 29

We strongly support the conclusion in the third sentence. Uncertainty should be considered in relation to the value provided, not solely the means adopted to form an opinion.

Paras 34 – 38

We endorse these comments, particularly those in para 35.

c) Responses to the specific questions posed in the draft

> **Qu. 1:** *Do you agree that it is only when material, or abnormal, uncertainty attaches to a valuation on a specific time or date that that specific disclosure is necessary when the valuation*

is reported? If not please explain why you consider that an uncertainty statement should be provided in all cases.

Yes. It is important that valuation users understand that any valuation is an opinion and not an expression of mathematical certainty. A statement of uncertainty accompanying every valuation would only serve to diminish the status of both valuation and valuer. Professional standards - accessible to users as well as to providers of valuations - should cover the issue of uncertainty and, if possible, give an indication of the circumstances under which an uncertainty opinion ie a specific disclosure or comment should be given (see question 6).

It should perhaps be cautioned that the distinction between "normal" and "abnormal" – whilst useful – may not always be easy to delineate. Thus a "normal" incident in the context of the market – such as an impending lease expiry – may be nearer the "abnormal" category in the context of an individual asset.

Qu 2: *Do you believe that the Board has identified all major sources and types of material valuation uncertainty? If not please identify what additional causes of uncertainty exist and how often you encounter these in practice?*

As mentioned in our opening remarks we suggest that reference is made to uncertainty that is related specifically to the property (or asset) rather than a characteristic of the market in that type of property. The former is relatively common in relation to real estate, though often to be considered in combination with the latter.

Overall it is clearly difficult to attempt a comprehensive list of sources and types. Political uncertainty, regulatory uncertainty and uncertainty about the pace of "building obsolescence", against the growing expectations and requirements of the "sustainability" agenda, illustrate where the existing headings (plus one to cover "asset-specific" uncertainty) would have to be interpreted broadly to be sufficient by themselves.

Qu 3: *Do you agree with the Board's conclusion that an explanation of any abnormal uncertainty identified and an explanation of the impact this has on the valuation (a qualitative statement) is more helpful to users in understanding the valuation than a purely numeric expression of the range of possible values created by the uncertainty (a quantitative statement)?*

We agree with the Board's conclusion. In most instances there are considerable dangers in attempting a quantitative statement, which may be seen as providing some yardstick of assurance to the user, but which still requires understanding and professional judgement in its interpretation. Indeed a quantified expression of uncertainty alone, particularly if too precise and/or too wide, may have the effect of undermining the opinion of value, leading in turn to a question as to whether a professional opinion is required at all. For many purposes, such as valuations for financial statements, a range of values would not be appropriate. On the other hand a valuation for investment may benefit from such information, carefully articulated, provided it is what the client wants and is expressed in terms of the probabilities that the valuer thinks are appropriate. Such a statement, necessarily including qualitative comment, would then link to specific assumptions and would not undermine the basic valuation provided.

Qu 4: *Do you think the IVSB should include an explicit requirement in the proposed IVS 105, Valuation Reporting, to disclose any material uncertainty or is the principle that requires valuation reports not to be ambiguous or misleading sufficient?*

It is important that the valuer's credibility is maintained and that the report should be transparent, with both "normal" and "abnormal" uncertainties properly taken into account in arriving at the valuation opinion. We would not object to a requirement that unusual uncertainty is expressly identified but, reflecting our comment to question 3, it is the method of disclosure that causes us some concern. We would prefer to see a statement that there are various (possibly specified) uncertainties but in exercising judgement to arrive at a professional opinion, and so providing a single figure, the valuer has weighed the various factors, not all of which will in any event lend themselves to a quantified assessment, and properly reflected market sentiment.

Qu 5: *Do you consider that there are cases where a qualitative statement of the causes and impact of uncertainty on the valuation is inadequate and should be either augmented or replaced by a quantitative statement? If so please*

a) *state the circumstances and assets classes where you believe that quantitative statements are more helpful to users, and*
b) *provide a brief explanation or example of the type of quantitative statement that you believe would be useful*

We have considered this issue as part of the development of our own standards and, including informal consultation with valuation users, we have come to the conclusion that a quantitative statement would be of little assistance and would contribute to the lessening of the impact of the opinion. For instance, to take the simplest of examples, indicating that a value is x +/- 20% may be germane to challenges of what constitutes professional competence but otherwise is likely to convey little. We cannot immediately see that – for real estate – a purely quantitative assessment could ever displace the need for qualitative comment. The user has a reason for commissioning the valuation and, provided the uncertainties are identified, the user should be able to interpret those, and bring into account also their own objectives and associated assessments of risks, to reflect their needs at the time.

Qu 6: *Do you consider that it would be helpful if IVSC developed guidance on methods for making a quantitative disclosure of uncertainty under specific circumstances? If so please indicate the circumstances and any methods that you either use or encounter in your market*

Although the development of more detailed guidance on methods of quantifying uncertainty, presumably using mathematical or statistical modelling, may be of assistance in some contexts, it would not be possible to cover every eventuality. Furthermore, uncertainty itself is a variable - its duration and impact will depend on the specific market and how the market forecasts, and reacts to, the uncertainty whether in the short or medium term. So this subject area would need to be approached with considerable caution, at least in relation to real estate valuation.

Royal Institution of Chartered Surveyors
Valuation Professional Group – 14 December 2010