Comments on the Exposure Draft:

Valuation uncertainty

Henri Hakala, MSc student
Ville Kauppinen, MSc student
Tatu Pakarinen, BSc student

1. The proposed TIP defines valuation uncertainty at para 7. Do you agree with this definition? If not, how do you think that it could be improved?

Writers of the Article, The Uncertainty of valuation (French & Gabrielli, 2003) states on uncertainty by following: “Uncertainty is a real and universal phenomenon in valuation. The sources of uncertainty are rational and can be identified.” It is clear that there will always be varying amount of uncertainty, which cannot be removed. The sources of valuation uncertainty identified in previous are: Status of valuer, Scope of work, Market uncertainty, Model uncertainty and Input uncertainty. Based on our research we would add asset uncertainty to the above mentioned list.

Uncertainty appears also due to the fact that all the possible variables affecting the value are not possible to take into account, in any market. To be able to do that, it would require knowing all existing information in the market and being able to assimilate it.

We agree with the definition and it clearly states that markets might not work as predicted in the valuation. Valuation uncertainty should always be distinguished from market risk and uncertainty of a single valuation is always linked to the specific value date whereas market risk is dependent on safety of cash flows in the future.

2. Various prudential regulatory authorities either have or are contemplating introducing disclosure requirements for assets that are deemed to be subject to “valuation uncertainty” and to apply different risk weightings to these in capital adequacy regulations for banks and other financial institutions. The Board has decided to exclude prudential valuation adjustments for valuation uncertainty from the scope of this guidance. The reason is that the IVSC is only concerned with proper valuation practice, not with how valuations are then used by the recipient in complying with other standards, laws or regulations. Do you agree with the Board’s decision to exclude prudential valuation adjustments for valuation uncertainty from the scope of this guidance?
The main goal of this draft of TIP is defined to reduce diversity of practice by identifying commonly accepted processes and procedures. This TIP as others are not meant to be used: as valuation training or instruction neither used as strict guidelines about how the valuation is supposed to do in any particular case.

IVSC is an organization to strengthen the worldwide valuation profession. The goal is to develop high quality international standards for valuation and to adopt their use. IVSC’s goal is not to produce guidelines for users of valuations. The way the valuation is used by clients is their own matter.

Laws and regulations vary heavily between countries. Guidelines that fit to all these laws and regulations are really hard to do. And as the goal is to be guidance to valuers, in our opinion it is not necessary to fit guidelines, about how to use the valuation, here.

In our opinion as the TIP’s purpose is not to offer solution in any particular case but to give overall practices to support proper valuation practice, it is not relevant to include guidance on how these valuations are meant to be used. And it is not possible to give any common guides for using valuations on reports to different prudential regulatory authorities.

3. The proposed TIP provides guidance on the distinction between valuation uncertainty as defined in the paper and risk, in particular between market uncertainty and market risk. It was clear from comments received on the Discussion Paper and made elsewhere that the concepts are regularly confused. Some believe that the brief explanation of market risk in paras 16 and 17 is not needed given that the focus of the paper is on uncertainty rather than risk. Others consider that the inclusion of a brief illustration of market risk helps readers understand the distinction between this and market uncertainty. Which of these views do you support?

We find it important to describe market risk as a part of the TIP because of the common misuse of these terms.

Articles relating this subject, such as (Adair & Hutchinson, 2005), (French & Gabrielli, 2004) and (Mallison & French, 2000) include definitions of market uncertainty and market risk and they mainly describe the need similarly to the exposure draft: the terms are often used incorrectly and as synonyms although the meaning is different.

We find the short description as in (French & Gabrielli, 2004) where they adopt the definitions from Byrne and Cadman 1984 very descriptive:

Uncertainty. This is anything that is not known about the outcome of a venture at the time when the decision is made.

Risk. This is the measurement of a loss identified as a possible outcome of the decision.

4. The paper identifies three main sources of valuation uncertainty: market uncertainty, model uncertainty and input uncertainty. Do you agree that these three categories represent the main sources or causes of valuation uncertainty as defined? If not please explain why, and in particular identify any other source of uncertainty that is not mentioned.
Identify the sources of uncertainty in property valuation. All the sources could be categorized under these three main categories that were in the draft.

Nevertheles uncertainty in the property is one source, which could have been separated on its own. Liquidity, knowledge of its properties and intrinsic uncertainties of the asset itself causes big part of the uncertainty of property valuation. We suggest that asset (property) uncertainty is to be categorized on its own.

(French & Gabrielli, 2004) describes that the accuracy of simulation depends on the accuracy of the inputs used. We wanted to separate this data, into input values and asset characteristics. In this categorization the asset has properties that are transformed in to input data for the valuation. Uncertainty in the asset characteristics result in a greater influence on the valuation than uncertainty in the data that the model is based on. Although incorrect data for a model will result in model uncertainty but the model will reduce uncertainty of a single input.

In our proposition the four main sources or causes of valuation uncertainty are: market uncertainty, asset uncertainty, model uncertainty and input uncertainty.

5. The proposed guidance indicates that because market uncertainty arises when the impact of events on value is unknown it is identifiable but not measureable. In contrast, model and input uncertainty can be both observable and measureable. Do you agree with this position?

Market uncertainty is due to unexpected events on the market that haven’t been identified. Market uncertainty is mainly about factors in the economy that haven’t been identified as a possible outcome. If we consider how a simple performance for an investment is calculated, the result is the sum of all possible outcomes multiplied with their probability (Byrne & Lee, 1994).

\[ E(R_i) = \sum_{j=1}^{n} P_j r_j \]

where,

\[ P_j = \text{Probability of scenario } j \]

\[ r_j = \text{return if scenario } j \text{ occurs} \]

\[ n = \text{number of scenarios} \]

Market uncertainty can be identifiable but when its not measurable it is uncertainty as when it is measurable it is risk of the asset.

In model uncertainty the uncertainty can be result of different applicable valuation methods that result in an uncertainty. Model uncertainty can be analyzed for example with residuals but because the model cannot perform exactly like the market there will always be a level of uncertainty.
We find that market uncertainty is more commonly going to have the effect that the scenario hasn’t been figured out in the valuation as model and input uncertainty are more likely to be more identifiable and possibly measurable. It is certain that model and input uncertainty can also be non-measurable and unidentified. Because there are no standardized spreadsheets or programs for all valuers the different models are going to result in different results possibly creating uncertainty as providing more than one valuation for a similar property with the same input data.

TIP’s position on market uncertainty being identifiable but not measurable whereas model and input uncertainty are more likely to be measurable and identifiable is from our perspective correct.

6. The requirement in IVS 103 is to disclose any material uncertainty that affects the valuation. Paras 29-39 of the proposed TIP provide guidance on identifying when uncertainty is material, with reference to the requirement in IFRS 13 for valuations for financial reporting and more general guidance where valuations are for other purposes. Do you find the guidance on materiality to be helpful? Are there any improvements or other considerations that you would suggest be included?

Two main aspects about materiality in our opinion are also mentioned in exposure draft. Materiality should be considered from two aspects: whether the impact on valuation significant and whether it is of concern to a user of the valuation. Even if the valuer judges that the uncertainty is material it will always depend on the user is it a matter of relevance or not.

According to (French & Gabrielli, 2003) all valuations are uncertain. Even if the valuation is expert’s view on the expected price for the asset, it is not a fact. Value is never a fact; it is always subjective and should never be mixed with the future transaction price. For Real Estate, there is a prevalent, odd belief that valuations would be final and exact.

Explanation on materiality in the Exposure draft is extensive and it also describes that the valuation should reflect on the customer’s needs and use of the valuation.

7. Para 42 sets out matters that it is recommended be included in a qualitative disclosure of uncertainty. Do you agree that this identifies the matters that should normally be included in a disclosure of uncertainty? If not please indicate any additional matters that you consider should be included or any matters mentioned that should be excluded

In the para 42 it is proposed that sources of uncertainty are to be described qualitatively in the valuation report.

Michael Mallison and Nick French wrote on their article of Uncertainty in property valuation that including the details of uncertainty to the report varies on valuer’s. They suggested that openness about uncertainty, in professionally organized manner, will be good for both client and valuer.

In (Adair & Hutchinson, 2005) there is separation between normal uncertainty and abnormal uncertainty. This classification is also recognized in almost same way in (Mallison & French, 2000) and (French & Gabrielli, 2004). Normal uncertainty is recognized as uncertainty and if the uncertainty is abnormal, the abnormalness should be told.
Because the users of valuation are commonly unprofessional, when it comes to different valuation methods, models and inputs, a qualitative explanation of uncertainty is from our perspective more important as it will be easier to represent that the valuation has a certain level of uncertainty. We considered this also as a way to change the widely spread understanding about valuation uncertainty. Financial markets describe risk more clearly and openly and the players understand that there is risk and uncertainty to realize that valuations always include a level of uncertainty and only when it is substantial it needs to be taken into account even more.

Based on these articles we agree, that it is recommended normally to add qualitative disclosure of uncertainty as well as quantitative disclosure to valuation report. And if there are some abnormal uncertainties, it should be mentioned and the sources and effects of abnormal uncertainty included as detailed as they could.

As we proposed in the answer of question 4, asset uncertainty is also a form of uncertainty and qualitative disclosure should include explanation on uncertainty relating the asset properties. The disclosure should also present how the asset characteristics are formed to inputs and the uncertainty relating this process.

8. Para 47 suggests that model and input uncertainty may be more readily measureable for financial instruments than for other types of asset. Do you have experience of quantitative measures of valuation uncertainty for tangible or intangible assets being disclosed in reports? If so please indicate the types of asset and the techniques used to quantify the uncertainty.

Valuation and the especially the input data can be compared to market benchmarks if there is a reliable source for comparison data. This kind of benchmarking can reveal outliers or corrupted data from the input values.

We have experience on using the benchmarking in the real estate valuations. We used it to analyze input data while performing cash flow projections and analyzed sales comparables while using the sales comparable method.

9. Para 51 sets out proposed principles for quantitative measures of uncertainty. Do you agree with this list? If not please indicate any additional principles that you believe should be included or any listed that you believe are inappropriate.

Joslin (2005) describes clearly in his article that the uncertainty should be dealt in three ways either ignore it, express it verbally or verbally. There is a difference between Enever’s and Isaac’s (2002) definition from (Joslin, 2005) because if uncertainty and describing it cannot excluded from the valuation.

From the client point of view the qualitative description of uncertainty is important to understand the quantitative analysis and its results.

It is important to understand the uncertainty that is related to valuation, but the expose draft lefts it to the valuer to decide when the description of uncertainty needs to be included. As there can be acknowledged a normal uncertainty and “abnormal” uncertainty, should the proper analysis and explanation only be included when valuer finds it necessary.
10. It is proposed that the final TIP will include a few simple illustrative examples of uncertainty disclosures to assist readers understanding how the guidance may be applied in practice. The Board has decided not to develop these until it has received comments on the principles in this draft. The Annexe to this draft contains an indication of situations for which examples are being considered. Do you agree with the Board’s proposal to include illustrative examples of typical disclosures? If so, please indicate the situation for which you consider an example would be most useful.

Even though TIP’s purpose is not to include instructions on valuation or give examples for particular cases, in we would find it useful for the application of the TIP that it includes examples of disclosures. Including the illustrations is a good tool to implement similar processes and illustrations for assessing uncertainty, but it needs to be stated that the examples are only to be used as guidance not as a direct reference. From the TIP it needs to be clear that illustrations are only from a particular case and not to be used directly in another case.

It would be useful to include examples that have a combination of different type of uncertainties, for example identified both model and input uncertainty. This is because when more than one kind of uncertainty is present the overall uncertainty rises and can result in a greater range for the estimated value.