International Valuation Application 1
Valuation for Financial Reporting
(Adopted 2003)

IVSC

International Valuation Standards Committee

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1.0 Introduction

1.1 The objective of this Application is to explain the principles that apply to valuations prepared for use in financial statements and related accounts of business entities.

1.2 This Application addresses the criteria that Valuers must observe in preparing valuations for financial statements and related accounts. It also discusses concepts that are understood by accountants, regulatory authorities, and other users of valuation services. Valuers undertaking work of this nature are expected to have an understanding of accounting concepts and principles, which are outlined in Addendum A of this Application. For technical certainty Valuers must always refer to the relevant international or national Accounting Standards. The application of valuation bases to accounting principles is similar in both the public and private sector. The International Valuation Standards Committee (IVSC) will issue an Application addressing any variations necessary in respect of public sector assets and their treatment for financial reporting under the International Public Sector Accounting Standards (IPSASs).

1.3 The Valuer's adherence to market-based definitions, objectivity, and full disclosure of relevant matters within a pertinent and user-friendly format are fundamental to the requirements of valuation for financial reporting. When *specialised properties* preclude the sole use of *Market Value* concepts, this Application provides for proper treatment and disclosure in valuations.

2.0 Scope

2.1 This Application applies to all valuations of asset classes included in any financial statement, which fall within the skills and remit of Valuers.

2.2 International Valuation Standards facilitate cross-border transactions and the viability of global markets through harmonisation and transparency in financial reporting. As such this Application is developed in the context of International Accounting Standards. While there is strong momentum toward convergence of national and International Accounting Standards (IASs), some national standards are still at variance with IASs.

2.3 International Accounting Standards (IASs) adopt two models for the recognition of property assets in the balance sheet: a *cost* model, generally the benchmark treatment, and a *Fair Value* model, the latter being an allowed alternative treatment only in certain specified cases. Where the *Fair Value* model is applied, a current revaluation of the asset is required, and this Application focuses on these particular circumstances where *Market,* and sometimes *Non-Market,* values are to be reported.

2.4 Legislative, regulatory, accounting, or jurisprudence requirements may oblige modification of this Application in some countries or under certain conditions. Any departure due to such circumstances must be referred to and clearly explained in the Valuation Report.

3.0 Definitions

International Valuation Standards Definitions

3.1 *Market Value*. The estimated amount for which a property should exchange on the date of valuation between a willing buyer and willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion (IVS 1, para. 3.1).

3.2 *Depreciated Replacement Cost* (DRC). An acceptable method used in financial reporting to arrive at a surrogate for the *Market Value* of *specialised* and *limited market* properties, for which market evidence is unavailable. DRC is based on an estimate of the *Market Value for the Existing Use* (MVEU) of the land plus the current gross replacement (or reproduction) costs of improvements less allowances for physical deterioration and all relevant forms of obsolescence and optimisation (para 3.8 IVS 2, Valuation Bases Other Than Market Value).

Note: In order to remain consistent with IAS 16, modification of this definition is required. An exposure draft of the proposed new definition will be released as soon as possible.

3.3 *Improvements*. Buildings, structures or modifications to the land, of a permanent nature, involving expenditures of labour and capital, and intended to enhance the value or utility of the property. Improvements have differing patterns of use and economic lives.

3.4 *Specialised Trading Property*. Property with trading potential, such as hotels; gas, or petrol, stations; restaurants; or the like, the *Market Value* of which may include assets other than land and buildings alone. These properties are commonly sold in the market as an operating package that may make separate identification of the value of the land, building, personal property, intangible assets, and business itself difficult or impossible (Property Types, para. 4.3.2).

3.5 *Specialised Property*. A property that is rarely if ever sold in the open market, except by way of sale of the business of which it is a part (called the business in occupation) due to its uniqueness arising from the specialised nature and design of the building(s), its configuration, size, location, or otherwise.

International Accounting Standards Definitions

3.6 *Fair Value*. The amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's-length transaction (IAS 16, para. 6).

3.7 *Depreciable Amount*. The cost of an asset, or other amount substituted for cost in the financial statements, less its residual value (IAS 16, para. 6).

3.8 *Residual Value*. The net amount which an entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal (IAS 16, para. 6).

3.9 *Owner-Occupied Property*. Property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes (IAS 40, para. 4).

3.10 *Investment Property*. Property (land or building, or part of a building, or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation, or both, rather than for

a) use in the production or supply of goods or services or for administrative purposes, or

b) sale in the ordinary course of business (IAS 40, para. 4).

Note: In its Exposure Draft of Proposed Improvements to International Accounting Standards (issued May 2002) the IASB proposed an amendment to this definition. The words "(by the owner or by the lessee under a finance lease)" will be deleted altogether. Additional wording will be introduced to enable property held under an operating lease to be classified as *investment property* and accounted for as if it were a finance lease subject to meeting strict criteria. (See para. 6.3.5 below.) The revised IAS 40 will be effective for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application (after publication of the revised Standard programmed for second quarter 2003) is encouraged.

3.11 *Current Assets*

An asset that

a) is expected to be realised in, or is held for sale or consumption in, the normal course of the entity's operating cycle; or

b) is held primarily for trading purposes or for the short-term and expected to be realised within twelve months of the balance sheet date; or

c) is cash or a cash equivalent asset which is not restricted in its use (IAS 1, para. 57).

All other assets should be classified as *non-current assets*.

3.12 *Carrying Amount*. The amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon (IAS 16, para. 6; IAS 36, para. 5).

3.13 *Depreciation*. The systematic allocation of the depreciable amount of an asset over its useful life (IAS 16, para. 6; IAS 36, para. 5).

3.14 *Net Selling Price*. The amount obtainable from the sale of an asset in an arm's-length transaction between knowledgeable, willing parties, less the costs of disposal (IAS 36, para. 5). The IASB has decided to amend the above definition of *net selling price* to "fair value less cost to sell".

3.15 *Net Realisable Value*. The estimated selling price in the ordinary course of business, less selling costs of completion and the estimated costs necessary to make the sale (IAS 2). *Net realisable value* is used only within the context of IAS 2, Inventories, for properties held for disposal. In those circumstances, that figure would equate to *Market Value* less selling costs where all requirements of the *Market Value* definition are met. The term is equivalent in meaning to *net selling price*.

3.16 *Recoverable Amount*. The higher of an asset's net selling price and its value in use (IAS 36, 5O).

3.17 *Revalued amount*. *Fair value* at the date of the revaluation less any subsequent accumulated *depreciation* and subsequent accumulated *impairment* losses.

3.18 *Property, Plant and Equipment*. Tangible assets that

a) are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

b) are expected to be used during more than one period (IAS 16, 6).

3.19 *Value in Use*. The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life (IAS 36, para. 5).

3.20 *Useful Life*. Either

a) the period over which a depreciable asset is expected to be used by an entity; or

b) the number of production or similar units expected to be obtained from the asset by the entity (IAS 16, para. 6; IAS 17, para. 3; IAS 36, para. 5).

3.21 *Impairment*. When recoverable amount declines below carrying amount (IAS 36, para. 5).

4.0 Relationship to Accounting Standards

4.1 This Application is to be used in conjunction with IVS 1, IVS 2, and IVS 3 and in the context of International Accounting Standards (IASs), published by the International Accounting Standards Board (IASB).

4.2 Asset valuations are currently an option under IAS 16, Property Plant and Equipment; and IAS 38, Intangible Assets (alternative measurement basis); IAS 40, Investment Property (*fair value* model although even if the *cost* model is chosen, the *fair value* should be disclosed); and IAS 20, Government Grants (grant of non-monetary assets).

Asset valuations are also currently required under IAS 22, Business Combinations (initial measurement of acquired identifiable assets); IAS 19, Employee Benefits (assets held by a long-term employee benefit fund); IAS 36, Impairment of Assets *(net selling price);* and IAS 41 Agriculture. These references are not necessarily exhaustive.

5.0 Application

To perform valuations that comply with this Application and Generally Accepted Valuation Principles (GAVP), it is mandatory that Valuers adhere to all sections of the IVS Code of Conduct pertaining to Ethics, Competence, Disclosure, and Reporting (sections 4, 5, 6, and 7)

5.1 ***Classification of Assets*. Valuers shall request from the directors of the owning entity a list of assets to be valued, designating them as operational assets, i.e., assets requisite to the operations of the entity, or non-operational assets, being properties held for future development, investment, or assets surplus to the operations of the entity.**

5.2 ***Basis of Value*. Assets valued for financial reporting shall be valued as follows, unless the circumstances and extent of proper disclosures so warrant:**

5.2.1 **All *non-specialised properties,* including *specialised trading properties,* shall be valued on the basis of *Market Value* in accordance with IVS 1.**

5.2.2 ***Specialised properties* shall be valued using DRC in accordance with IVS 2.**

5.3 ***Allocation of Value*. As required under IAS 16, Valuers shall apportion the reported values, allocating value separately to the land element, on the basis of *Market Value at its highest and best use,* and to the *improvements*.** Valuers may be further required to advise on appropriate useful lives for the *improvements* over which they should be depreciated.

5.4 ***Componentisation of Improvements*. When required, value shall be apportioned to each material component of an asset according to its useful life or pattern of use.**

5.4.1 ***Residual Value*. Where requested, the Valuer shall provide an estimate of the residual value of the asset(s) so the depreciable amount may be accurately determined.**

5.4.2 ***Useful Life*. Where requested, the Valuer shall provide an estimate of the remaining useful life of the asset(s).**

5.5 **The valuation conclusion shall be reported in accordance with IVS 3, Valuation Reporting.**

5.6 **Valuers shall ensure that reports include sufficient information to meet all the following requirements of the IAS when preparing financial statements:**

5.6.1 **IAS 16 (revised 1998), paragraph 64, requires, amongst others, the following disclosures.**

When items of property, plant and equipment are stated at revalued amounts the following shall be disclosed:

a) **the basis used to revalue the assets;**

b) **the effective date of the revaluation;**

c) **whether an independent Valuer was involved (Note, IVS interprets this as *External Valuer*);**

In its Exposure Draft of Proposed Improvements to International Accounting Standards (issued May 2002) the IASB proposed an amendment to IAS 16 to require additional disclosure of the following:

d) **the methods and significant assumptions applied in estimating the assets' *fair values*; and**

e) **the extent to which the assets' *fair values* were determined directly by reference to observable prices in an active market or recent market transactions on arm's-**

length terms or were estimated using some other valuation techniques.

The revised IAS 16 will be effective for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application (after publication of the revised Standard programmed for second quarter 2003) is encouraged.

5.6.2 **IAS 40, paragraph 66, requires amongst others the following disclosures**

b) the methods and significant assumptions applied in determining the *fair value* of *investment property,* including a statement whether the determination of *fair value* was supported by market evidence or was more heavily based on other factors (which the entity should disclose) because of the nature of the property and lack of comparable market data; and

c) the extent to which the fair value of *investment property* (as measured or disclosed in the financial statements) is based on a valuation by an independent (IVS interprets this as *External*) valuer who holds a recognised and relevant professional qualification and who has recent experience in the location and category of the investment property being valued.

5.7 ***Liaison with Auditors*. At the client's request and subject to appropriate consent, Valuers shall discuss and explain their valuations openly with the entity's auditors.**

6.0 Discussion

6.1 *Market Value* and *Fair Value*. Although sometimes used interchangeably between Accountants and Valuers informally seeking common ground, the expressions *Market Value* and *Fair Value* are not necessarily always synonymous. (See Addendum A, paragraph A6.4.)

6.1.1 *Fair Value* under IAS 16, is usually *Market Value* but in an 'inactive market' might be considered as a broader definition than that of *Market Value* within the IVS, and would include non-market related methods including *depreciated replacement cost*.

6.1.2 IAS 40 paragraph 29 recognises that *Fair Value* for *investment property* is usually the same as its *Market Value*. Paragraphs 27 to 46 of IAS 40 provide a detailed consideration of the *Fair Value* model in the context of *investment property*.

6.2 IAS 16, *Property, Plant and Equipment*

6.2.1 IAS 16 essentially covers property occupied or used by the owner.

6.2.2 IAS 16 provides for benchmark treatment of assets in paragraph 28 as follows:

"Subsequent to initial recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses."

6.2.3 The allowed alternative treatment, which requires regular revaluations, is contained in paragraph 29 as follows:

"Subsequent to initial recognition as an asset, an item of property, plant and equipment should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date."

6.2.4 *Identification of Property Class*. Under IAS 16, paragraph 60, property is required to be identified according to class. The purpose of this identification is to assist the preparers of financial statements in complying with the requirements of IAS 16, paragraph 60 (Disclosure), which states in part:

"The financial statement should disclose for each class of property, plant and equipment: a) the measurement bases used for determining the gross carrying amount. When more than one basis has been used, the gross carrying amount for that basis in each category should be disclosed."

When an item is revalued, the entire class to which it belongs should be revalued in order to avoid both selective revaluations and the reporting of a mix of costs and fair values as at different dates. A class of asset for this purpose is a grouping of assets of a similar nature and use in an entity's operations.

6.2.5 *Owner-occupied Properties*. The Valuer may be required for statutory or other valid reasons to assume either:

6.2.5.1 Vacant possession, which assumes a property has no current occupants. The valuation report or certificate should refer to the value derived from market evidence of vacant possession sales of comparable properties. This approach reflects the replacement of the asset at its lowest cost; or

6.2.5.2 Occupation of the property, which reflects the continuing benefit of the asset to the business. In some jurisdictions, a notional lease is assumed and the cash flows capitalised to arrive at the *fair value* figure.

6.2.5.3 The above approaches will produce differing valuation conclusions, and IVSC has sought clarification from the IASB as to which approach should be applied.

6.2.5.4 *Inter-company Leases*. Property occupied by a subsidiary company under an inter-company leasing arrangement within a group may be valued at *Market Value* having regard to those arrangements for the purposes of financial reporting within subsidiary companies. However, at group consolidation level, it should be valued as owner-occupied.

Paragraph 14 of IAS 40, Investment Property, offers the following explanation:

"In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary. The property does not qualify as investment property in consolidated financial statements that include both entities, because the property is owner-occupied from the perspective of the group as a whole. However, from the perspective of the individual entity that owns it, the property is investment property if it meets the definition in paragraph 4. Therefore, the lessor treats the property as investment property in its individual financial statements."

6.2.5.5 The split between *owner-occupied property* and *investment property* is not well defined within the International Accounting Standards, and classification is inconsistent between States. Addendum C to IVA 1 is a "decision tree" to assist in determining what constitutes an *investment property*. (See also Addendum A, para. A6.2.4.2.)

IAS 40 offers the following explanation as to what constitutes *investment property*.

"If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods and services or for administrative purposes" (IAS 40, para. 8).

"Judgement is needed to determine whether a property qualifies as investment property. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definitions of investment property and with the related guidance in paragraphs 5 to 11. Paragraph 66(a) requires an entity to disclose these criteria when classification is difficult" (IAS 40, para. 12).

IVSC considers that if an owner-occupier occupies less than 20% of the property and the remainder is let for rent, then the property should be regarded as *investment property*.

6.2.6 *Specialised Property*. IAS 16 does not provide direction in the assessment of *fair value* when there is no reliable market data. Under these circumstances, non-market assessment of *specialised property* by reference to DRC, as explained in IVS 2, requires an appropriate disclosure in the Valuer's Certificate or Valuation Report. For discussion of DRC, see Guidance Note (GN) 8.

6.2.7 *Componentisation*. In its Exposure Draft of Proposed Improvements to International Accounting Standards (issued May 2002) the IASB proposed an amendment to IAS 16 which lays greater emphasis on the allocation of asset value to components of an asset with different useful lives. This places a greater obligation on Valuers to produce such information if required. The revised IAS 16 will be effective for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application (after publication of the revised Standard programmed for second quarter 2003) is encouraged.

6.2.8 *Frequency of Revaluation*

Paragraph 32 of IAS 16 states:

"The frequency of revaluations depends upon the movements in the fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. Some items of property, plant and equipment may experience significant and volatile movements in fair value thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant movements in fair value. Instead, revaluation every three or five years may be sufficient."

6.3 IAS 40, *Investment Property*

6.3.1 *Investment property* is selected for individual treatment under IAS 40. The Standard permits entities to choose either of the following accounting models:

a) *A Fair Value Model*. *Investment property* should be measured at *fair value* and changes recognised in the income statement; or

b) *A Cost Model*. The "historic" cost model is the benchmark treatment in IAS 16. An entity that chooses the (historic) cost model should nonetheless disclose the *fair value* of its investment property.

6.3.2 Addendum B of this document reproduces Appendix A to IAS 40, which is a "decision tree" summarising how an entity determines whether it applies IAS 40, Investment Property; IAS 16, Property, Plant and Equipment; or IAS 2, Inventories.

6.3.4 *Transaction Costs*. The *fair value* of *investment property* is not reduced by transaction costs that may be incurred upon the sale. This prescription is in keeping with the use of *Market Value* as the appropriate basis of recognition as opposed to *net selling price*.

6.3.5 *Leasehold Properties*. At present IAS 40 does not permit a lessee to treat its interest in property held under an operating lease as *investment property,* even if the lessee acquired its interest in exchange for a large up-front payment or the lease has a very long term. IAS categorises all leases as either *operating* or *finance leases,* and IAS 17, Leases, deals with the accounting of these assets. (See Addendum A, paragraph A6.2.2.)

In its Exposure Draft of Proposed Improvements to International Accounting Standards (issued May 2002) the IASB proposed that the definition of *investment property* be amended to permit a property interest held by a lessee under an operating lease to qualify as *investment property* provided that

a) the rest of the definition of *investment property* is met; and

b) the lessee uses the *fair value* model set out in IAS 40, paragraphs 27-49.

Further, a lessee that classifies a property interest held under an operating lease as *investment property* is required to account for the lease as if it were a finance lease. The revised IAS 40 will be effective for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application (after publication of the revised Standard programmed for second quarter 2003) is encouraged.

6.3.6 *External Valuations*. Entities are encouraged, but not required, to determine the *fair value of investment property* on the basis of a valuation by an independent (External) Valuer who holds a recognised and relevant professional qualification and who has recent experience in the location and category of the *investment property* being valued (IAS 40, para. 26).

6.4 Other Requirements under International Accounting Standards

6.4.1 *Portfolios*. A collection or aggregation of properties held by a single ownership and jointly managed is referred to as a *portfolio*.

6.4.1.1 The *Market Value* of such assets viewed or treated as a portfolio or as an assembled group of properties could exceed or could be less than the sum of the *Market Value* of each asset individually. Where this is the case, it should be reported separately to the directors or trustees.

6.4.1.2 In reporting the assets in a portfolio, the aggregate of properties valued at *Market Value* shall be identified and separated from those valued at DRC to meet disclosure requirements and to avoid any potential confusion.

6.4.2 *Financial Interests*. These are described in section 5 of IVS Property Types. By their very nature such interests are diverse and, particularly in the case of interests in *real property,* usually unique. The basis upon which a financial interest may be valued is determined by the Accounting Standard under which it is to be recognised or disclosed (Addendum A, para. A6.7). Valuers should therefore consult with management and auditors on the manner in which the financial interest is to be presented.

6.4.3 *Business Valuations*. Valuations of entire businesses, as described in GN 6, Business Valuation, are not recognised as such under International Accounting Standards. Business valuations and components thereof may be used as a basis for making allocations of various assets, particularly financial interests as described in paragraph 6.4.2 above, in the preparation of financial statements.

6.4.4 *Properties Held for Sale in the Ordinary Course of Business*. Valuations of properties held for sale in the ordinary course of business should comply with the requirements of IAS 2, Inventories. These properties are measured at *net realisable value,* which would be *Market Value* less the costs of sale.

6.4.5 *Impairment*. An entity is required, under IAS 36, Impairment of Assets, to review, at each balance sheet date, whether there is any indication that an asset may be impaired. The *impairment* review examines whether the *recoverable amount* has declined below the *carrying amount* (which may have been based on cost or a [past] valuation then adjusted for depreciation or earlier impairment). Establishment of *recoverable amount* entails the identification of the higher of *net selling price* (*Market Value* less costs of sale), in which the Valuer will have a role, and *value in use,* the prerogative of directors. (Also see IVA 1 Addendum A, para. A6.3.4.1.)

6.4.6 *Disrupted Markets*. When markets are disrupted or suspended, Valuers must be vigilant in their analyses as explained in IVS 1, paragraph 6.5. Under IAS 29, Financial Reporting in

Hyperinflationary Economies, Valuers may be required to assess balance sheet value.

6.5.7 *Agriculture*. Depending on which Standard is appropriate in the circumstances, valuations of agricultural assets should comply with the requirements of IAS 16, Property, Plant and Equipment; IAS 40, Investment Property; or IAS 41, Agriculture. IVS GN 11, Valuation of Agricultural Properties, takes up these IASB Standards.

7.0 Disclosure Requirements

7.1 **The Valuer shall make all disclosures required under IVS 3, Valuation Reporting.**

7.2 **For disclosures required under International Accounting Standards, see paragraphs 5.6.1 and 5.6.2 above.**

7.3 **The Valuer shall disclose the regulatory framework and any departure required from these Standards to comply with local legislation, regulation (including accounting rules), or custom.**

8.0 Departure Provisions

8.1 **In following this Application any departures must be in accordance with directions made in IVS 3, Valuation Reporting.**

9.0 Effective Date

9.1 This International Valuation Application becomes effective 30 April 2003.