Guidance Notes

International Valuation Standards Committee

International Valuation Guidance Note No. 1

Real Property Valuation (Revised 2003)

1.0 Introduction

1.1 The International Valuation Standards Committee's (IVSC) General Valuation Concepts and Principles set forth terms and concepts that are fundamental to all valuations. The purpose of Guidance Note No. 1 (GN 1) is to amplify those fundamentals so they may be better understood in valuations of real property.

1.2 *Real property* constitutes a substantial portion of the world's wealth. If the operations of property markets are to be established on dependable valuations, there must be generally agreed upon Standards by which *Market Value* and other value types are determined and reported by Valuers. Correct understanding and proper application of these Standards will inevitably promote the viability of international and domestic transactions in real property, improve the relative position of real property among other investment alternatives, and reduce the instances of fraud and abuse.

1.3 The term *property* in a legal sense may be defined as ownership rather than the physical entity of land, buildings, and tangible personal items. In this context, the IVSC identifies four general property types:

1.3.1 Real Property (GN 1)

1.3.2 Personal Property (GNs 3, 4, and 5)

1.3.3 Businesses (GN 6)

1.3.4 Financial Interests

1.4 As with other property types, there are commonly agreed upon and generally accepted methods for valuing real property. It is important to the Valuer and the users of valuation services that proper methods be thoroughly understood, competently applied, and satisfactorily explained. By meeting this objective, Valuers contribute to the soundness and reliability of *Market Value* estimates and, thereby, the well-being of the markets in which they practice.

1.5 Promotion of understanding and avoidance of abuses in the market require that the Valuer and user of valuation services carefully distinguish between the types of property. Failure to do so can result in improper or ill-advised market decisions and misrepresentations of reported values. Over- or under-reporting of value is a common result where property types are confused or mixed. The same is true when terminology is indistinct or inadequate.

1.6 Real Property Valuers recognise the complexities of markets and the real estate bought and sold therein. Differences in real estate markets and between individual properties are reflected accurately and reliably where Generally Accepted Valuation Principles (GAVP) are followed.

1.7 In all IVSC Member States, it is recognized that the valuation of real property requires special education, training, and experience. Just as the emergence of professional valuation societies at the national level attests to a market need for competent and highly ethical Valuers within each country, the globalisation of property markets and the establishment of IVSC reflect the market need for Valuers to adopt consistent methods throughout the world. GN 1, Real Property Valuation, provides an international framework for the application of generally accepted methods used for real property valuation.

1.8 The relationship between GN 6, pertaining to business valuation, and GN 1, pertaining to real property valuation, must be clearly understood. Real property is valued as a distinct "entity", i.e., as physical assets to which particular ownership rights apply. For example, an office building, a residence, a factory, or other property types generally incorporate an underlying land component. Business valuation, however, values a business entity of which real property may be a component. The *Market Value* of real property is always valued in accordance with International Valuation Standard 1 (IVS 1). When a real property value estimate is incorporated as an element of a business valuation, it is a *Market Value* estimate of the real property. As discussed in GN 1, this convention is distinct from the unacceptable practice of purportedly developing a *Market Value* estimate for real property as an allocation of the value of a going concern.

1.9 Although the Guidance contained in GN 1 does not necessarily parallel the specific practice of all States, it presents a systematic approach that reflects Generally Accepted Valuation Principles (GAVP). It is important that Valuers and users of valuation services be aware of the International Valuation Standards (IVS).

1.10 It is not the objective of GN 1 to provide specific Guidance as to how a given valuation should be performed or to supercede the qualifications for and procedures applied by Valuers. These are addressed within the training programs of each State. It is the IVSC's intent to establish a framework and requirements for real property valuation that will serve to harmonise worldwide valuation practices.

2.0 Scope

2.1 This GN is provided to assist in the course of rendering or using real property valuations.

2.2 Principal elements of GN 1 include

2.2.1 an identification of key terms and definitions;

2.2.2 a summary of the Valuation Process and its rationale;

2.2.3 an elaboration on the importance of principles and concepts;

2.2.4 a discussion of proper disclosure and reporting requirements;

2.2.5 examples of abuses and misunderstandings; and

2.2.6 a presentation of real property Guidance.

2.3 The specific application of quantitative and qualitative valuation procedures is beyond the scope of GN 1. It is important to stress, however, that Valuers are trained in such procedures, and that the procedures are included in generally accepted practices. In application, Valuers commonly apply several procedures in each valuation and then reconcile the results into a final indication of *Market Value* or other specified value.

3.0 Definitions

3.1 General Valuation Concepts and Principles defines the concepts of *land* and *property; real estate, property,* and *asset; price, cost,* and *value; Market Value, highest and best use,* and *utility*. The Glossary of Terms further defines many of the concepts and technical terms used throughout the Standards and Guidance Notes. The following definitions are specific to GN 1 and are included here for reader convenience.

3.2 *Comparable Data*. Data generally used in a valuation analysis to develop value estimates. *Comparable Data* relate to properties that have characteristics similar to those of the property being valued (the subject property). Such data include sale prices, rents, income and expenses, and market-derived capitalisation and yield/discount rates.

3.3 *Elements of Comparison*. Specific characteristics of properties and transactions that cause the prices paid for real estate to vary. *Elements of comparison* include, but are not limited to, the following: property rights conveyed, financing terms, conditions of sale, market conditions, location, and physical and economic characteristics. (See para. 5.22 of this document for a full presentation of *Elements of Comparison*.)

3.4 *Highest and Best Use*. The most probable use of a property which is physically possible, appropriately justified, legally permissible, financially feasible, and which results in the highest value of the property being valued. (See General Valuation Concepts and Principles, section 6.)

3.5 A *Market*. The environment in which commodities, goods, and services trade between buyers and sellers through a price mechanism.

3.6 *Market Value*. Definitions are included in General Valuation Concepts and Principles and International Valuation Standard 1, section 3.

3.7 *Property Rights*. The rights that are related to the ownership of real estate. These include the right to develop or not develop the land, to lease it to others, to farm it, to mine it, to alter its topography, to subdivide it, to assemble it, and to use it for waste disposal. The combination of these property rights is sometimes referred to as the *bundle of rights* inherent in the ownership of real estate. *Property rights* are typically subject to public or private restrictions such as easements, rights of way, specified development density, zoning, and other restrictions that may encumber the property.

3.8 *Real Estate*. Land and all things that are a natural part of the land, e.g., trees and minerals, as well as all things that are attached by people, e.g., buildings and site improvements. All permanent building attachments such as plumbing, heating and cooling systems; electrical wiring; and built-in items like elevators, or lifts, are also part of the *real estate*. *Real estate* includes all attachments, both below and above the ground. (See also General Valuation Concepts and Principles as well as the Glossary of Terms.)

3.9 *Real Property.* All the rights, interests, and benefits related to the ownership of *Real estate*. *Real property* is a legal concept distinct from *real estate,* which is a physical asset. There may also be potential limitations upon ownership rights to real property. (See Property Types, para. 2.2.1 and 2.2.4.)

3.10 *Units of Comparison*. Typically use two components to develop a factor (e.g., the price per measurement unit or a ratio such as that produced by dividing a property's sale price by its net income, i.e., net income multiplier, or years' purchase) that reflects differences between properties and facilitates analysis in the three approaches to value.

3.11 The *Cost Approach*. One of the approaches to value commonly applied in *Market Value* estimates and many other valuation situations. *Depreciated Replacement Cost* (DRC) is considered an acceptable method for deriving a surrogate for the *Market Value* of limited market, or specialised, properties where relevant data are scarce or non-existent.

4.0 Relationship to Accounting Standards

4.1 For a general discussion of the accounting requirements for real property valuations, the utility of *Market Value* in promoting the objectivity and comparability of real property valuations, and the importance of the continued independence of Accounting and Valuation Standards, see IVA 1.

5.0 Guidance

5.1 Value, in its broadest sense, is defined as the relationship between something owned and an individual or individuals who wish(es) to own it. To distinguish between the broad subjective relationships that may occur among people, Valuers must identify a particular type of value as the basis of any valuation. ***Market Value* is the most common value type, but *Non-Market Values* also exist.** (See Introduction to Standards 1, 2, and 3; and IVS 1 and 2.)

5.1.1 *Market Value* has evolved in concept and definition under the influence of market forces and in response to various principles of real estate economics. **By applying a definition of value such as *Market Value* in valuations, Valuers and the users of their services are afforded an objective plan of analysis.**

5.1.2 **When *Market Value* is the purpose of a valuation, the Valuer shall apply definitions, processes, and methods consistent with IVS 1.**

5.2 **Where a type of value other than *Market Value* is the purpose of a valuation, the Valuer shall apply the appropriate definition of value and shall follow IVS 2 and applicable GNs. It is the responsibility of the Valuer to avoid potential misunderstandings or misapplications of the valuation estimate in situations where a value other than *Market Value* is the purpose of the assignment.** Proper disclosures, identification and definition of terms, and stated limitations on the applicability of the valuation and the Valuation Report normally ensure compliance.

5.3 GN Figure 1-1 illustrates the Valuation Process as it is applied in many States. The process reflects Generally Accepted Valuation Principles (GAVP) and is approximated in virtually all States, whether or not the particular steps are explicitly followed. The principles from which this process derives are common to all States. Although the process may be used for either *Market Value* or *Non-Market Value* applications, *Market Value* applications require the development of valuations solely on the basis of market data.

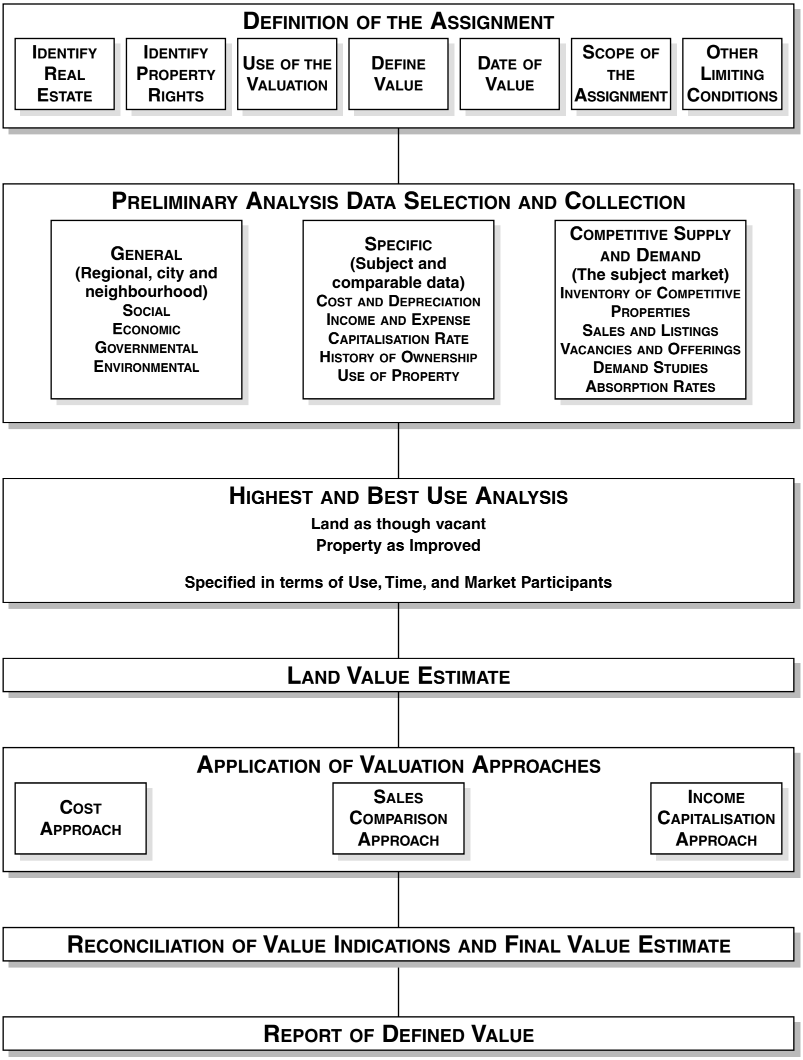
5.4 **A valuation must be distinguished from a Valuation Report. Valuation includes all of the research, data, reasoning, analysis, and conclusions necessary to arrive at a value estimate. A Valuation Report communicates those processes and conclusions. Although requirements differ among States, it is a requisite under these Standards that adequate records be kept to demonstrate that a Valuation Process was followed and that the conclusions are credible and reliable. These records must be available in case reasonable enquiry is subsequently made.** (See IVS Code of Conduct, para. 5.3.5 and 5.3.6.) In practice, some forms of reporting may incompletely represent the entire basis for the valuation. **If the report is in any way limited, the Valuer will generally identify and distinguish between the scope of the valuation and that of the Valuation Report.**

5.5 **It is appropriate and customary that a *client's instruction* (para. 5.6) be stated in writing in a *letter* or *contract for services*.** In *Market Value* situations it is also common for the independence, or external status, of the Valuer to be established in an affirmative statement. The agreement also sets forth the business relationship between the Valuer and the client, fee and payment terms, special directives and limitations, an identification of the Standards to be applied, and other pertinent matters.

5.6 As GN Figure 1-1 indicates, **a Valuer and the valuation client must agree on the context and scope of the valuation. The *definition of the assignment* includes**

5.6.1 **an identification of the real estate involved in the valuation;**

Guidance Note Figure 1-1
The Valuation Process



5.6.2 **an identification of the property rights to be valued;**

5.6.3 **the intended use of the valuation, and any related limitations;**

5.6.4 **the identification of any subcontractors or agents and their contribution;**

5.6.5 **a definition of or the basis of the value sought;**

5.6.6 **the date as of which the value estimate will apply; and the date of the intended report;**

5.6.7 **an identification of the scope/extent of the valuation and of the report;** and

5.6.8 **an identification of any contingent and limiting conditions upon which the valuation is based.**

5.7 **In performing the steps of a *preliminary analysis,* and *data selection and collection,* suggested in the Valuation Process, the Valuer becomes familiar with the general market and subject property, thereby proceeding to a position from which more specific analyses can be made.**

5.7.1 ***General economic data*** are collected at the neighbourhood, city, regional, and even national and international levels, depending on the property involved. Social, economic, governmental, and environmental factors that may have bearing on *Market Value* (or other defined value type) are examined to better understand the particular property. Any other specific forces that must be considered are investigated in detail.

5.7.2 ***Property-specific data,*** or data more directly relevant to the property being valued and to comparable properties, are also gathered and examined. These include site and improvement data, cost and depreciation data, income and expense data, capitalisation and yield rate data, ownership and utilisation histories, and other information determined to be significant and generally considered by buyers and sellers in their negotiations and transactions.

5.7.3 ***Supply and demand data*** characteristic of the most probable market for the property are analysed to develop an inventory of properties that compete with the subject property for market share as well as an inventory of existing properties to be adapted or new properties to be built, which will increase the competitive supply. Markets are analysed to determine market trends, relationships between supply and demand, absorption rates, and other market-specific information.

5.8 Once the above data are gathered and analysed, the Valuer will be able to determine possible land uses for the subject property. Because different real estate parcels may have different use potentials, **the first requisite step toward selecting sales and other comparable data is to determine the *highest and best use* (HABU) of the subject property. The Valuer considers both the *highest and best use of the land as though vacant* and the *highest and best use of the property as improved.*** (See the discussion of HABU in General Valuation Concepts and Principles, para. 6.0 et seq.)

5.8.1 **The concept of HABU** is based on the notion that although two or more parcels of real estate may have physical similarities and closely resemble one another, there may be significant differences in how they can be used. How a property can be optimally utilised is a foundation for determining its *Market Value*.

5.8.2 **Basic determinants of HABU** include the answers to the following questions:

- Is the suggested use a reasonable and likely one?
- Is the use legal, or is there a reasonable likelihood that a legal entitlement for the use can be obtained?
- Is the property physically suited to the use or can it be adapted to the use?
- Is the suggested use financially feasible? And
- Of those uses that meet the first four tests, is the selected HABU the most productive use of the land?

5.9 **Several methods are used for land valuation.** Their applicability differs according to the type of value estimated and availability of data. **For *Market Value* estimates, any method chosen must be supported by market data.** (See para. 5.25 et seq.)

5.10 In many, but not all, States **three *valuation approaches* are recognised in the Valuation Process: *cost, sales,* and *income capitalisation.*** While a well-evidenced market may make the *cost approach* less relevant, a lack of comparable data may cause the *cost approach* to be predominant. The laws of some States preclude or limit the application of one or more of the three approaches. Unless there are such restrictions, or unless there are other compelling reasons for a particular omission, **it is reasonable for the Valuer to consider each approach.** In some States, the use of each approach is mandated unless the Valuer can demonstrate a lack of supporting data or other valid reason for omission of a particular approach. **Each approach is based, in part, on the Principle of Substitution,** which holds that when several similar or commensurate commodities, goods, or services are available, the one with the lowest price attracts the greatest demand and widest distribution. In simple terms, the price of a property established by a given market is limited by the prices commonly paid for properties that compete with it for market share, the financial alternatives of investing money elsewhere, and the cost of building a new property or adapting an old property to a use similar to that of the subject property (property being valued).

5.11 **The *cost approach,*** also known as the contractor's method, is recognised in most States. In any application, **the *cost approach* establishes value by estimating the costs of acquiring land and building a new property with equal utility or adapting an old property to the same use with no undue expense resulting from delay.** The cost of land is added to the total cost of construction. (Where applicable, an estimate of entrepreneurial incentive, or developer's profit/loss, is commonly added to construction costs.) The *cost approach* establishes the upper limit of what the market would normally pay for a given property when it is new. **For an older property, some allowance for various forms of accrued depreciation (physical deterioration; functional, or technical, obsolescence; and economic, or external, obsolescence) is deducted to estimate**

a price that approximates *Market Value*. Depending upon the extent of market data available for the calculations, the cost approach may produce a direct indication of *Market Value*. The *cost approach* is very useful in estimating the *Market Value* of proposed construction, special-purpose properties, and other properties that are not frequently exchanged in the market.

5.11.1 ***Depreciated Replacement Cost* (DRC) is considered an acceptable method for deriving a surrogate for the *Market Value* of limited market and specialised properties where relevant data are scarce or non-existent. DRC may be used for financial reporting when *Market Value* cannot be determined.** (See GN 8, DRC.)

5.12 **The *sales comparison approach*** recognizes that property prices are determined by the market. ***Market Value* can, therefore, be calculated from a study of market prices for properties that compete with one another for market share.** The comparative processes applied are fundamental to the Valuation Process.

5.12.1 **When data are available, the *sales comparison approach* is the most direct and systematic approach to estimating value.**

5.12.2 When data are insufficient, the applicability of the *sales comparison approach* may be limited. Insufficient research by the Valuer, however, is not an excuse for omission of this approach where data are available or could reasonably be developed. (See Section 6.7 et seq. for discussion of market research, data verification, adjustment procedure, and reconciliation of indications.)

5.12.3 **After sales data are gathered and verified, one or more *units of comparison* are selected and analysed.** Units of comparison use two components to produce a factor (e.g., the price per measurement unit or a ratio such as that produced by dividing a property's sale price by its net income, i.e., net income multiplier, or years' purchase) that reflects precise differences between properties. The units of comparison that buyers and sellers in a given market use in making their purchase and sale decisions take on special relevance and may be afforded greater weight.

5.12.4 ***Elements of comparison*** **are the specific characteristics of properties and transactions that cause the prices paid for real estate to vary.** They are crucial considerations in the *sales comparison approach*.

5.12.5 **To make direct comparisons between a comparable sale property and the subject property, a Valuer shall consider possible adjustments based on differences in the elements of comparison.** Adjustments can narrow the differences between each comparable and the subject. **Valuers apply quantitative and/or qualitative methods to analyse differences and estimate adjustments.**

5.13 **The *income capitalisation approach* can be applied in both *Market Value* assignments and other types of valuations. However, for *Market Value* applications, it is necessary to develop and analyse relevant market information.** This focus differs distinctly from the development of subjective information for a specific owner or the reflection or viewpoint of a particular analyst or investor.

5.13.1 **The *income capitalisation approach*** is based on the same principles that apply to other valuation approaches. In particular, it perceives value as created by the expectation of future benefits (income streams). *Income capitalisation* employs processes that consider the present value of anticipated future income benefits.

5.13.2 As with other approaches, **the *income capitalisation approach* can be used reliably only when relevant comparative data are available.** When such information is not available, the approach may be used for general analysis but not for the purpose of direct market comparison. **The *income capitalisation approach* is particularly important for properties that are purchased and sold on the basis of their earnings capabilities and characteristics and in sit-**

uations where there is market evidence to support the various elements incorporated into the analysis. Nonetheless, the mathematical precision of the procedures used in the approach must not be mistaken as an indication of the precise accuracy of the results.

5.13.3 **Market research** is important to the *income capitalisation approach* in a number of ways. In addition to **providing specific data that will be processed, market research also furnishes qualitative information to determine comparability and to assist in weighing the applicability of the results of the analysis.** Thus, the approach is not merely quantitative, or mathematical, but requires qualitative assessments as well.

5.13.4 Once appropriate market research is completed and comparable data are collected and verified, **Valuers analyse the income and expense statement provided for the subject property. This step involves a study of the historical incomes and expenses of the property under consideration and of other competing properties for which data are available.** Subsequently, **a cash flow (based upon a *reconstructed operating statement*) is developed that reflects market expectations, eliminates the special experiences of a particular owner, and provides a format that assists further analysis.** The purpose of this step is to estimate the income that can be earned by the property, which will be capitalised into an indication of value. **This estimate may reflect income and expenses for only a single year or a series of years.** (See also para. 6.12.)

5.13.5 Following the development of a cash flow (based on a *reconstructed operating statement*), the Valuer must choose a means of capitalisation. ***Direct capitalisation* applies an *overall rate,* or *all risks yield,* which, when divided into a single year's or stabilized net operating income, produces a value indication.** *Direct capitalisation* is used in particularly well-evidenced markets. ***Yield capitalisation* considers the time value of money, and is applied to a series of net operating incomes for a period of years. A method called**

***discounted cash flow analysis* (DCF) is a prominent example of *yield capitalisation*.** (See Guidance Note 9.) Either *direct capitalisation* or *yield capitalisation* (or both) can be applied to estimate *Market Value* if the capitalisation and yield rates are appropriately supported by the market. If applied correctly, both procedures should result in the same value estimate.

5.13.6 **In some States, reconstructed operating statements specify that the income projection is subject to the assumption that the property is run by competent management or an average, efficient operator.**

5.14 The three approaches to value are independent of one another even though each approach is based on the same economic principles. All three approaches are intended to develop an indication of value, but **the final value conclusion depends on consideration of all data and processes employed and the reconciliation of the value indications derived from different approaches into a final estimate of value.** As shown in GN Figure 1-1, the reconciliation process is followed by a report of defined value.

5.15 **The requirements for valuation reports are addressed in the IVS Code of Conduct and IVS 3, Valuation Reporting.**

5.16 **Where there is sufficient market data to support the valuation, *Market Value* is derived. In other circumstances, where there is insufficient market data or special instructions have been given, the result will be *Non-Market Value*.**

5.17 The existence of different types of value must not confuse Valuers or the users of valuation services. ***Market Value,* the value type most commonly sought in the market, is distinct from all other value types. Each of the other value types has its own rationale and application and shall be investigated only in an appropriate context.** By proper reporting, adequate disclosure and discussion, and the assurance that the value type identified in the valuation report suits the intended purpose and use of the valuation, the Valuer assists the market in its reliance on valuations.

5.18 **The terms *market* and *markets* imply properties, buyers, sellers, and some degree of competition.** If a property chosen for comparison does not, or cannot, compete in the same market as the property being valued, it is likely that the comparison property belongs to a different market.

5.19 The totality of private ownership rights associated with a particular property is referred to as a *freehold interest,* a *fee simple interest,* or by other appropriate terms depending on the State.

5.20 **In any analysis of comparable data, it is essential that the properties from which the comparable data are collected have characteristics similar to the property being valued.** These include legal, physical, locational, and use characteristics that are consistent with those of the subject property and reflect conditions in the market where the subject property competes. Differences shall be noted and analysed to develop adjustments in all three valuation approaches.

5.20.1 **In the *cost approach,* comparable data** refer to the costs of building or development, and adjustments are made to account for differences in quantities, qualities, and utility. In addition, analysis of comparable land data and comparable depreciation estimates is undertaken. (See the discussion of *Depreciated Replacement Cost* (DRC) in para. 5.11.1 above.)

5.20.2 **In the *sales comparison approach,* comparable sales data** are adjusted to reflect the differences between each comparable property and the subject property. **Elements of comparison** include real property rights conveyed, financing terms, conditions of sale, expenditures made immediately after purchase, market conditions, location, physical characteristics, economic characteristics, use, and non-realty components of a sale.

5.20.3 **In the *income capitalisation approach,* comparable data** include rental, income, expense, and capitalisation and yield rate data. **The categories of** comparable income and expense **data** used in projections of future income and expenses and in the development of capitalisation and yield rates **must be identical.**

5.21 **Suitable *units of comparison*** are selected to conduct proper analyses. Different units of comparison may be used, depending on the property type and focus of the analyses. Office buildings and warehouse properties can be compared using price per square metre or square foot of leaseable or lettable area. In some markets, comparison of warehouse properties may use price per cubic metre or cubic foot; apartments can be compared using price per apartment unit or flat; and agricultural properties can be compared, using crop yield per hectare or per acre or supportable Animal Units (AU) per hectare or per acre. **Units of comparison are only useful when they are consistently selected and applied to the subject property and the comparable properties in each analysis and most closely reflect the units of comparison used by buyers and sellers in a particular market.**

5.22 ***Elements of comparison*** identify specific characteristics of properties and transactions that may explain price variations. Market analysis identifies which elements are especially sensitive. **The following elements of comparison are considered as basic in comparable sales analysis.**

5.22.1 ***Real property rights conveyed.*** A precise identification of the real property rights conveyed in each comparable transaction, selected for analysis, is essential because the transaction price is always predicated on the property interest conveyed.

5.22.2 ***Financing terms.*** Where different financing arrangements can cause the price paid for one property to differ from that of another identical property, the types and conditions of financing arrangements in the transaction shall be fully understood, analysed, and accounted for.

5.22.3 ***Conditions of sale.*** The special motivations of the parties to the transaction in many situations can affect the prices paid and even render some transactions as non-market. Examples of special conditions of sale include a higher price paid by a buyer because the parcel had assemblage, or marriage, value; a lower price paid because a seller was in a hurry to conclude the sale; a financial, business, or family relationship between the parties involved in the transaction; unusual tax considerations; lack of exposure of the property in the (open) market; or the prospect of lengthy litigation proceedings.

5.22.4 ***Expenditures made immediately after the purchase*** are expenditures that would have to be made upon purchase of the property and that a knowledgeable buyer may negotiate into the purchase price. Examples include the cost to repair or replace structures or parts of structures, the cost to remediate environmental contamination, or the costs associated with zoning changes to permit development.

5.22.5 ***Market conditions.*** Market conditions at the time of the sales transaction of a comparable property may differ from those on the valuation date of the property being valued. Factors that impact market conditions include rapidly appreciating or depreciating property values, changes in tax laws, building restrictions or moratoriums, fluctuations in supply and demand, or any combination of forces working in concert to alter market conditions from one date to another.

5.22.6 ***Location.*** The locations of the comparable sale properties and the subject property are compared to ascertain whether location and the immediate environs are influencing the prices paid. Extreme locational differences may indicate that a transaction is not truly comparable and should be disqualified.

5.22.7 ***Physical characteristics.*** Attributes such as the size, construction quality, and physical condition of the subject property and the comparable properties are described and analysed by the Valuer. If the physical characteristics of a comparable property vary from those of the subject property, each of the differences is considered, and the Valuer shall adjust for the impact of each of these differences on value.

5.22.8 ***Economic characteristics.*** Qualities such as income, operating expenses, lease provisions, management, and tenant mix are used to analyse income-producing properties.

5.22.9 ***Use.*** Zoning and other restrictions or limitations affect the use of a property. If there is a difference in the current use or *highest and best use* of a comparable property and that of the subject property, its impact on value shall be carefully considered. Generally, only properties with the same or similar *highest and best uses* are used in comparable analysis.

5.22.10 ***Non-realty components of sale.*** Personal property, business interests, or other items that do not constitute real property may be included in either the transaction price or the ownership interest in the property being valued. These components shall be analysed separately from the real property. Typical examples of personal property are furniture, fixtures, and equipment (FF&E) in a hotel or restaurant.

5.23 **In applying the *sales comparison approach,* a Valuer follows a systematic procedure. The Valuer will:**

5.23.1 **Research the market** to develop appropriate market information for similar properties that compete with the subject for market share; this information will vary among different property types but will commonly include the property type, date of sale, size, location, zoning, and other relevant information.

5.23.2 **Verify the information** by confirming that it is accurate and that the terms and conditions of sale are consistent with *Market Value* requirements; where differences occur, the Valuer will determine whether the data warrant only general consideration.

5.23.3 **Select relevant units of comparison** (e.g., price per metre or per square square foot; price per room; income multiplier, or years' purchase; or others) and develop a comparative analysis for each unit.

5.23.4 **Compare the sale properties with the subject property** using the elements of comparison and adjusting the sale price of each comparable property when data are available to support such adjustments. As an alternative, the Valuer may use the sales data to bracket or determine a probable range of values for the property. If the data are found not to be sufficiently comparable, the sale property shall be eliminated as a comparable.

5.23.5 **Reconcile the results into a value indication.** Where market conditions are indefinite, or when an array of the sales data shows varying degrees of comparability, it may be advisable to develop a range of value indications.

5.24 ***Highest and best use*** **underlies the analysis for all Market Value assignments.** An understanding of real estate market behaviour and dynamics is essential to the determination of a property's *highest and best use*. Since market forces create *Market Value,* the interaction between market forces and *highest and best use* is of fundamental importance. ***Highest and best use*** **identifies the most profitable use among potential uses to which the property can be put, and is, therefore, market-driven.**

5.24.1 It is possible that the *highest and best use* (HABU) of land as though it were vacant and the HABU of an improved parcel of land are different. In many States, it may be illegal to demolish buildings even if a more productive use is possible. Where demolition and site clearance are legal and possible, the costs associated with them might make new construction economically unfeasible. Thus, it is possible that there is a difference between the HABU of land as though vacant and that of the property as improved. The Valuer must analyse and report these considerations, and clearly distinguish which HABU was selected. The Valuer must also provide support for the HABU selection.

5.24.2 In many States, it is necessary to make a land value estimate based on the HABU as though there were no improvements on the land. This HABU determination is, of course, necessary if the land is vacant, but it also provides an economic basis for judging the productivity of the improvements when they are present. The practice also involves analysing market information to determine the extent of accrued depreciation that may be present in the improvements. In other States, or in situations where there is little, if any, market information on vacant land sales, it is possible that land value may not be estimated. Local standards within each State prescribe practice in these situations, but in any event such restrictions shall be fully and clearly understood.

5.25 **The primary methods of valuing land are:**

5.25.1 **A *sales comparison* technique** for land valuation involves direct comparison of the subject property with similar land parcels for which actual data on recent market transactions are available. Although sales are the most important, analysis of listings and prices offered for similar parcels that compete with the subject may contribute to greater understanding of the market.

5.25.2 **A *subdivision development* technique** may also be applied to land valuation. This process entails projecting the subdivision of a particular property into a series of lots, developing incomes and expenses associated with the process, and discounting the resulting net incomes into an indication of value. This technique may be supportable in some situations, but is subject to a number of assumptions that may be exceedingly difficult to associate with the *Market Value* definition. Caution is advised in the development of supportable assumptions, of which the Valuer is advised to make full disclosure.

Where direct land comparisons are not available, the following methods can be applied with caution.

5.25.3 ***Allocation*** is an indirect comparison technique that develops a ratio between land value and improvement value or some other relationship between property components. The result is a measure that allocates a total market price between the land and improvements for comparative purposes.

5.25.4 ***Extraction*** is another indirect comparison technique (sometimes called *abstraction*). It provides a value estimate of improvements by applying a cost less depreciation analysis and extracting the result from the total price of otherwise comparable properties. The residual is an indication of possible land value.

5.25.5 **The *land residual* technique** for land valuation also applies income and expense data as elements in its analysis. A financial analysis is made of the net income that can be obtained by an income-producing use and a deduction from the net income is made for the financial return required by the improvements. The remaining income is considered residual to the land and is capitalised into a value indication. The method is limited to income-producing properties and is most applicable to newer properties for which fewer assumptions are required.

5.25.6 **Land can also be valued by *ground rent capitalisation*.** If the land is capable of independently producing a ground rental, that rent may be capitalised into a *Market Value* indication where sufficient market data are available. Care must be taken, however, not to be misled by special terms and conditions in a ground-rent lease that may not necessarily be representative of the particular market. In addition, since ground leases may have been drawn up many years before the valuation date, the rents quoted therein may be outdated, and current income capitalisation rates may be hard to obtain.

5.26 **A real estate market** may be defined as the interaction of individuals or entities that exchange real property rights for other assets, typically *money*. **Specific real estate markets** are defined by the property type, location, income-producing potential, typical tenant characteristics, attitudes and motivations of typical investors, or other attributes recognised by those individuals or entities participating in the exchange of real property. In turn, **real estate markets** are subject to a broad variety of social, economic, governmental, and environmental influences.

5.26.1 In comparison to markets in goods, securities, or commodities, **real estate markets are still considered inefficient.** This feature is attributable to a variety of factors including the relatively inelastic supply and the fixed location of real estate. Consequently, the supply of real estate does not adjust quickly in response to changes in market demand.

5.26.2 **Investment in real estate,** which is relatively illiquid, involves large sums of money for which appropriate financing might not be readily available. Valuers shall recognize these inefficiencies, and their understanding of the particular characteristics of a real estate market and/or sub-market shall produce a credible and objective analysis for the clients they serve.

5.27 **The use of the *cost approach*** is usually most appropriate when properties are new or of relatively new construction. In depressed markets, economic or external obsolescence must be factored into the indication of value derived from the cost approach. The approach can be persuasive when the land value and depreciation estimates are supported by market evidence.

6.0 Effective Date

6.1 This International Valuation Guidance Note (revised 2003) became effective 30 April 2003.