

# **EUROPEAN VALUATION STANDARDS**

# **EUROPEAN VALUATION STANDARDS**

**2009**

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## CHAIRMAN'S FOREWORD

*The valuation profession in Europe has to provide best practice under globally accepted standards and work within European and national legislation. This latest edition of EVS is derived from earlier EVS versions and current EU legislation to offer best practice for valuers across Europe. The rationale of providing a set of standards for Europe comes from a demand for valuations which are consistent across Europe, with a quality that can be relied upon as a common benchmark by investors, the financial industry and valuers throughout the EU and beyond.*

*Cross border investment and globalisation of companies has for some time now established the need for consistent standards and EVS sets out the framework under which valuers should operate to achieve those client-driven aspirations.*

*Many of the older established economies within Europe have mature property markets. In other countries, markets are still in their infancy and valuation practice is less well established. EVS 2009 offers all valuers a common approach that can give the end users of the valuations confidence in locally produced valuation reports.*

*Volatility in the marketplace as a result of global banking issues and in many cases linked to recessionary pressures poses a particular challenge for valuers. The adoption of European benchmark standards should help all valuers reach consistent conclusions, assisting confidence in the marketplace.*

*Education of valuers is an important component of TEGoVA's activity. TEGoVA is particularly keen to raise the standards of education for valuers across Europe, especially in regions where valuation is a relatively new profession, and endorses EVS as part of this process.*

*EVS 2009 sets out the applicable standards in general terms without any country specific issues. These will be considered in subsequent papers to be published on the TEGoVA website to support the work of a modern trans-European valuation industry.*

*TEGoVA is indebted to the individuals who have given of their time to produce these standards. In particular as Chairman of TEGoVA, I should like to thank the entire working group, the Editorial Board and especially John Hockey the Chairman and Jeremy Moody who has latterly done much of the drafting and editing, as well as Michael MacBrien, Gabriela Cuper and François Isnard of the TEGoVA Secretariat, for their role in pulling this all together.*

*The result is an excellent product for TEGoVA that should serve our members and so their clients and all reliant on property in these changing times.*



**Roger Messenger BSc FRICS IRRV MCI Arb**  
**Chairman of the Board**

*January 2009*

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## EVS 2009 - INTRODUCTION

**1.1.** While the law of real property remains a matter for member states, the activity and legislation of the EU has a considerable and growing influence on property and the extent to which people and businesses can benefit from it. In general, EU citizens have the right to live and work anywhere in the Union. There is a core common currency and an Internal Market with free circulation of, inter alia, capital and services, guaranteeing the right to invest in property and to offer real estate services, including valuation services, anywhere in the Union without obstacle.

**1.2.** In this context, cross-border property investment has increased exponentially from the very low levels of the early 1990s. It is set to increase much further as investors seek new opportunities, market niches, pan-European scale, or to spread geographic risk in their property portfolios.

**1.3.** In response to this, new EU legislation has been passed or drafted, and initiatives are being promoted to EU legislators by the European property industry, providing the legislative framework needed for optimal pan-European property investment conditions:

- *Directive 2006/48/EC of 14 June 2006* relating to the taking up and pursuit of the business of credit institutions is also known and referred to as part of *the Capital Requirements Directive*. This has consequences for property valuation for lending purposes, with definitions of value, criteria for assessment, monitoring and revaluation as well as requirements with respect to the qualification and independence of valuers.
- *The Services Directive (Directive 2006/123/EC of 12 December 2006)* applies, inter alia, to providers and recipients of valuation services. It contains detailed provisions prohibiting and dismantling national obstacles to the provision of services, and provides for codes of conduct aimed at facilitating the provision of services with special emphasis on estate agents.
- *The Commission White Paper on Mortgage Credit* is an important step toward a true EU housing finance market, with predictable positive effects on the refinancing of mortgages, the expansion of refinancing markets, and the encouragement of housing finance product development. The White Paper emphasises the importance of common European standards for property valuation.

- An EU passport for open-ended real estate funds is under consideration by the Commission with the active involvement of a coalition of the European property industry including TEGoVA. Valuation is a key issue.
- An EU legislative framework for a Real Estate Investment Trust, or EU REIT, is being promoted by a coalition of the European property industry including TEGoVA in order to reduce the remaining obstacles to pan-European property investment: distorted competition, impediments to specialisation, adverse effects on investment performance, disadvantages to small member states and poor allocation of capital. Here, too, valuation is a central issue.

**1.4.** In the current context of the increasing movement between countries by citizens of EU member states and the rapid development of pan-European property investment underpinned by increasingly property-focussed EU legislation, European Valuation Standards (EVS) take on special significance. The impact of EU regulations on property valuation should be consistent and founded on a common understanding of valuation approaches and processes. In an increasingly fluid pan-European (and so cross-border) investment market it is particularly important for there to be understanding and certainty about the qualifications of valuers and whether a valuer has sufficient market knowledge and is qualified to value a particular property.

**1.5.** To meet these needs, EVS 2009 serves:

- to assist valuers to prepare coherent reports for presentation to their clients by providing clear guidance on valuation standards;
- to promote consistency by the use of standard definitions of value and approaches to valuation;
- to enable users of valuations to know and understand more fully what is meant by particular terms and definitions so that they are better able to use the valuations which have been prepared on their instructions;
- to provide a benchmark for a 'qualified valuer'. TEGoVA has developed this further with its *Recognised European Valuer Scheme*;
- to increase public awareness of the role of the valuer;
- to provide standards which when adopted will ensure clear and justified Valuation Reports and Certificates that are consistent with national and EU legislation and with valuation and accounting standards;
- to promote consistency in valuations used by the real estate investment sector to construct indices representing financial performance; and
- to promote coherence in national and EU regulations and recommendations of best practice.

**1.6.** As the analysis of valuation has developed progressively over many years, there is much shared understanding of the concepts between those drafting Standards, Applications and other texts. Each successive publication carries this process forward. This text not only develops the equivalent parts of EVS 2003 but also acknowledges developments in IVS 2005 and IVS 2007, citing those texts as appropriate.

**1.7.** EVS 2009 considers valuation issues in a European context and, in particular, addresses the valuation requirements and definitions of EU and EEA legislation. It sets out five core standards:

- EVS1 covering market value
- EVS2 covering other bases of value
- EVS3 addressing the qualified valuer
- EVS4 applying to the valuation process and
- EVS5 on valuation reporting

EVS1 and 2 address basic concepts, EVS3 ethical matters and EVS4 and 5 more technical issues. These are then developed in five European Valuation Applications (EVAs 1 to 5) which consider the application of these standards to a number of general purposes that require property to be valued - financial reporting, lending, securitisation, insurance and investment.

**1.8.** EVS 2009, having outlined general standards, will be supplemented in due course by more specific guidance notes addressing their application to individual property sectors, current practical issues and other topics, including country specific circumstances and legislation. These will be published on TEGoVA's website [www.tegova.org](http://www.tegova.org).

**1.9.** EVS 2009 does not impose specific valuation methodologies as they are a matter for the professional judgement of the valuer in each case according to his circumstances.

**1.10.** The purpose for which the valuation is required is crucial to the choice of the appropriate valuation basis. This must be established by the valuer with the client and any other advisers at the beginning of the assignment when the conditions of engagement are agreed. Within the overriding requirements of good professional practice, coherence, consistency and transparency, only recognised bases of valuation and reporting practice that are compatible with European and national laws and client needs should be adopted. These will often be Market Value (see EVS1) but other bases may need to be used as

required by the law, circumstances or a client's instructions where the assumptions underpinning market value are not met. The result will not be a market value but may follow one of the other bases of value as considered below in EVS2.

**1.11.** Previous editions of EVS were revised and updated to take account of intervening changes, including a widening of the scope beyond valuations for financial statements to cover valuations for a wide variety of commercial purposes. The 2009 edition continues that process and replaces EVS 2003 with effect from 1<sup>st</sup> January 2009.



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# PART 1

## EUROPEAN VALUATION STANDARDS

### **EVS1 - Market Value**

Valuers should use the following definition of Market Value unless otherwise directed by legislation:

“The estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.”

### **EVS2 - Valuation Bases Other than Market Value**

The valuer should establish the purpose for which the valuation is required before using any basis of value other than Market Value.

Only recognised bases of valuation and reporting practice that are compatible with international practice, European and national laws, regulations and client needs must be adopted, subject to the overriding principles of transparency, consistency and coherence.

Such other bases of value may need to be used as required by law, circumstances or a client’s instructions where the assumptions underpinning Market Value are not qualified or cannot be met. The result will not be a Market Value.

### **EVS3 - The Qualified Valuer**

Each valuation carried out in accordance with these Standards must be carried out by, or under the strict supervision, of a Qualified Valuer.

Valuers will at all times maintain the highest standards of honesty and integrity and conduct their activities in a manner not detrimental to their clients, the public, their profession, or their respective national professional valuation body.

All Qualified Valuers and their representative professional or technical organisations are required to adhere to the TEGoVA Professional Code of Conduct and the Code of Conduct of their Member Association.

**EVS4 - The Valuation Process**

The terms of engagement and the basis on which the valuation will be undertaken must be set out in writing before the valuation is reported.

The valuation must be researched, prepared and presented in writing to a professional standard.

**EVS5 - Reporting the Valuation**

The valuation must be presented in clear written form to a professional standard, transparent as to the instruction, purpose, basis, method, conclusion and prospective use of the valuation.

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# EVS1

## MARKET VALUE

### CONTENTS

1. Introduction
2. Scope
3. European Valuation Standard 1: Definition of Market Value and Market Rent
4. Definitions of Market Value in EU and EEA Legislation
5. Commentary

#### EUROPEAN VALUATION STANDARD 1

*Valuers should use the following definition of Market Value unless otherwise directed by legislation:*

*“The estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.”*

## 1. Introduction

**1.1.** Market Value is a key concept in establishing an informed expectation as to the price for something, one that is neutral as between buyer and seller. The nature of the market in which that value is determined will differ according to the subject of the trade while market conditions will vary with the changing balance of supply and demand, changing knowledge, fashion, rules, expectations, credit conditions, hopes of profit and other circumstances. "Value" does not mean a specific price, the actual sum that may prove to be paid in a given transaction between specific parties. At an individual level, the value of an asset to a person will reflect its usefulness to him when judged against his resources and opportunities. In the context of a market with competing parties, it is rather an estimate of the amount that could reasonably be expected to be paid, the most probable price in market conditions at the date of valuation. While the asset in question may have different values for different individuals who may be in the market, its market value is the estimate of the price in the present market on assumptions that are deliberately neutral to achieve a standard basis of assessment for both buyers and sellers.

**1.2.** The "market value" of an asset is understood to mean its "current value in the market, saleable value" (*Oxford English Dictionary*) irrespective of actual parties. For a valuation, that means as at the valuation date.

**1.3.** The ultimate test for market value, however determined, is whether parties in the market place could really be expected in practice to pay the value that has been assessed, hence the importance of soundly analysing good quality comparable evidence where it can be obtained. Any valuation arrived at with a purely theoretical underpinning must face this final test. This is particularly applicable to valuations of real property, given the usual nature of the assets and markets concerned, especially at times of flux.

## 2. Scope

**2.1.** EU legislation makes a number of references to "market value". Most refer to financial instruments or the aggregate capitalisation of businesses. These are generally based on transaction prices or values reported from official exchanges and other markets for generally homogenous, fungible and widely traded assets which can often be sold immediately at a price.

**2.2.** EVS1 specifically refers to:

- *real estate and related property rights* which is less homogenous as an asset class and for which such instant, liquid and reported market conditions rarely exist but for which market values often need to be identified
- *that is marketable*, that is legally and physically saleable

**2.3.** In marked distinction to many financial instruments, real property is commonly more individual in both its legal and physical nature, less frequently traded, has buyers and sellers with varied motives, faces higher transaction costs, takes longer to market and buy and is more difficult to aggregate or disaggregate. These features make the valuation of real property an art requiring care, experience of the specific market, research and the use of market evidence, objectivity, an appreciation of the assumptions required and judgement – in short, professional skills.

**2.4.** The definition of Market Value approved by TEGoVA at paragraph 3.1 is built on the range of assumptions explored in Section 5.

### **3. TEGoVA's Approved Definition of Market Value**

**3.1. Unless otherwise directed by legislation (see below), "market value" means:**

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

**3.2.** As in EVS 2003, TEGoVA recommends that its definition of market value, identical to that in *Directive 2006/48/EC*, be used as the basic definition and interpreted in accordance with the commentary in Section 5 below, save where legislation specifically requires otherwise.

**3.3.** As a corollary and applying the definition of market value to leasehold interests, the TEGoVA approved definition of "market rent", usually expressed as an annual figure, is:

“The estimated amount of rent at which the property should be leased on the date of valuation between a willing lessor and a willing lessee on the terms of the tenancy agreement in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.”

## 4. Definitions of Market Value in EU and EEA Legislation

**4.1.** There are several definitions of market value within EU legislation, each provided for specific purpose – EU law does not provide a general definition. After analysis and consideration of the legal cases and other rulings arising under these provisions (especially the 1997 State Aid rules (see 4.3.1 below) as the relevant regulation that has been most closely analysed in practical situations by EU and EEA institutions), these definitions are perceived to be consistent in practice with that set out in EVS1.

**4.2.1.** *The Capital Requirements Directive Definition* - The definition used in EVS1 is (as noted above) now employed by EU legislation for the purposes of assessing the value of real estate as collateral for a lending institution, in essence as part of implementing the Basel 2 Agreement (*Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (Text with EEA relevance)*) at paragraph 63 in 1.5.1(a) [Real Estate Collateral] of Part 3 of Annex VIII, Credit Risk Mitigation).

**4.2.2.** It is invoked for the purposes of Articles 84 to 89 of the Directive which under the heading of its Title V (Principles and Technical Instruments for Prudential Supervision and Disclosure), Chapter 2 (Technical instruments of prudential supervision), Section 3 (Minimum own funds requirements for credit risk) provides as sub-section 2, the EU’s legal framework for the Internal Ratings Based Approach. Article 76 provides that this Approach may be used to calculate an institution’s “risk weighted exposure amount” that it has to match with a minimum level of its own funds under Article 75. Under Article 91, this IRB Approach can also be relevant to credit risk mitigation. Thus, where a credit institution lends on the basis of property, these rules are of significant importance both to the amount of capital it needs to hold in its balance sheet and for its management of credit risk.

**4.2.3.** This definition is immediately followed in the same paragraph of the Capital Requirements Directive by the provision that “The market value shall be documented in a transparent and clear manner.” This is seen as a procedural requirement for the purposes of the directive rather than a factor helping determine the market value of any property and is thus addressed below in EVS5.

**4.3.1.** The definition used in both the *State Aid Communication* and the *Insurance Accounts Directive* - This second definition is used in the EU legislation governing:

- the rules for assessing whether a sale of property by a public authority in the European Economic Area to a business and which might distort international competition should be investigated as a potentially illegal state aid. These are set out in the *Commission Communication on State aid elements in sales of land and buildings by public authorities (OJ C 209, 10/07/1997, p0003-0005 – 31997Y0710(01)* and extended to EFTA countries by *EFTA Surveillance Authority Decision No 275/99/COL of 17 November 1999 introducing guidelines on State aid elements in sales of land and buildings by public authorities and amending for the 20<sup>th</sup> time the Procedural and Substantive Rules in the field of State aid.*
- accounting for insurance undertakings requiring the market value for “land and buildings” as provided in *Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings*

and states that for these purposes :

- “Market value shall mean the price at which land and buildings could be sold under private contract between a willing seller and an arm’s length buyer on the date of valuation, it being assumed that the property is publicly exposed to the market, that market conditions permit orderly disposal and that a normal period, having regard to the nature of the property, is available for the negotiation of the sale.”  
*State Aid Communication II.2.(a) (last paragraph) and Directive 91/674/EEC, Article 49(2)*

**4.3.2.** Until 2006, this definition was also used for the assessment of property as collateral for secured lending by credit institutions, being replaced in 2006 for this purpose by the definition now adopted above as the TEGoVA definition of Market Value.

**4.3.3.** In the *State Aid Communication*, where a value in question was achieved by a “Sale on Unconditional Bidding” this is to be after:

“a sufficiently well-publicized, open and unconditional bidding procedure, comparable to an auction, accepting the best or only bid is by definition at market value”.

**4.4. VAT Definition** - A third definition is provided for VAT purposes. VAT can apply to real estate under Articles 135 and 137 of *Council Directive of 28 November 2006 on the common system of value added tax (2006/112/EC)* which consolidated VAT law including the Sixth VAT Directive (77/338/EEC) with its Articles 13A and 13B. Its Article 72, being Chapter 1 (Definition) of Title VII (Taxable Amount), provides a general definition of open market value for the VAT system.

“For the purposes of this Directive, ‘open market value’ shall mean the full amount that, in order to obtain the goods or services in question at that time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a supplier at arm’s length within the territory of the Member State in which the supply is subject to tax.”

As this definition is provided for all VAT purposes and so applies to any goods or services, it is not drafted with specific reference to real property. However, it is seen to cover the main points of an assumed transaction between arm’s length, competitive, hypothetical parties for an actual subject property.

**4.5. EU Accounting Definition** - A further provision is given for the EU’s own internal accounting when assessing tangible fixed assets (specifically including land and buildings) for the accounts of an EU institution. Any asset acquired free of charge is to be assessed at its market value which is defined as:

“The price which a buyer would be prepared to pay for it, having due regard to its condition and location and on the assumption that it could continue to be used”

at Article 19(2) of *Commission Regulation (EC) No 2909/2000 of 29 December 2000 on the accounting management of the European Communities’ non-financial fixed assets*.

## 5. Commentary

**5.1.** The advantage of the definition used in EVS1 over other available EU definitions is that it more clearly sets out the key concepts involved, namely:

- the result
- the real property being valued
- the transaction
- the date of valuation
- the nature of the hypothetical parties as willing and competitive
- the necessary marketing
- the consideration by the parties
- other matters

This commentary takes each phrase of the definition in turn and explores its meaning in seeking the market value of real property.

**5.2.** The definition in EVS1:

- is the same as that used in both EVS 2003 and *Directive 2006/48/EC*
- is virtually the same as that used by IVS 2007, the difference being that IVS refers to the value of “a” property when EVS1 refers to the value of “the” property but nothing of significance is seen to turn on this;
- is consistent with most definitions of market value in European countries; and
- can be taken as setting a basic definition of Market Value that is available for general application.

The same points essentially apply to the TEGoVA approved definition of “Market Rent” in 3.3 above. Developed from the definition in EVS1, there are minor differences of expression in this definition from that used in IVS 2007 but again nothing of significance is seen to turn on these.

### 5.3. The Result

**5.3.1.** “*The estimated amount ...*” - This refers to a price expressed in terms of money (normally in the local currency), payable for the property in an arm’s length market transaction. Market Value is measured as the most probable price reasonably obtainable in the market at the date of valuation in keeping with the Market Value definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer.

**5.3.2.** This estimate specifically excludes an estimated price inflated or deflated by any special terms or circumstances such as financing which are not typical, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any elements of Special Value.

**5.3.3.** Special Value is considered with related issues under EVS2 – ‘Valuation Bases Other Than Market Value’.

**5.3.4.** The application in practice of the 1997 EU State Aid rules may potentially have regard to special value, whether specific synergistic value or otherwise.

## **5.4. The Real Property Being Valued**

**5.4.1.** “... *the property* ...” - This is where the asset itself with its legal, physical, economic and other attributes is to be analysed with all its actual opportunities and difficulties. This is introduced into the definition of Market Rent at 3.3 above by the need to consider the terms of any tenancy agreement.

**5.4.2.** It is thus, in principle, based on the highest and best use of the property:

**5.4.3.** “Highest and best use” has been defined by the IVSC, with a definition in common use as well as being widely understood in North America and more specifically defined by the law of some European countries, as “The most probable use of property which is physically possible, appropriately justified, legally permissible, financially feasible, and which results in the highest value of the property being valued.” (International Valuation Standards Council (IVSC), International Valuation Standards, Eighth Edition 2007, pp. 28 and 368)

**5.4.4.** The IVS definition used here is noteworthy in referring to “the most probable use” of the property. This appears to encapsulate the notion that the use be a reasonable and likely one (see also IVS 2007, p. 173-4). Fundamentally, it must be a use for which the hypothetical transaction could be expected to take place at a value that can be sustained by evidence.

**5.4.5.** Valuers must take due regard where the purchase price of any property includes items additional to the property itself. For a residential property this might include, for example, fittings, carpets and curtains.

**5.4.6.** If particular conditions are imposed on the sale, the State Aid rules will only regard the offer as ‘unconditional’ if all potential buyers would have to, and be able to, meet that obligation, irrespective of whether or not they run a business or of the nature of their business.

**5.4.7.** The 1997 State Aid rules for an unconditional offer are:

“ ... when any buyer, irrespective of whether or not he runs a business or of the nature of his business, is generally free to acquire the land and buildings and to use it for his own purposes, restrictions may be imposed for the prevention of public nuisance, for reasons of environmental protection or to avoid purely speculative bids. Urban and regional planning restrictions imposed on the owner pursuant to domestic law on the use of the land and buildings do not affect the unconditional nature of an offer.”

*State Aid Communication II.1.(b)*

## **5.5. The Transaction**

**5.5.1.** “... *should exchange* ...” - It is an estimated amount rather than a predetermined or actual sale price. It is the price at which the market expects a transaction to be completed on the date of valuation that meets all the other elements of the Market Value definition.

**5.5.2.** The use of “should” conveys that sense of reasonable expectation. The valuer must not make unrealistic assumptions about market conditions or assume a level of Market Value above that which is reasonably obtainable.

**5.5.3.** The definition used in the State Aid rules expects the price to be that at which the land and buildings “*could be sold under private contract*”. The use of “could” reflects the hypothetical nature of the transaction. This is not assumed to mean the best possible price that could be imagined but rather the reasonable expectation of the price that would be agreed.

**5.5.4.** The hypothetical sale is by “private contract” and so is the subject of negotiation.

## **5.6. The Date of Valuation**

**5.6.1.** “... *on the date of valuation* ...” - This requires that the estimated Market Value be time-specific to a given date and this is normally the date on

which the hypothetical sale is deemed to take place and is usually, therefore, different from the date the valuation is actually prepared. As markets and market conditions may change, the estimated value may be incorrect or inappropriate at another time. The valuation amount will reflect the actual market state and circumstances at the effective valuation date, not at a past or future date. The date of valuation and the date of the valuation report may differ, but the latter cannot precede the former. The definition also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might otherwise be made in a Market Value transaction.

**5.6.2.** Market Value is quite expressly not an assessment of value over the longer term but only at the time of the hypothetical transaction.

**5.6.3.** In EVS 2009, the phrases ‘date of valuation’ and ‘valuation date’ are used to refer to the date at which the valuation is assessed or determined (and for which the evidence supporting it is to be relevant) rather than the, usually later, date when the valuation is prepared and considered with the Valuation Report then completed for the client. The completion of the Valuation Report will never be earlier than the valuation date as it would then be contemplating circumstances that have not happened, may not happen, and for which important evidence may yet be found.

**5.6.4.** The valuation date will not be later than the date of the Report. By providing that the hypothetical exchange of contracts is deemed to take place on the date of valuation, this ensures that the valuation is informed by those factors that would have been in the expectations of the parties as to value at that point in time.

## **5.7. The Parties – Hypothetical, Willing and Competitive**

**5.7.1.** “... *between a willing buyer ...*” - This assumes a hypothetical buyer, not the actual purchaser. That person is motivated, but not compelled, to buy. This buyer is neither over-eager to buy nor determined to buy at any price.

**5.7.2.** This buyer is also one who purchases in accordance with the realities of the current market and with current market expectations, rather than on an imaginary or hypothetical market, which cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than that which the market requires him to pay. The present property owner is included among those who constitute the market.

**5.7.3.** Equally, the motivated buyer cannot be presumed to be reluctant or unwilling. He is attending to this as a practical man of business.

**5.7.4.** The State Aid rules refer to an “arm’s length buyer” unconnected with and independent of the seller.

**5.7.5.** “... and a willing seller ...” - Again, this is a hypothetical seller, rather than the actual owner and is to be assumed to be neither an over-eager nor a forced seller who is prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in the current market. The willing seller is motivated to sell the property at market terms for the best price obtainable in the open market after proper marketing, whatever that price might be. The factual circumstances of the actual owner are not part of this consideration because the ‘willing seller’ is a hypothetical owner.

**5.7.6.** Thus, while the property to be valued is to be valued as it is in the real world, the assumed buyer and seller are hypothetical parties, albeit acting in current market conditions. The requirement that they both be willing to make the transaction creates the tension between them in which Market Value can be assessed.

**5.7.7.** Market Value is thus independent of and uninfluenced by the objectives of the client instructing the valuation.

**5.7.8.** “... in an arm’s length transaction ...” - An arm’s length transaction is one between parties who do not have a particular or special relationship (for example, parent and subsidiary companies, or landlord and tenant) which may make the price level uncharacteristic of the market or make it inflated, because of an element of special value. The Market Value transaction is presumed to be between unrelated parties, each acting independently.

## **5.8. The Marketing**

**5.8.1.** “... after proper marketing ...” - The property would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably achievable in accordance with the Market Value definition. The length of exposure may vary with market conditions, but must be sufficient to allow the property to be brought to the attention of an adequate number of potential purchasers. The exposure period occurs prior to the valuation date.

**5.8.2.** Under the guidance for applying the EU State Aid rules, the property is to have been:

“repeatedly advertised over a reasonably long period (two months or more) in the national press, estate gazettes or other appropriate publications and through real-estate agents addressing a broad range of potential buyers, so that it can come to the notice of all potential buyers.”

*State Aid Communication II.1.(a), 1<sup>st</sup> paragraph*

As the EU and EEA rules are intended to ensure that transactions are at market value, they are also concerned that, where the sale might attract international bidders, it should be advertised accordingly and

“such offers should also be made known through agents addressing clients on a Europe-wide or international scale”.

*State Aid Communication II.1.(a), 2<sup>nd</sup> paragraph*

**5.8.3.** The State Aid rules are specific in expecting the sale to be one in conditions that allow “*orderly disposal*” – no undue haste is imposed that could limit the proper testing of the market or compel the owner to sell precipitately. The rules refer to a “*normal period*” for the negotiation of the sale which is to be judged by the “*nature of the property*”.

**5.8.4.** These factors, testing the general range of bidders that may come forward, should (subject to the market conditions that anyway frame the market value) bring out the qualities required of the hypothetical buyer.

## **5.9. The Parties’ Consideration of the Matter**

**5.9.1.** “... *wherein the parties had each acted knowledgeably* ...” - This presumes that both the willing buyer and willing seller are reasonably well informed about the nature and characteristics of the property, its actual and potential uses, and the state of the market at the date of valuation.

**5.9.2.** The parties will thus appraise what might reasonably be foreseen at that date. In particular, the hypothetical buyer may be better informed for this assessment than some or all of the real bidders. This does not just involve knowledge of the property but also of the market and therefore the evidence (including such comparables as may be available) on which to judge the value of the property.

**5.9.3.** “... *prudently* ...” - Each party is presumed to act in their own self interest with that knowledge, and prudently to seek the best price for their respective positions in the transaction. Prudence is assessed by referring to the state of the market at the date of valuation, not with the benefit of hindsight at some later date. It is not necessarily imprudent for a seller to sell property in a market with falling prices which are lower than previous market levels. In such cases, as for other purchase and sale situations in markets with changing prices, the prudent buyer or seller will act in accordance with the best market information available at the time.

**5.9.4.** “... *and without compulsion* ...” - This establishes that each party is motivated to undertake the transaction, but is neither forced nor unduly coerced to complete it.

## **5.10. Other Matters**

**5.10.1.** *Documentation* - While Market Value exists independently of documentation, a professional valuation under this standard should be properly recorded in writing in a way that is transparent and clear to the client in accordance with EVS4 and to anyone else who might reasonably seek to rely on it or appraise it.

**5.10.2.** The definition of Market Value should be recorded in both the terms of engagement and the Valuation Report.

**5.10.3.** *Transaction costs and taxes* - Market Value is to be the estimated value of a property and so excludes the additional costs that may be associated with sale or purchase as well as any taxation on the transaction. Market Value will reflect the effect of all the factors that bear on participants in the market and so reflect such influences as transaction costs and taxes may have but, if they need to be recognised, this should be as a sum in addition to the Market Value. These factors may influence the value but are not part of it.

**5.10.4.** In particular, Market Value will be the value before any taxes which may apply to any real transaction in the property being valued. The fact of transaction taxes or Value Added Tax as they may affect some or all potential parties will be part of the wider framework of the market and so, along with all other factors, influence value, but the specific taxation due on a transaction is over and above its Market Value.

**5.10.5.** However, the position on this may vary (perhaps especially for accounting purposes) with different national legislation. In certain circumstances EU law also takes a different approach. Article 49(5) of *Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings* states that:

“Where on the date on which the accounts are drawn up and land and buildings have been sold or are to be sold within the short term, the value arrived at ... shall be reduced by the actual or estimated realization costs.”

**5.10.6.** In such cases, the valuer may choose to state the Market Value both before and after these costs of disposal. In either case, he should make it clear whether such costs have been deducted and, if so, specify how much has been deducted for each identified cost.

# EVS2

## VALUATION BASES OTHER THAN MARKET VALUE

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9. Forced Sale Value
10. Depreciated Replacement Cost

### EUROPEAN VALUATION STANDARD 2

*The valuer should establish the purpose for which the valuation is required before using any basis of value other than Market Value.*

*Only recognised bases of valuation and reporting practice that are compatible with international practice, European and national laws, regulations and client needs should be adopted, subject to the overriding principles of transparency, consistency and coherence.*

*Such other bases of value may need to be used as required by law, circumstances or a client's instructions where the assumptions underpinning Market Value are not qualified or cannot be met. The result will not be a Market Value.*

## 1. Introduction

Although the majority of professional valuations will be on the basis of Market Value, there are circumstances where alternative bases may be required or more appropriate. It is essential that both the valuer and the users of valuations clearly understand the distinction between Market Value and other bases of valuation together with the effects that differences between these concepts may create in the construction and production of valuations.

## 2. Scope

EVS2 defines, explains and distinguishes bases of value other than Market Value.

## 3. Basis of Value

**3.1. Definition** - "A statement of the fundamental measurement principles of a valuation on a specified date" (IVSC), 2007, pp. 84 and 337)

### 3.2. Commentary

**3.2.1.** A basis of value as a statement should be distinguished from the methods or techniques used to implement a chosen basis. Established terms and methods used in the valuation should be defined in the valuation report.

**3.2.2.** In the event that none of the bases in EVS 2009 is suitable for the completion of an instruction, a clear and transparent definition of the basis used must be expressly stated, and the valuer should explain the reason for deviating from a recognised basis. If the resultant valuation does not reflect a sum that would equate to a valuation prepared on the basis of Market Value, this should be stated. Any assumptions or special assumptions used should be set out in the valuation report.

**3.2.3.** By contrast, a basis of valuation (or a valuation approach) is a methodology that can be used to determine a valuation from the available evidence. The income, cost and depreciated replacement value approaches are thus, in principle, bases of valuation.

## 4. Fair Value

**4.1. Definition** - "The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's-length transaction" (International Accounting Standards Board (IASB), International Accounting Standard (IAS) 16, par. 6)

### 4.2. Commentary

**4.2.1.** Fair Value is a recognised and permissible basis of valuation which accords with International Financial Reporting Standards (IFRS), subject to additional conditions, though any figures reported will usually equate to Market Value.

**4.2.2.** It will often be met as the basis for financial reporting (see EVA1) where it may frequently be indistinguishable from Market Value. As discussed in EVA1, international discussions are continuing over a potential revision of this definition so that it becomes the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." These discussions have not yet reached a conclusion and in the meanwhile TEGoVA affirms the definition in 4.1 above.

**4.2.3.** "Although in many cases the price that is fair between the parties will equate to that obtainable in the general market, there will be cases where the assessment of *Fair Value* will involve taking into account matters that have to be disregarded in the assessment of *Market Value*." (IVSC, 2007, pp. 90-91)

**4.2.4.** As a basis of value, it is less specific and exacting in its assumptions than Market Value. Although its use often originates from accounting requirements, there will be many situations where it will be used to address the value of a property in a particular real or prospective transaction. While this can appear potentially subjective, the Financial Accounting Standards Board's (FASB's) *Statement of Financial Accounting Standards No. 157, Fair Value Measurement (September 2006)* "emphasises that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on assumptions that market participants would use in pricing the asset or liability."

**4.2.5.** Fair Value may represent a price that is deemed fair between the relevant parties, but does not presume that the property has been properly marketed.

**4.3. Special Value** - One important consequence of the less specific assumptions of Fair Value is that it allows recognition of the individual value a property may have to one bidder.

**4.3.1. Definitions - Special Value** is defined as: "An amount above the Market Value that reflects particular attributes of an asset that are only of value to a Special Purchaser" (IVSC, 2007, pp. 88) – NB In its glossary at p. 411, the IVS does not use the definite article.

**4.3.2. A Special Purchaser** is "a purchaser to whom a particular asset has Special Value because of advantages arising from its ownership that would not be available to general purchasers in the market" (IVSC, 2007, p. 409).

**4.3.3. Commentary** - Where particular qualities or characteristics of a property are valued by one acquiring party at a level above that which would represent Market Value, that party may be described as a Special Purchaser and any figures reported that equate to a sum representing that purchaser's opinion of value would represent a Special Value.

**4.3.4. Special Value** could be associated with elements of Going Concern Value. The valuer must ensure that such criteria are distinguished from Market Value, making clear any special assumptions made.

**4.3.5. Synergistic Value** - This is a particular class of Special Value which valuers will commonly meet and is also generally known as Marriage Value.

**4.3.6. Definition** - This is defined as "an additional element of value created by the combination of two or more interests where the value of the combined interest is worth more than the sum of the original interests" (IVSC, 2007, pp. 88 and 414).

**4.3.7. Commentary** - If a Special Value arises where a combination of interests results in a greater value than the total of those interests valued separately, this value is often described as a Synergistic Value or Marriage Value. Terms of Engagement and Valuation Reports should clearly specify where such values are required or will be provided and Market Value should also be reported to identify the differential between the two bases.

**4.3.8.** This might often be found where the acquisition of a property, often a neighbouring one, unlocks extra value for the purchaser. It may be relevant to transactions between landlord and tenant. However, where a property offers marriage value opportunities to several potential bidders (as by offering any of them greater scale of operation) then that may more usually be a function of Market Value.

## 5. Investment Value or Worth

**5.1. Definition** - "The value of property to a particular investor, or a class of investors, for identified investment or operational objectives. This subjective concept relates specific property to a specific investor, group of investors, or entity with identifiable investment objectives and/or criteria" (IVSC, 2007, pp. 88 and 377).

### 5.2. Commentary

**5.2.1.** As valuations prepared on this basis assess what an individual buyer may be prepared to bid, they are not a measure of the overall judgement of the market on the property. Thus, they would not be expected to be consistent with or equivalent to valuations prepared on any other basis, including Market Value. Such valuations:

- are to determine the value for a specific individual investor with his own actual concerns rather than a hypothetical party;
- do not assume an exchange of property between parties.

**5.2.2.** The application of this definition is discussed in EVA5.

## 6. Mortgage Lending Value

**6.1. Definition** - The value of the property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the Mortgage Lending Value.

## 6.2. Commentary

**6.2.1.** The above definition is also that given in *Directive 2006/48/EC (the Capital Requirements Directive)* at Annex VIII, paragraph 64 in the context of real estate collateral for the capital requirement and credit risk management of credit institutions.

**6.2.2.** *Directive 2006/48/EC*, transposing the Basel II accord into European law, recognises real estate as a security or as risk-mitigating collateral inducing a lower risk weight, i.e. lower capital requirements to be allocated by credit institutions. The Directive stipulates that

“the property shall be valued by an independent valuer at or less than the market value. In those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or less than the mortgage lending value” (Annex VIII, Part 3, paragraph 62).

**6.2.3.** The 2006 definition is for all practical purposes the same as the definition given in Article 62 of its predecessor Solvency Ratio Directive 2000/12, save that the 2006 Directive expressly requires the determination to be by a valuer.

**6.2.4.** The concept of Mortgage Lending Value (MLV) is of particular value in some European countries in the context of long term lending programmes. It is a value-at-risk approach to manage the risk exposure of credit institutions taking into account special safety requirements. It is understood by banking supervisors as a risk management tool. In contrast, the use of the Market Value concept is universally understood as representing a spot market assessment of value at a given point in time (see EVS1 and EVA2).

## 7. Insurable Value

**7.1. Definition** - The ‘insurable value’ of a property means the sum stated in the insurance contract applying to that property as the liability of the insurer where damage and financial loss is caused to the insured by a risk specified in the insurance contract occurring to that property.

**7.2. Commentary** - If the insurable value proves to have been less than the damage and financial loss suffered when a risk occurs, then the insured has an unrecoverable loss.

**7.3.** The application and assessment of this basis of valuation is discussed in EVA4, Assessment of Insurable Value.

## 8. Alternative Use Value

**8.1. Definition** - This means the market value of the property without presuming the continuation of its present use.

**8.2. Commentary** - While market value identifies the best available value for a property however used, some valuations may be required only to assume the present use, for example, a business is being assessed as a going concern. If it is material to consider alternative uses of the property which may not involve continuing the present business, then that would be its alternative use value. That value would not reflect any costs of ceasing the business.

**8.3.** This basis may also be relevant where a depreciated replacement cost valuation has been undertaken.

## 9. Forced Sale Value

**9.1. Definition** - A sum that could be obtained for the property where, for whatever reason, the seller is under constraints requiring the disposal of the property.

**9.2. Commentary** - The need for a valuation may arise where the seller is under compulsion to sell, is desperate to sell or a strict time limit is otherwise imposed. This might most obviously arise where the period in which the property is to be sold is too short to allow the proper marketing needed to be confident of the best bids. More generally, potential buyers may be aware that the seller is under constraint and so moderate their bids from those they may otherwise have offered. The nature of these specific constraints determines the situation in which the hypothetical transfer takes place – without those constraints, it would simply be Market Value.

**9.3.** Forced Sale Value can only be a basis of value once all the relevant constraints are identified. They describe the situation in which the hypothetical transfer takes place. It may also be seen as a market value assessment on special assumptions.

**9.4.** The valuer needs to know and state the time allowed and the relevant constraints on the seller. Such a value will reflect those very specific circumstances. It will not be a Market Value as there is no hypothetical willing seller but a real one under actual constraints.

## 10. Depreciated Replacement Cost

**10.1.** Depreciated Replacement Cost (DRC) is recognised as a method to address Market Value in the absence of better evidence.

**10.2. Definition** - It is defined as “the current cost of replacing an asset with its modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation” (IVSC, 2007, pp. 108, 146, 257, and 351).

### 10.3. Commentary

**10.3.1.** Depreciated Replacement Cost, also known as the Contractor’s Method, can be used to give a value to properties for which there are no relevant direct market comparisons, by referring to a wider range of evidence from the market. These may often be properties with non-conforming, unusual or distinctive attributes, either in terms of construction, orientation, location or other spatial characteristics.

**10.3.2.** In some countries it is recognised as a basis of value; though it is generally regarded as an approach to valuation leading to Market Value. The theoretical underpinning, namely that the relationship between cost and value can be correlated, is not a safe proposition as cost is only one factor in determining supply and demand and it cannot be assumed that costs have been incurred wisely or successfully. Accordingly, this method should only be used where an absence of demand or comparable evidence prevents an alternative method being used, or for valuations required in respect of matters relating to national taxation.

**10.3.3.** The valuer is required to provide a considered opinion of the Market Value of the land and buildings in their existing use to which is added the hypothetical cost of providing a similar property and relevant site works. Deductions are made from this gross sum to account for matters that would influence the value of any existing property, compared to any replacement property. Allowance is made for factors including depreciation, age, condition, and economic and functional obsolescence.

**10.3.4.** The application of this method will require *inter alia* a practical knowledge of current building control regulations, current building costs and relevant health and safety regulations.

**10.3.5.** The choice of depreciation rate is a valuation judgment.

**10.3.6.** In Germany, this method may be called the Asset Value method under which the valuer makes a final adjustment, reflecting his professional view of what would be the outcome of a transaction on the hypothetical terms, which results in Market Value.

# **EVS3**

## **THE QUALIFIED VALUER**

### **CONTENTS**

1. Introduction
2. Scope
3. General
4. The Qualified Valuer
5. Commentary

### **EUROPEAN VALUATION STANDARD 3**

*Each valuation carried out in accordance with these Standards must be carried out by, or under the strict supervision of, a Qualified Valuer.*

*Valuers will at all times maintain the highest standards of honesty and integrity and conduct their activities in a manner not detrimental to their clients, the public, their profession, or their respective national professional valuation body.*

*All Qualified Valuers and their representative professional or technical organisations are required to adhere to the TEGoVA Professional Code of Conduct.*

## 1. Introduction

For a client to be able to rely on a valuation, it must be professionally prepared by a suitably skilled, competent, experienced and objective valuer.

## 2. Scope

This Standard considers who should take responsibility for a valuation, requiring that the Valuation Report be approved by a Qualified Valuer who bears responsibility for it. All valuers contributing to a report must have sufficient expertise and work to professional standards and, where considering valuation issues, should meet the expectations of this standard.

## 3. General

**3.1.** A valuation should be prepared by a Qualified Valuer and meet the requirements of a professional service. Such a person will commonly be an individual but, on occasions and in some countries, a valuation may be made by a company with a legal personality in which case the relevant work should be undertaken by suitably qualified individuals retained by that company.

**3.2.** The valuer must be able to show professional skill, knowledge and competence appropriate to the type and scale of valuation and must disclose any factor which could compromise an objective assessment.

**3.3.** The terms and conditions for the valuer's instruction should be agreed before undertaking the valuation and set out clearly in writing before the valuation is reported (see EVS4 for further guidance).

**3.4.** Valuations which are to be in the public domain or which will be relied on by third parties are frequently subject to statute or regulation. There are often specific requirements that a valuer must meet in order to be deemed suitable to provide a truly objective and independent view. However, there are no specific criteria for most valuations, and the onus is on valuers to ensure that they are aware of potential conflicts of interest.

## 4. The Qualified Valuer

**4.1. Definition - A Qualified Valuer (including valuers working for valuation companies)** who is responsible for preparing and supervising valuations, bearing liability for them as included in financial statements and for other authorised purposes, shall be a person of good reputation, who can demonstrate:

- (i) either:
  - a university degree, post graduate diploma, or other recognised academic or vocational certification relevant to asset valuation that meets TEGoVA Minimum Educational Requirements (MER); and having at least two years' professional experience in property valuation and having maintained and enhanced his professional knowledge through a relevant programme of continuing education; or
  - long term relevant experience; or
  - having undertaken at least twenty written real property valuations within the last two years; or otherwise satisfied the requirements of TEGoVA's Recognised European Valuer Scheme (see the TEGoVA website).
- (ii) sufficient local knowledge and experience in valuing real property in the location and category of the subject property or, having disclosed the insufficiency to the client before accepting the assignment, having obtained assistance from competent and knowledgeable person(s);
- (iii) where required by national legislation or regulations, any required licence to practise as a valuer or membership of a professional association;
- (iv) compliance with all legal, regulatory, ethical and contractual requirements related to the valuation;
- (v) compliance with the regulations and professional practice code of the TEGoVA member organisation to which the valuer belongs which are to meet the minimum standards recommended by the TEGoVA code of professional ethics and conduct (see the TEGoVA website) save where this would be in conflict with national or EU law; and
- (vi) where such cover is commercially available and required by the Member Association, maintenance of professional indemnity insurance appropriate to the valuation work undertaken.

## 4.2. European Definition of an Asset Valuer for State Aid Rules

**4.2.1.** The 1997 Commission rules provide a definition of an “asset valuer” for the purposes of valuations undertaken for those rules (*Commission Communication on State aid elements in sales of land and buildings by public authorities* (OJ C 209, 10/07/1997, p0003-0005 – 31997Y0710 and extended to EFTA countries by *EFTA Surveillance Authority Decision No 275/99/COL of 17 November 1999 introducing guidelines on State aid elements in sales of land and buildings by public authorities and amending for the 20<sup>th</sup> time the Procedural and Substantive Rules in the field of State aid.*)

**4.2.2.** Under these 1997 Rules, the valuer is to be

“a person of good repute who:

- has obtained an appropriate degree at a recognized centre of learning or an equivalent academic qualification,
- has suitable experience and is competent in valuing land and buildings in the location and of the category of the asset.

If in any Member State there are not appropriate established academic qualifications, the asset valuer should be a member of a recognized professional body concerned with the valuation of land and buildings and either:

- be appointed by the courts or an authority of equivalent status,
- have as a minimum a recognized certificate of secondary education and sufficient level of training with at least three years post-qualification practical experience in, and with knowledge of, valuing land and buildings in that particular locality.

The valuer should be independent in the carrying out of his tasks, i.e. public authorities should not be entitled to issue orders as regards the result of the valuation. State valuation offices and public officers or employees are to be regarded as independent provided that undue influence on their findings is effectively excluded.”

*State Aid Communication II.2.(a)*

**4.3. National Legislation** - Several European states have specific certification systems to qualify valuers under national legislation or regulation. European Standard EN45013, the European Standard for Bodies operating Certification of Personnel, was issued in 1990. The European Accreditation’s Multilateral Recognition Agreement assists the mutual recognition of qualifi-

cations. For a qualification to be approved under this standard it must require training, compliance with professional ethics, monitoring of compliance with standards and periodic re-certification. In 2006, EN45013 became a world standard, ISO/IEC 17024.

**4.4. Recognised European Valuer (REV)** - TEGoVA has developed the Recognised European Valuer (REV) scheme to enable individual valuers, through their professional associations, to have an enhanced status, over and above TEGoVA's Minimum Educational Requirements, to assure clients, especially from other countries, of their valuation expertise. The requirements for REV are set out on the TEGoVA website.

**4.5. TEGoVA's Minimum Educational Requirements (MER)** - As part of its education strategy of supporting standards of professional competence, TEGoVA sets Minimum Educational Requirements (MER) for its Member Associations to require of their qualified members so that they apply to every valuer elected to practice after 1 January 2003. The TEGoVA requirements are set out in detail on the TEGoVA website. Many member associations demand more stringent qualifications.

**4.6. Continuing Professional Development** - The qualified valuer should maintain that expertise by keeping up to date with all relevant developments, whether legislative, technical or otherwise, affecting instructions to be undertaken so that he continues to have the commercial and professional expertise for the construction and provision of valuations.

## 5. Commentary

**5.1. General** - Valuers must ensure that they meet the requirements of the instruction with professional standards of knowledge, competence and independence. It follows that a valuer who is asked to undertake an instruction must make initial enquiries of the client as to the nature of the instruction and purpose of the valuation. The valuer must be able to meet both the requirements of the client and the rules, legislation and codes of conduct relevant to the task.

## **5.2. Conflicts of Interest**

**5.2.1.** The requirements of the valuer in terms of professional objectivity mean that he must be aware of anything that could be perceived as a conflict of interest. In his initial inquiries he should ask the client to identify any other interested or connected parties so as to establish whether there is a possible conflict of interest for the valuer, the valuer's partners, co-directors or close family.

**5.2.2.** If such a conflict exists, then this should be disclosed in writing to the client who may then choose whether or not to confirm the appointment, subject to a clear statement of the circumstances in any Certificate or Report that is produced by the valuer.

**5.2.3.** There may be circumstances where the valuer, despite the client's wishes, will still decline to accept the instructions.

## **5.3. Independence of the Valuer**

**5.3.1.** While the valuer must always be objective and professional in his appraisal and assessment of value, in many cases it will be necessary and professional for the valuer (and where appropriate any valuation company) to show that he is independent of any party interested in the outcome of the valuation. Any such connection, other potential conflict of interest or other threat to the valuer's independence and objectivity, should be disclosed in writing to the client and recorded in the valuation report.

**5.3.2.** Where joint valuers are appointed they are subject to the same requirements individually and severally as regards independence and objectivity, as set out above.

**5.3.3.** There are various circumstances where the relationship with the client or another party makes it imperative that the valuer be, and be seen to be, not only competent to act, but also independent, and without any undisclosed potential conflicts of interest which are actual or possible and which can be foreseen at the time when the instructions are accepted.

**5.3.4.** Where a country has national rules on objectivity and independence, they must also be complied with and referred to in the Report.

**5.3.5. EU Definitions** - *Directive 2006/48/EC*, in considering the monitoring of the values of property used as collateral for credit institutions, defines an "independent valuer" at Annexe VIII, Part 2, 1.4, paragraph 8(b) as:

"a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process."

**5.3.6.** The 1997 State Aid rules provide that "The valuer should be independent in the carrying out of his tasks" (for the full text see 4.2.2 above).

## **5.4. The Valuer's Liability**

**5.4.1.** The valuer has been instructed to undertake a professional task, advising as to the value of property, on which the client can expect to rely in taking decisions. Thus, the valuer's role is one that carries liability and any deficiency may result in loss to the client and legal action against the valuer.

**5.4.2.** According to the circumstances and the national legal system, that liability may arise where loss follows a failure to apply skill and care, breach of the contract or otherwise.

**5.4.3.** The extent of that liability may be defined by the written instructions and the terms of engagement as well as by the drafting of and qualifications in the valuation report.

**5.4.4.** The valuer may seek to limit his liability in the terms of his contract with the client. Unless it is clear that a third party needs to have access to the report (for example, if the property is to be used as security), its use could be limited to the client and liability to third parties expressly excluded.

**5.4.5.** However, in a number of countries there are strict limits, statutory or otherwise, to the limitation of liability and, before attempting to draft clauses which are intended to do this, valuers are advised to take legal advice as to the likely effect of any limiting clauses.

**5.4.6.** As a professional, the valuer's fundamental duty is to his client. Any limitations on his liability should not be at the expense of the professionalism of the valuation.

**5.4.7.** The valuer should undertake tasks within his competence and fulfil them professionally within his instructions, appraising the property and seeking out all relevant evidence before determining the value, maintaining sound records while doing so, and reporting in a professional way.

**5.4.8. *Recognise Limits on Expertise*** - The valuer should not accept instructions outside his expertise. In more complex cases, the valuer may, on occasion, lack specific necessary specialist expertise for the proper completion of the instruction. This may, for example, concern geology, environmental issues, minerals, accountancy or a legal point. In these circumstances, the valuer must advise the client and seek specialist professional assistance to complete the assignment. To avoid confusion as to responsibilities and potential issues of contractual liability, valuers are advised that the client should, wherever possible, instruct the expert directly, rather than the valuer instructing the expert.

**5.4.9. *Professional Indemnity Insurance*** - As the level of liability for the valuer that could arise out of a valuation (together with any costs of associated legal action or interest accruing over the period of a dispute) may often be greater than the valuer's personal or corporate assets, professional indemnity insurance is available in many countries. Recognising that such cover is an assurance to the client, many professional associations make the maintenance of appropriate cover a condition of qualified membership. However, it is not universally available or required in all countries in which it is available.

# **EVS4**

## **THE VALUATION PROCESS**

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7. Valuation Reviews

### **EUROPEAN VALUATION STANDARD 4**

*The terms of engagement and the basis on which the valuation will be undertaken must be set out in writing before the valuation is reported.*

*The valuation must be researched, prepared and presented in writing to a professional standard.*

## 1. Introduction

A valuation must be professionally prepared with the property appraised and all available evidence considered so that the result can be sustained under challenge.

## 2. Scope

This Standard considers the procedural steps followed in preparing the Valuation Report – starting with terms of engagement. It continues with the appraisal and inspection of the property and then reviews the Valuation Report. Finally, it discusses what may be considered when instructed to review an existing valuation.

## 3. Terms of Engagement

Detailed terms of engagement covering valuation assumptions, responsibilities of the valuer, and the fee basis should be recorded in writing. Terms must be agreed before the work is undertaken for the instructing client for valuation and advice to lenders and other parties to other financial or receivership processes. If matters arise after the engagement, they must also be recorded in writing to avoid misunderstandings and consequential dispute.

## 4. Liaison with Client's Advisers, Auditors and Others

The valuer may need to liaise with the client's other advisers to secure necessary information. Where the valuation is required for inclusion in financial statements, it will be important to liaise closely with the auditors to ensure that the work undertaken is what is required, and ensuring consistency and the use of appropriate bases of value.

## 5. Commentary

**5.1.** Valuers have an absolute responsibility to ensure:

- (i) that they are, and can be seen to be, competent, qualified and not debarred by reason of any actual, potential or perceived conflicts of

- interest or have otherwise declared, and taken steps to remedy, any real or apparent deficiency so that they may carry out the proposed assignment;
- (ii) that their appointment is clearly set out in unambiguous wording, covering all heads of terms that are relevant to the instruction and corresponding to the client's needs and the requirements of statute, regulation, deemed fiduciary responsibility and professional ethics. The appointment should be explicitly agreed by both parties prior to acceptance of new or repeated instructions; and
  - (iii) that any departure from the Standards that is required by the client is unambiguously expressed in the letter of instruction and the Valuation Report. Additionally, it is important to ensure that any such departure is not likely to mislead or confuse the user of the Report because of the qualifications imposed or assumptions made.

**5.2.** The valuer should establish the client's needs and requirements with precision as a matter of good business practice. Unambiguous written conditions of engagement may also be very important in any subsequent review or dispute.

**5.3.** Unexpected events such as legal disputes may occur many years after the original valuation instructions have been completed. The historic context and reasoning behind any special terms and conditions may then be difficult to recall unless they were contemporaneously recorded in writing. Such a record will also show if the valuation has been used for purposes other than that for which it was prepared.

**5.4.** Apart from the benefits to the valuer of a clear and concise record which has been prepared and agreed in advance of the assignment, it also ensures that the client and the client's professional advisers know what to expect and are able to judge whether what they receive is what they wanted and expected.

**5.5. Sub-Contracted Valuations** - Prior approval must be obtained from the client where work is sub-contracted to other specialist valuers or where substantial third party professional assistance is necessary. This approval must be recorded in writing from the client and disclosed in the Valuation Report.

**5.6. Valuations Passed to a Third Party** - There is a risk that valuations prepared for one purpose may be passed to a third party and used for another

unrelated purpose. The conditions of engagement must therefore exclude all third party liability and must specify the restricted nature of the valuation which is for the sole purpose of the client.

**5.7. Valuations which are Inconsistent with the Standards** - Where a valuer is asked to carry out a valuation on a basis that is inconsistent with, or in contravention of, the Standards, the valuer must advise the client at the beginning of the assignment that the Report will be qualified to reflect the departure from the Standards.

**5.8. Valuations Carried Out with Limited Information or Where Special Assumptions are Necessary** - A situation may arise where there is limited information, inadequate opportunity to inspect the property, or restricted time available to the valuer. In some cases the Report may be required for the internal purposes of the management, in others the Report may be required in relation to a takeover or merger where time is of the essence. In such cases, the valuer must ensure that the Report will not be published by agreeing this at the beginning of the assignment.

**5.9.** A valuer may need to make special assumptions or be required to value on the basis of special assumptions by the client. Such situations could include:

- vacant possession when the property is tenanted;
- to value on the basis of an assumed planning consent which differs from the actual consent;
- assumptions to provide a basis for the valuation of fire damaged property;
- special assumptions when valuing trading property.

In such circumstances it is essential that the conditions of engagement state clearly that the Valuation Report, and any publication based on it, will set out in clear terms the instructions relating to the valuation, the purpose and context of the valuation, the extent to which enquiries have been restricted, the assumptions that have been made, the dependence that has been placed on the accuracy of the sources of information used, the opinion that the valuation represents and the extent of non-compliance with the Standards.

**5.10.** Exceptionally, it may be appropriate and expedient to sanction publication of valuations containing appropriate qualifications in instances where the limited circumstances set out below apply:

- (i) the valuer has already inspected the subject property and is familiar with it and with the market and the locality; or

- (ii) the valuer has received sufficient detailed supplementary information from management and/or Internal Valuers to the undertaking, to make up for the deficiency in the valuer's own enquiries.

## 6. Supporting the Valuation

**6.1.** A professional valuation relies on the valuer appraising the subject property in its context, researching and verifying all matters with a bearing on the value of the property. The quality of the valuation will, in part, rely on the quality of the information used to prepare it and so the valuer will need to verify any sources and the date of that information. Market conditions relevant to the subject property should also be reviewed as, where soundly appraised, these form part of the basis on which decisions may be made.

**6.2. Property Inspection** - As part of obtaining a personal knowledge of the subject property, the valuer should make his own visual inspection of it. This will usually include the interior of the buildings, the locality and the environment to record all matters which appear relevant to the value of the property. Exceptionally, if instructed or agreed by the client, there may be a more limited inspection or the valuer may be authorised to rely on an inspection report prepared by a third party but, in each case, this should then be recorded in the valuation report. A valuation relying on a third party inspection carries risks as to the quality of that inspection and the interpretation that the valuer has made of it. The valuer should draw attention to the fact that his conclusion may have been different if he had made a personal and proper inspection.

**6.3.** The nature of the on-site inspection will depend upon the property and national legislation, custom and practice, but the valuer should record the main characteristics of the property which affect the value.

**6.4.** The nature and scale of the property inspection(s) will depend on the purpose of the valuation and the basis agreed with the client. There may be circumstances, such as the provision of a portfolio valuation, where it is appropriate to restrict the inspection(s), for example, to the exterior and locality only or a desk valuation. If an inspection has not been made, or it was not carried out in a proper way to gather all necessary information, this fact and the reason for the restriction must be recorded in the valuation report or certificate as factors which could significantly affect the property's value may not have been identified.

**6.5.** Consideration should also be given to establishing relevant financial, legal and regulatory points regarding the property, including Energy Performance Certificates required by *Directive 2002/91/EC of 16 December 2002 on the energy performance of buildings* and other factors arising under environmental regulation.

**6.6.** Having inspected the property, valuers should seek out and consider available comparables (for sale or for rent as appropriate) and analyse them on a common basis as to evidence of prices and/or yields.

**6.7.** Where the valuer is aware of market uncertainty, volatility or other issues putting the value at risk, these should be considered and reported in the assessment.

## 7. Valuation Reviews

**7.1.** A valuer may be asked to review a valuation prepared by another valuer for a variety of reasons which may concern potential litigation or relate to other sensitive issues. In some instances these may be retrospective valuations. As a result the valuer will need to exercise special care before agreeing to undertake a review of another valuer's work. There are, however, circumstances where such a review can give confidence or remove or reduce doubt.

**7.2.** Circumstances where the valuer may be involved in such a review include:

- where the valuation is to support a valuation carried out internally,
- where the valuer is seeking to co-ordinate the work of teams of independent valuers, and
- where a representative sample of properties provides a check as to the overall accuracy of the valuation.

**7.3.** The instructions to the reviewing valuer may vary from a need for general comments on methodology and compliance with standards to a specific and thorough review of an individual valuation.

**7.4.** On occasion, a valuer may be required to review a valuation carried out by management, a valuation internal to the client or another party, or to carry out a revaluation of properties already known to the valuer. In such cases, the valuer must set out in writing, in advance and by mutual agreement, the

conditions of engagement, the limitations imposed and the resulting nature of the qualification to the Valuation Report. It is normally advisable for the valuer to discuss the case with the original valuer though this may sometimes not be possible, for example, in litigation. The reviewing valuer should clarify with the client, in the conditions of engagement, whether or not he may do so. It must be made clear in the Report whether or not discussions with the original valuer have taken place.

**7.5.** A Valuation Report for such a review may sometimes be limited to comments on the appropriateness of the basis adopted or, following a sample valuation of a representative cross section, to a more general statement as to the overall accuracy of the aggregate valuation or whether European Valuation Standards have been observed.

**7.6.** The reviewing valuer should be in possession of (at least) all the facts and information relevant to the valuation date on which the first valuer relied. As with an initial valuation, it will be more robustly supported if he has carried out a personal inspection and made all proper inquiries. If he does not have this information then, while his views may be of use to the client, any such limitation should be noted and the resulting views should not be disseminated further (unless required by a dispute resolution process). Critical comments that are not properly justified could be defamatory.

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# **EVS5**

## **REPORTING THE VALUATION**

### **CONTENTS**

1. Introduction
2. Scope
3. Valuation Reporting
4. Valuation Report or Certificate
5. Contents of the Valuation Report

### **EUROPEAN VALUATION STANDARD 5**

*The valuation must be presented in clear written form to a professional standard, transparent as to the instruction, purpose, basis, method, conclusion and prospective use of the valuation.*

## 1. Introduction

The valuation, as determined by the valuer, must be clearly and effectively conveyed to the client. The Valuation Report will be the document on which the client will rely in taking decisions, making it important that it be exact both as to what it says and as to the qualifications to which it is subject.

## 2. Scope

This Standard reviews the Valuation Report in which the valuer advises the client of the value determined.

## 3. Valuation Reporting

**3.1.** Having defined both Market Value and Mortgage Lending Value, *Directive 2006/48/EC* provides in the next sentence of the same paragraphs that:

“The market value shall be documented in a transparent and clear manner.”

and

“The mortgage lending value shall be documented in a transparent and clear manner.”

**3.2.** A valuation must provide a clear and unequivocal opinion as to value with sufficient detail to ensure all matters agreed with the client in the terms and conditions of engagement and all other key areas are covered and that no misunderstanding of the real situation of the property can be construed.

**3.3.** A valuation report must be in writing, prepared and presented in a reliable and comprehensible manner for the users and clients. This is as required by the definition of Market Value in EVS1 and is appropriate to all other bases of valuation, giving certainty between valuer and client.

**3.4.** The valuer should set out the instruction, the valuer’s qualifications, relevant details of the property, any assumptions that have been made, any limitations on the report and the conclusion as to value.

**3.5.** Where the market for the property being valued is affected by uncertainty and this is relevant to the valuation, the valuer should proceed with caution and comment on the issue to the client.

**3.6.** The valuer may wish to consider and state the period after which the valuation will be deemed to have expired. This may be particularly important in times when values are volatile. This may be specified by national legislation in some countries or by the requirements of the contract.

## 4. Valuation Report or Certificate

**4.1.** The Valuation Report should record the instructions for the assignment, the basis and purpose of the valuation and the results of the analysis that led to the opinion of value, including, where appropriate, details of comparables used. It may also explain the analytical processes undertaken in carrying out the valuation, and present the supporting information.

**4.2.** The Valuation Certificate may be incorporated into the Valuation Report and can provide the valuer's summary conclusion of value. Exceptionally, in countries where legislation or practice determines that a valuer must certify the amount of the valuation of the property, it is usually a short letter and will include:

- the client's name and address
- details of the property
- the valuation date
- the purpose of the instruction
- the date of the Certificate
- any assumptions upon which the valuation is based
- the name, address and qualifications of the valuer.

**4.3.** The Report or Certificate must not be ambiguous, must not mislead the reader in any way nor create a false impression. For this and other reasons it needs to be written in terms which a person with no knowledge of the property or of valuations can understand.

**4.4.** The Report or Certificate must be objective. The valuer must ensure that no conflict of interest exists. The valuer must not be influenced by pressure brought by the client or a third party to produce a particular result in terms of the valuation or any other associated advice. In appropriate cases the valuer must refuse to act where his reputation for objectivity is likely to be put at risk.

**4.5.** The form and detail of the Report or Certificate used will be a matter for the valuer's discretion, but must meet the specific instructions from the

client to the valuer and have regard to the purpose of the valuation and the use that the client proposes to make of the valuation.

**4.6. Draft Reports** - There may be circumstances where it is appropriate to provide an advance draft of a valuation or an update in abbreviated form that does not comply with this European Valuation Standard. In such cases the existence of, and reference to, a future detailed Report or an earlier comprehensive Certificate must be made.

## 5. Contents of the Valuation Report

**5.1.** The Valuation Report should include:

- a description of the property, including a note as to the basis on which areas have been measured
- a summary of the legal context (tenure, tenancies, development control, etc)
- a commentary on the market for the property
- a description of the valuation methodology and analysis.

**5.2.** It is recommended that all valuations should include a statement to the effect that the Qualified Valuer responsible for the valuation to the client has conformed to the requirements of these European Valuation Standards and, exceptionally, the extent and reasons for any departure or why any key part of the valuation process has been omitted.

**5.3.** The Valuer should confirm whether in undertaking the instruction he has become aware of matters that could affect the figures reported. Such matters might include potential contamination on or nearby the subject property, the presence of deleterious materials or title.

**5.4. Value Added Tax** - Where relevant, the valuation should identify the rate of VAT, if any, which applies in the country to the property as at the valuation date. It should state that any VAT that may be due on any transaction in the property will be in addition to the valuation reported.

## **PART 2**

# **EUROPEAN VALUATION APPLICATIONS**

**EVA1 - Valuation for the Purpose of Financial Reporting**

**EVA2 - Valuation for Lending Purposes**

**EVA3 - Property Valuation for Securitisation Purposes**

**EVA4 - Assessment of Insurable Value**

**EVA5 - Application of Investment Value (Worth) for Individual Investors**

# **EVA1**

## **VALUATION FOR THE PURPOSE OF FINANCIAL REPORTING**

### **CONTENTS**

- 1. Introduction**
- 2. Framework for the Preparation and Presentation of Financial Statements**
- 3. Classification of Assets**
- 4. The Selection of Consistent Bases of Valuation**
- 5. Fair Value**
- 6. Apportionment between Land and Buildings**
- 7. Disclosure Provisions**

## 1. Introduction

**1.1.** In order to achieve consistency and comparability of financial reporting, the EU has, over a period of more than 25 years, developed a set of accounting rules laid down in *Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings.*

**1.2.** *Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002* requires publicly quoted companies governed by the law of a Member State to prepare their consolidated accounts for each financial year starting on or after 1 January 2005 in conformity with the International Accounting Standards as adopted by the European Commission. International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) were developed by the International Accounting Standards Committee (IASC, until April 2001) and the International Accounting Standards Board (IASB, since April 2001) in the public interest to provide a single set of high quality, consistent and uniform accounting standards.

**1.3.** The EU has since introduced most of the International Accounting Standards/International Financial Reporting Standards through *Commission Regulation (EC) No. 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) 1606/2002.*

**1.4.** The IAS/IFRS applicable to property or property-related assets are:

- IFRS 6: Exploration for and Evaluation of Mineral Resources
- IAS 2: Inventories
- IAS 11: Construction Contracts
- IAS 16: Property, Plant and Equipment
- IAS 17: Leases
- IAS 40: Investment Property
- IAS 41: Agriculture

**1.5.** The EU had not sought to provide separate European Accounting Standards for the valuation of real estate, preferring instead to support the adoption of, or consistency with, International Accounting Standards.

**1.6.** Valuers undertaking valuations prepared for the purpose of financial statements must, in consultation with the directors and the auditor of the client

company, take account of EU Directives, national law and regulation, national and international accounting standards, the strategy of the undertaking, and the operational purpose and resultant classification of the subject property.

## **2. Framework for the Preparation and Presentation of Financial Statements** (extract from IASB technical summaries)

**2.1.** The following “*Framework*” as adopted by the IASB in April 2001 sets out the concept underlying the preparation of financial statements. Valuers undertaking valuations for the purpose of financial statements must understand this concept.

**2.2.** *The objective of financial statements* is to provide information about the financial position, performance and changes in the financial position of an entity that is useful to a wide range of users in making economic decisions. Financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future.

**2.3.** *Qualitative characteristics* determine the usefulness of information in financial statements. They are understandability, relevance, reliability and comparability.

**2.4.** *Recognition and measurement of assets.* The elements directly related to the measurement of a financial position are assets, liabilities and equity:

- (i) An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- (ii) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- (iii) Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular base of measurement.

### 3. Classification of Assets

**3.1.** The classification of assets affects both the basis of valuation and the presentation of valuation reports. Land and buildings are normally classified for the purpose of financial statements into one of five categories:

- (i) owner-occupied for the purpose of the business, whether specialised or general;
- (ii) investment for the purpose of generating income or capital gain;
- (iii) surplus to the requirements of the business;
- (iv) trading stock, designated as current assets; and
- (v) leases.

**3.2 Property, Plant and Equipment** - IAS 16 defines these as “tangible items that are held for use in the production or supply of goods or services, for rental to others or for administrative purposes and are expected to be used during more than one period.”. IAS 16 applies to **owner-occupied properties** which are defined by the commentary to IAS 40 as 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.

**3.3. Investment Properties** - IAS 40 defines these as “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:

- use in the production or supply of goods or services or for administrative purposes, or
- sale in the ordinary course of business.”

Investment property shall be recognised as an asset when

- it is probable that the future economic benefits that are associated with the investment property will flow to the entity, and
- the cost of the investment property can be measured reliably.

**3.4. Property Surplus to Operational Requirements** - This is land with or without buildings which is surplus to the foreseeable future operational uses of the undertaking, and will normally be held for sale.

**3.5. Trading Stock** - Certain property may have been purchased for trading purposes and be classified not as fixed assets, but as current assets for balance sheet purposes.

**3.6. Leases** - The objective of IAS 17 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

**3.7.** A lease is classified as a *finance lease* if it transfers substantially all the risks and rewards relevant to ownership. All other leases are classified as *operating leases*. A lease must be classified at its inception (IAS 17.4). Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the lease. Where, for example, the lease contract transfers the ownership of the property to the lessee by the end of the lease term or stipulates a purchase option in favour of the lessee at a price which is expected to be lower than fair value at the date the option becomes exercisable, this would normally lead to a lease being classified as a finance lease.

**3.8.** In a lease of land and buildings, land and building elements would normally be separated for these purposes. Lease payments are allocated between land and building elements in proportion to their relative fair values. The land element is normally classified as an operating lease, the buildings element is classified as an operating or finance lease by applying the classification criteria in IAS 17 (IAS 17.15).

## 4. The Selection of Consistent Bases of Valuation

**4.1.** International Accounting Standards currently adopt two models for the recognition of property assets in the balance sheet:

- the Cost Model: after recognition as an asset, "an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses" (IAS 16 par. 28), and
- the Fair Value Model relying on the price at which the property could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (IAS 40).

**4.2.** The three most relevant International Accounting Standards applicable to property valuation for accounting purposes are IAS 16 (owner occupied property, plant and equipment), IAS 17 (leases) and IAS 40 (investment property). The following commentary will focus on these three Standards.

### **4.3. IAS 16 - Property, Plant and Equipment**

**4.3.1. Measurement at recognition** - An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost. This cost is the cash price of the item equivalent at the recognition date and includes its purchase price, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

**4.3.2. Measurement after recognition** - An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

**4.3.3.** The revaluation model specifies that “any item of property, plant and equipment whose fair value can be measured reliably shall be carried at a re-valued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent impairment losses. Revaluation shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date” (IAS 16 par. 31).

### **4.4. IAS 17 - Leases**

**4.4.1.** At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities at the lower of the Fair Value of the asset and the present value of the minimum lease payments (IAS 17.20). The depreciation policy for assets held under finance leases should be consistent with that of owned assets. If there is no reasonable certainty that the lessee will obtain ownership at the end of the lease, the asset should be depreciated over the shorter of the lease term or the life of the asset (IAS 17.27).

**4.4.2.** For operating leases, the lease payments should be recognised as an expense in the income statement over the lease term on a straight-line basis, unless another systematic basis is more representative of the time pattern of the user's benefit (IAS 17.33).

### **4.5. IAS - 40 Investment Property**

IAS 40 applies to land or buildings held for rental income, capital appreciation or both. Investment property is initially held at cost. Transaction cost shall be

included in the initial measurement. After recognition, investment property is carried either at cost or Fair Value. Where an entity chooses the cost model, it should nevertheless disclose the Fair Value of its investment property.

## 5. Fair Value

**5.1.** Under IAS 16, the commentary as to Fair Value is as follows:

- “The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers.” (IAS 16 par. 32)
- “If there is no market-based evidence for Fair Value because of the specialised nature of the item of property ... and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.” (IAS 16, par. 33).

**5.2.** Under IAS 40, the Fair Value of a property is to reflect market conditions at the balance sheet date (IAS 40, par. 38). The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts (IAS 40, par. 45).

**5.3.** In the absence of current prices in an active market, a valuer is to consider information from a variety of sources, including:

- (i) current prices in an active market for properties of different nature, condition or location (or subject to different lease terms or other contracts), adjusted to reflect those differences;
- (ii) recent prices of similar properties in less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and
- (iii) discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows (IAS 40, par. 46).

Costs of sale should not be deducted but can be reported separately.

**5.4.** In common with IVSC, TEGoVA considers that the fair value requirement is, in principle, met by the valuer adopting Market Value (EVS1), but Fair Value and Market Value are not synonymous, particularly in circumstances where Market Value is not readily identifiable.

**5.5. New Fair Value Measurement Guidance.** The International Accounting Standards Board is currently reviewing the Fair Value measurement basis in IAS/IFRS with the aim to increase the consistency in the measurement of Fair Value and to establish a single source of guidance for all fair value measurements required by IFRSs. A *Fair Value Measurement discussion paper* was issued by the IASB in November 2006 addressing the definition of Fair Value, the methods used to measure it, and related disclosure issues. A new definition of Fair Value was offered for public consultation:

“Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

The *discussion paper* raises the question whether an exit price would be more appropriate to measure the fair value of an asset, because it embodies current expectations about the future inflows associated with the asset from the perspective of market participants. This is within a wider context that Fair Value is to be a market-based assessment and not based on the perspective of the entity concerned.

**5.6.** A discussion paper also describes a three-fold hierarchy for the quality of evidence used in assessing Fair Value with:

- the highest ranking, Level 1, given to quoted prices in active markets for identical assets or liabilities which do not need adjustment;
- Level 2 as observable prices in active markets for similar assets or liabilities, in inactive markets for identical or similar assets or liabilities, other observable evidence for the asset or liability itself and other corrections which are all to be adjusted as appropriate; and
- the lowest ranking Level 3 where prices cannot be observed, either directly or indirectly, in a market which may be used if evidence from Levels 1 and 2 is not available.

**5.7.** The discussion paper will be followed by an Exposure Draft of an IFRS on Fair Value Measurement in the first half of 2009. The introduction of such

an IFRS is expected for 2010. Until that review is completed, TEGoVA's advice regarding the valuation of assets for financial reporting is to follow the present guidance in EVS.

## 6. Apportionment between Land and Buildings

**6.1.** An apportionment may be required to allow a proper accounting to be made for depreciation, and thus for the purpose of the preparation of financial statements. This technical task should be distinguished from valuation. EU Directives and international and national accounting standards all require an apportionment for depreciation purposes.

**6.2.** Depreciation is defined as the measure of the wearing out, consumption or other loss of value of a fixed asset whether from use, passage of time or obsolescence arising from technological or market changes. Depreciation of buildings and, to a more limited extent, land is typically allocated so as to charge a fair proportion to each accounting period of the estimated amount of the asset consumed during the expected economic life of the asset. This necessitates an assessment to be made of the useful economic life to the business of the buildings and of their value or cost apportionment, known as the depreciable amount.

**6.3.** The exercise therefore involves the assessment of the depreciable amount, the residual amount or land element, and the remaining useful economic life. The responsibility for the assessment falls on the directors (or their equivalents in other organisations) who will normally consult with their valuers and other advisers.

**6.4.** The apportionment to assess the depreciable amount must be established by one of the following procedures:

- (i) deducting from the cost or valuation of the asset the value of the land for its existing use at the relevant date. In many instances there will be ample evidence of land values on which notional apportionment can be made. In cases where this does not apply, method (ii) should be adopted;
- (ii) making an assessment of the net current replacement cost of the buildings to reflect the value of the assets to the business at the date of valuation.

Once one of these approaches is adopted, it should be followed consistently in successive accounting periods.

**6.5.** The land element is considered to be the bare land which is in a developable state for the purpose of the undertaking. It excludes all improvements such as roads, fences, paved areas and other site works which are incorporated in the building element and have to be depreciated.

## **7. Disclosure Provisions**

**7.1.** Valuations for the purpose of financial statements must be clearly presented and contain at least the following information:

- (i) the instructions, date and purpose of the valuation;
- (ii) the basis of the valuation, including type and definition of value;
- (iii) tenure of the property and its classification as an asset;
- (iv) identification of the property and its location;
- (v) date and extent of the inspection;
- (vi) regulatory framework;
- (vii) any special assumptions and limiting conditions;
- (viii) plant, machinery and equipment;
- (ix) compliance statement with European Valuation Standards;
- (x) methods of valuation employed; and
- (xi) other matters relevant to the valuation.

More detail on the contents of the Valuation Report is contained in EVS5.

# **EVA2**

## **VALUATION FOR LENDING PURPOSES**

### **CONTENTS**

- 1. Introduction**
- 2. Commentary on Land and Property Categories**
- 3. Usual Bases of Value**
- 4. Application of Mortgage Lending Value**
- 5. Responsibilities and Obligations of the Valuer**
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## 1. Introduction

**1.1.** EVA2 applies to all circumstances in which valuers are required to advise or report to institutions and others lending money on the basis of property valuations and where the objective of the valuation relates to loans, mortgages or debentures.

**1.2.** EVA2 applies to valuations prepared prior to, and in contemplation of, a new loan, a renewal or an additional loan. It also applies in analogous cases where a secured lender is considering whether to repossess or appoint a receiver in case of default and/or instructions on disposal of a property are being formulated.

**1.3.** Lending institutions rely on sound valuations not simply for obvious reasons of commercial prudence in lending but also under the rules following the Basel II agreement governing their credit structures (as applied to credit institutions in the EU by *Directive 2006/48/EC*).

**1.4.** These two factors mean that the valuation of property for lending purposes carries a high degree of fiduciary responsibility. It must take account of, among other factors:

- the purpose of valuation;
- the basis required by the client;
- the objective assessment of risk linked to the structure of the loan;
- the duration of the proposed loan facility; and

be clear in its reporting of valuation data, market context and cash flow.

**1.5.** Where financing arrangements are secured on specific property, valuers are typically asked to prepare the valuation on the basis of Market Value (see EVS1). In some countries an assessment of Mortgage Lending Value (see EVS2) may be required.

## 2. Commentary on Land and Property Categories

**2.1.** The five different categories are:

- (i) investment properties;
- (ii) owner occupied properties;
- (iii) development properties;

- (iv) properties normally valued on the basis of trading potential;
- (v) wasting assets, mineral assets, etc.

Specialised properties are not normally suitable as security for loans other than on a basis that takes account of alternative uses of the property.

**2.2. *Investment Properties*** - Revenue-producing investment properties are valued individually. In the case of a portfolio, the valuation can additionally be carried out and reported as an assessment of the current value of the subject property if it were to be sold as part of an investment portfolio to reflect the market discount or premium applicable. The distinction between the two values must be clearly explained.

**2.3. *Owner Occupied Properties*** - These should be valued on the basis of the Market Value or Mortgage Lending Value, as if vacant and to let or for sale.

**2.4. *Development Properties*** - Where advice is to be given in respect of development land or land and buildings in the course of development, the valuation and appraisal will depend on whether the lender will advance funds only when planning permission has been obtained and whether the lender intends to finance the site purchase or subsequent development. In the latter case, the current estimated value of the development, as proposed to be completed, will be required.

**2.5.** Development properties present a number of problems for valuers, and valuations must always contain a feasibility analysis. The volatility of development values following changes in any of the underlying assumptions of rent, yield, cost and timing must be explained to the lender, as part of the risk assessment. It is advisable to make the methods of valuation explicit, and to ensure that cash flow, discounted cash flow, residual valuations, and assessment by comparison are all, as relevant, shown clearly with appropriate explanatory notes.

**2.6. *Properties normally valued on the basis of their trading potential*** - These could include hotels, public houses and bars, private healthcare facilities, and most types of leisure facilities. They are normally valued on the basis of a careful assessment of the sustainable level of net income derived from accounting data or projections. This will exclude any special goodwill derived from an operator with above average management skills. In such cases, the lender must be made aware of the significant difference in value that will arise

between an operating business unit and one where either:

- the business is closed;
- the inventory is removed;
- licences/certificates, franchise agreements or permits are removed or are in jeopardy;
- the property is vandalised; or
- there are other circumstances that may impair future financial performance.

**2.7.** The valuer should advise on potential future fluctuations in the status of the property as security, and any vulnerability to changes of occupier, fashion, regulatory framework and cultural shifts. In certain cases, an assessment on the basis of Alternative Use Value or Forced Sale Value may be appropriate. Where such operational properties are being developed or redeveloped with borrowed money, the time to obtain all necessary licences and to build up a sustainable level of trade and commercial risks must be assessed, and the lender advised of the dynamics of the industry.

**2.8. *Wasting Assets*** - In some jurisdictions, wasting assets may not be used as security for loans. Where this asset class is permitted as security, special problems are associated with valuation. As a result, mineral producing properties and other wasting assets are not an asset class favoured by lenders. Where a loan is proposed, particular attention needs to be drawn to the duration and financial profile of the loan, including interest and capital repayment dates, as they relate to the life of the wasting asset and the planned programme for its extraction or productive use.

### **3. Usual Bases of Value**

**3.1.** Market Value (MV), as the paramount basis of valuation, has been considered in detail in EVS1 with the definition adopted by TEGoVA and other definitions where provided in EU legislation.

**3.2.** Mortgage Lending Value (MLV) as defined in EU legislation has been considered with a brief commentary in EVS2. Its application is considered in more detail here.

## 4. Application of Mortgage Lending Value

**NB** – This section is based on an explanatory note prepared by the European Mortgage Federation

**4.1.** Mortgage Lending Value has a particular relevance as an approved basis for assessing the collateral value of real property for credit institutions. It should provide an assessment of the *long term sustainable* value of the security, available to guide internal banking decisions in the credit decision process on such matters as loan-to-value ratio, amortisation structure, loan duration, funding or risk management. Mortgage Lending Value is a basis for assessing whether a mortgaged property provides sufficient collateral to secure a loan over a long period. Alternatively, lenders may address this directly by their choice of the appropriate loan-to-value ratio.

**4.2.** Mortgage Lending Value is distinguished from Market Value as it is intended to be an estimate of the value of the property for a long period of time. Market Value is an assessment only as at the valuation date.

**4.3.** There are thus important differences between Market Value and Mortgage Lending Value. Market Value is internationally recognised for the assessment of the value of a property at a given moment in time. It estimates the price that could be obtained for a property at the date of valuation, notwithstanding that this value could alter over time, sometimes very rapidly. In contrast, the intended purpose of Mortgage Lending Value is to provide a long-term, sustainable value as a stable basis for judging the suitability of a property as a security for a mortgage which will continue through potential market fluctuations. As a matter of prudence and recognising the potential for short term market fluctuations, Mortgage Lending Value is likely, in most market conditions, to be below market value but offers a guide to expected underlying long-term trends in the market.

**4.4.** In very stable markets, Mortgage Lending Value may be indistinguishable from Market Value. However, where and when markets are more volatile, a marked differential between Market Value and Mortgage Lending Value may be expected to emerge but there will be no simple, standard or enduring ratio between the two bases.

**4.5.** Mortgage Lending Value can be used as a risk management measure in a number of ways in the context of:

- (i) lending secured by real estate;

- (ii) capital requirements for credit institutions as detailed in the *Capital Requirements Directive*;
- (iii) funding of mortgage loans through covered bonds secured by real estate as the cover assets;
- (iv) the development of capital market products converting real estate and real estate collateral into tradable assets (e.g. mortgage backed securities as discussed in EVA3).

**4.6.** The concept of Mortgage Lending Value is defined by legislation both by the EU (see EVS2 above) and, in some countries, by national law and rules.

**4.7.** The assessment of Mortgage Lending Value can, subject to the type of property and any specific legal, historic or other features of the market where the property is located, follow appropriate use of the three internationally recognised valuation methods on which market value may be assessed:

- sales comparison approach,
- income capitalisation approach,
- cost approach.

**4.8.** Mortgage Lending Value differs from Market Value in that it is not a “spot value” but serves to express prudent expectations as to value over the longer term. This requires a number of steps to exclude short-term market volatility or temporary market trends. The valuer should address the following key issues when determining the Mortgage Lending Value of a property:

- (i) The future marketability and saleability of the property has to be assessed carefully and prudently. The underlying time perspective goes beyond the short-term market and covers a long-term period.
- (ii) The long-term sustainable aspects of the property such as the quality of the location, construction and layout should be considered.
- (iii) The income stream of the property used in this valuation should be no more than the sustainable net rental income that the type of property which is the subject of the valuation usually produces over time in the specific local market, excluding any actual over-rented element and other additional unusual or extraordinary cash flows. This means assessing the sustainable yield on the basis of a judgement of past and current long-term market trends and not taking any uncertain elements of possible future income growth into account.

- (iv) The choice of capitalisation rates is also to be based on long-term market trends and exclude all short-term expectations regarding the return on investment. It should consider the sustainable income-producing capacity of the property, multi-purpose or appropriate alternative uses as well as the future marketability of the property.
- (v) The valuer must fully deduct administration costs and allow for obsolescence, reinvestment, annual maintenance, the risk of voids, a tenant not meeting his obligations and other risks to the rent.
- (vi) Should also be considered: the sustainability of the comparative values through the application of appropriate discounts where necessary if the Mortgage Lending Value is derived using comparables or the depreciated replacement cost approach.
- (vii) Mortgage Lending Value is generally based on the current use of the property. The Mortgage Lending Value should only be calculated on the basis of a better alternative use under certain circumstances, such as where there is a proven intention to renovate or change the use of the property. Essentially speculative or transient uses are excluded.
- (viii) Further requirements, for example, with respect to compliance with national standards, transparency, content and comprehensibility of the valuation, complement the legal framework for the calculation of Mortgage Lending Value.

**4.9.** Some of these principles require further commentary:

- (i) *Future marketability* - The valuer has to identify situations where current values reflect short term demand due to market inefficiencies such as may arise in the development cycle (shortage of supply of a property type followed by over-supply) or where identifiable factors such as consumer taste distort a market so that future marketability is at risk.
- (ii) *Normal and local market conditions* - For some properties, the valuer may need to examine the potential impact of wider economic and social factors. Examples of these might be an analysis of demographics, patterns of wealth, income ratios, employment and socio-cultural spending habits within the catchment area, transport infrastructure, legal and political risk, as well as the cost of finance and the inter-relationship with capital markets, currency fluctuations and estimates of economic growth. There will be a responsibility on valuers to develop or acquire, maintain and use authoritative relevant information as to local trends and sustainable values to underpin their valuations, only discounting that data where

exceptionally warranted by the circumstances of the case. If such information is not available, the valuer has nevertheless to demonstrate that the valuation is based on market data.

- (iii) *Current use* - As it is not uncommon for property to have a higher value in an alternative use, lenders should be made aware of any potential to improve value. However, Mortgage Lending Value is primarily based on the existing use of the property, unless there are special circumstances, such as imminent redevelopment, which may make a valuation on the basis of an alternative use more realistic.
- (iv) *Elimination of speculative elements* - The valuer is required to identify explicitly any current market phenomena which are not sustainable, such as where a rising or falling trend no longer supported by fundamentals is magnified at the end of a cycle.
- (v) *Clear and transparent documentation* - The lender needs to have confidence in the valuation. Thus, transparent and clearly stated valuation methods should be both adopted and expressed clearly in the valuer's report. Only well-recognised valuation methodologies should be used, most commonly the income capitalisation approach (investment method) or the comparative approach. A cost-based approach is frequently used in some jurisdictions, or when limited market information is available. While of assistance to valuers operating in stable markets in which owner-occupiers predominate, this is more appropriately employed as a cross-check rather than a prime valuation method. The need to use a cost approach could indicate a specialist property of a type that is not normally bought and sold and so, potentially, a property which would not be considered suitable for loan (or securitisation) purposes.

**4.10.** The valuer instructed to give the Mortgage Lending Value of a property should also report on its Market Value, and explain carefully the difference in value, if any, that exists. As is clear from the commentary on preparing Mortgage Lending Value, there is no reason to assume that there will be any standard ratio between the two bases - a simple percentage adjustment to derive one from the other will not be appropriate.

## **5. Responsibilities and Obligations of the Valuer**

**5.1.** Valuers advising on matters relating to secured property lending must not undertake such work unless, as a minimum, they can comply with the educational and experience requirements set out in EVS3.

**5.2.** The valuer must be competent to give advice on comparative property and sector-related risks if this is required. It is generally the role of the lender to assess risk as it relates to the financial status of the borrower or in the context of the overall geographical, sector, and client bias. A valuer may, however, be consulted on any of these matters because of his specialist knowledge.

**5.3.** As far as the valuation is concerned, these matters relate to, and depend on, the type of property on which the loan is to be secured, the property's geographical or sector context, client bias and, particularly, on the effects of liquidation procedures in the country in which the property is located.

## **6. Forced Sales and Liquidation Sales**

**6.1.** "Lending institutions may request valuations on a forced, or liquidation, sale basis or impose a time limit for disposal of the security. Because the impact of a constraint on the price obtainable will depend upon the specific circumstances under which the sale takes place, it is not realistic for the valuer to speculate on a price that could be obtained without either knowledge of the reasons for the constraint, or the circumstances under which the property might be offered for sale. An alternative valuation may be provided based on defined assumptions, but the valuer should draw the lender's attention to the fact that this opinion is valid only at the valuation date, and may not be relied upon in the event of future default, when both market conditions and the sale circumstances may be different." (IVS, 2007 pp.140-141)

**6.2.** It should be noted that, as stated in EVS2, such valuations do not meet the definition of Market Value (or that of Mortgage Lending Value).

**6.3.** In any circumstances where a valuer is requested to provide valuations on a basis other than Market Value, the valuer should proceed only if that valuation is not in breach of local laws or regulations and will not otherwise be misleading. Under such circumstances it is customary for valuers to include a Market Value estimate or other appropriate information as to the extent to which a value on an alternative basis may differ from Market Value.

# EVA3

## PROPERTY VALUATION FOR SECURITISATION PURPOSES

### CONTENTS

1. Introduction
2. Scope
3. Definitions
4. Statement of the Application
5. Commentary

**Note** - For further reading see also "European Property and Market Rating: A Valuer's Guide" (TEGoVA, 2003, [www.tegova.org](http://www.tegova.org))

## 1. Introduction

**1.1.** The securitisation of property has become an important source of financial instruments in capital markets and a means for lending institutions and others involved in property to fund themselves. Property securitisation can be defined as the process of converting property-related assets into tradable paper securities by pooling debt or equity interests in real property (such as mortgage loans) into a form that can be sold with the income stream from those interests then assigned to investors. The creator of the asset (typically a lending institution) transfers the interests to a special purpose vehicle (SPV) which then issues securities into the capital markets where they will usually be purchased by financial institutions (such as insurance companies, pension funds or credit institutions).

**1.2.** The creator of the securities benefits from the removal of property-related assets from its balance sheet. This helps to improve its financial ratios, enhance its return on capital and achieve compliance with risk-based capital standards (such as Basel II, *Directive 2006/48/EC* and national regulations).

**1.3.** These securities offer their purchasers a chance to diversify their funding and achieve a better match between the duration of their loans and that of their funding.

**1.4.** Where property-based securities have been created from mortgages (or use them as collateral), investors are principally exposed to changes in:

- the underlying value of properties securing the mortgages, and
- the income from those mortgages.

Investors, therefore, usually rely on externally awarded credit ratings to assess the credit quality, structural integrity and other attributes of a particular security.

**1.5.** As every investment decision is based on the ability of a property to produce revenue over the long term up to the maturity of the security, property valuation is of fundamental importance to property securitisation.

## 2. Scope

**2.1.** This EVA applies to property valuation for the purpose of valuing these securities, whether for those creating them or those who might buy them. It does not address the valuation of the securities themselves. Its prime application is in the context of securities created on the basis of mortgages but the same principles generally apply to other forms of property securitisation. The identification of market and property related risks is crucial. The EVA also applies to revaluations of such properties and to the regular control (monitoring) of the collateral that helps to identify relevant changes in value.

**2.2.** Valuations relevant to REITs, property trusts and property unit trusts are considered in *EVA1, Valuation for the Purpose of Financial Reporting, and EVA5 Application of Investment Value (Worth) for Individual Investors*.

**2.3.** The assessment of other risks relating to the assets, such as debt service coverage and credit quality of the borrower, are not the subject of a valuer's work and are therefore not considered by this EVA.

## 3. Definitions

**3.1.** *Property Securitisation* is the procedure of creating and marketing financial assets assembled from debt and equity interests in real property that are managed by financial professionals and quoted in the securities markets.

**3.2.** *Property-Related Asset-Backed Securities (PRABSs)* are investment instruments backed by pools of cash flow-generating assets and sold to a bankruptcy-remote special purpose vehicle (SPV). Such instruments may be either mortgage-backed securities (MBS) or property-backed securities where the asset is the property itself. Some instruments will combine the two, such as PRABS based on receipts from a property project. There are generally two types of MBS, largely reflecting a division between retail and wholesale portfolios:

- *Residential mortgage backed securities (RMBS)*, based on residential mortgage loans.
- *Commercial mortgage backed securities (CMBS)*, based on commercial mortgage loans.

**3.3.** A *Special Purpose Vehicle (SPV)* is an entity expressly created to acquire and finance specific assets. This is usually established by the institution holding the underlying assets. It may often have a specially designed legal status to make its obligations secure even if the parent company goes bankrupt – where this is done it may be called a “bankruptcy-remote” entity.

**3.4.** *Net Asset Value* is a measure of the aggregate current value of assets, less all liabilities.

**3.5.** A *Sustainable Net Asset Value or Sustainable Asset Value* is sometimes estimated. This represents the sustainable value that an asset may be expected to achieve or maintain over the long term. This concept is used by those creating such securities, rating agencies, investors, and portfolio insurers. It is estimated either by reference to Mortgage Lending Value or by making adjustments to Market Value, depending on the phase in the market cycle and potentially destabilising factors such as market volatility and speculative activity. The estimate should reflect the expected course of the cycle and expectations of volatility and speculation specific to the subject market. As a concept, sustainable net asset value is similar to mortgage lending value.

**3.6.** Market Value is defined in EVS1.

**3.7.** Mortgage Lending Value is defined in EVS2.

**3.8.** A *risk profile*, in this context, is a detailed summary of the risks associated with a property or group of properties being issued as collateral. The main categories of risk can be identified as follows:

- market risks
- property related risks, including those relevant to its location and any proposed development
- fiscal and legal risks
- financial risks.

The valuer’s role will usually only require consideration of the first two risks – those relating to the market and to the property.

## 4. Statement of the Application

**4.1.** Where the valuation will be used to secure a loan on a property or a portfolio of properties intended to back a securitised instrument, this will

normally be on the basis of the *Market Value* of the property. In some jurisdictions, the *Mortgage Lending Value* may also be used.

**4.2.** When undertaking a valuation for securitisation purposes, valuers should focus on the market and property-related risks relevant to the property or properties being mortgaged so that interested parties can understand:

- the Market Value (and/or the Mortgage Lending Value) of the individual properties
- the net asset or sustainable asset values for a portfolio,
- the associated market and property risks, so facilitating the development of mortgage loan portfolios, portfolio ratings and investor decisions.

**4.3.** TEGoVA recommends valuers to undertake their task in two stages: the conventional valuation of the real property, and an assessment of the specific property risk profile. Where a portfolio of properties is being assessed, the valuation and risk assessment should relate to the whole portfolio.

## 5. Commentary

**5.1.** The first step is to consider the individual underlying properties. The valuer should determine the Market Value (and/or the Mortgage Lending Value) at the point when the mortgage is granted on the individual property, following EVA1 and EVA2. If such an assessment was not carried out when that initial mortgage was agreed, this must be done for each property at the point when the mortgage loans are being sold to the special purpose vehicle. Individual credit rating agencies may impose special conditions, which must be factored into the valuation and the advice provided.

**5.2.** The valuer should prepare a *structured risk assessment* (considering both market and property risks) for each property in mortgage loan portfolios at the moment when the relevant mortgages were granted. If this assessment was not carried out at the time when the individual properties were financed, this must be done for the first time at the point when the mortgage loans are being sold to the special purpose vehicle.

**5.3.** Valuations and risk assessments are carried out within the context of the market. Hence, any unusual volatility in the value of the subject properties or in the market for comparable properties should be stated in the valuation

report. In some jurisdictions, identifying such volatility may require the valuation to be reduced.

**5.4.** The *second step*, where a portfolio of properties is being assessed, is to assess the entire portfolio, determining its net asset value and/or the sustainable asset value.

**5.5.** Valuation of portfolios of mortgages on residential properties held by private investors should be undertaken by analysing groups of properties with a similar nature (“cluster analysis”) on the basis of the age of the properties, similar income streams, location or other features. The values of the individual properties within a cluster can be examined by a simplified method (such as a desk-top valuation), taking into account those factors most likely to influence values. If there has not been a previous valuation of the properties, they should be assessed at this stage. The valuations of the individual properties are then summarised as the value of the cluster, for which a risk assessment is also completed. Finally, the values of the individual clusters are used to derive the net asset value for the entire portfolio, which will also be risk-assessed.

**5.6.** Where valuing portfolios of mortgages on residential properties and commercial or mixed-use properties held by commercial or institutional investors, the validity of the market value of the individual properties should be verified on the basis of the initial valuation. If necessary, this may be adjusted to reflect the current market situation and any foreseeable long-term market changes. If market values have not been calculated before, they will have to be estimated at this stage. A risk assessment of the individual properties is also necessary. The net asset value and the risk profile for the entire portfolio are derived from the individual property values.

**5.7.** The same procedures can be used to estimate the *sustainable net asset value* and the Mortgage Lending Value, where applicable.

**5.8.** A lender may require a new valuation if information indicates that the value of the property may have declined materially relative to general market prices.

**5.9.** Valuations or revaluations of real estate serving as collateral for securitised interests are regulated in some jurisdictions. In case of doubt or conflict, national law prevails over this Application.

# **EVA4**

## **ASSESSMENT OF INSURABLE VALUE**

*[EVA4 will be reviewed in 2009]*

### **CONTENTS**

- 1. Introduction**
- 2. Definitions**
- 3. Recommendation**
- 4. Assessment Method**

## 1. Introduction

**1.1.** The purpose of insurance is to protect the insured from loss. The valuations used must assess the extent of that prospective loss if the insurance is to be adequate, normally by reference to reinstatement of the damaged property. As in the case of real property such a loss will usually concern damage to buildings, the valuer must have knowledge of buildings and construction techniques alongside valuation skills.

**1.2.** An assessment of insurable value is described in certain countries as a “Valuation for Insurance Purposes”.

## 2. Definitions

**2.1.** In general, the *Insurable Value* represents the maximum amount of cover agreed with an insurer as its liability in the case of damage stipulated in the insurance contract. This will usually be the cost of reconstruction with site clearance and fees together with – if applicable – additional items required by any relevant regulations.

**2.2.** The basis of assessment will usually be recorded in the insurance contract and is likely to be one of the following:

- (i) *New Replacement Cost (“New for Old”)* - The new replacement cost of the physical structures using the reconstruction costs as at the valuation date – usually the date on which the insurance contract becomes effective. This will be based on the current technical standards for building with fresh materials. Changed building standards may require the replacement structure to be more costly than a simple replacement of the old one.
- (ii) *Indexed New Replacement Cost* - This adjusts the new replacement cost by recognised construction indices. This approach limits the risk of under-insurance caused by increasing construction prices.
- (iii) *Depreciated Replacement Cost* - The depreciated replacement cost corresponds to the new replacement cost but after allowing for ageing and wear and tear of the structure. This cover only allows for the replacement of the building as it is, not for its replacement with a new building.

- (iv) *Cost of Rebuilding Only* - This can be quantified as at either before or immediately after the moment of damage. Even if the insurance contract does not set this basis for the insurable value, it can become relevant if the building has to be demolished or if its value is permanently depreciated by the damage.

**2.3.** Valuations for insurance will usually be applied to a future event as specified in the insurance contract. In preparing a valuation for insurance purposes, the valuer is not likely to know the date or term of the contract and so can usually only provide an opinion of the appropriate reinstatement cost at the date of publication of the valuation. In some cases, the valuer may wish to emphasise that the valuation as prepared may alter should circumstances change or if the insurance contract is not completed within a stated period after the submission of the valuation report. If the client is made aware of this, then the client may judge whether a higher level of cover is required.

**2.4. Definition** - The '*insurable value*' of a property means the sum stated in the insurance contract applying to that property as the liability of the insurer where damage and financial loss are caused to the insured by a risk specified in the insurance contract relating to that property.

**2.5.** The insurer is only liable up to the amount insured. If that cover is less than the cost of replacing the insured property, it is *under-insured* and the insured is not fully restored to the position before the damage. Over-insuring may mean that premiums are being incurred unnecessarily. Additional costs (such as those for site clearance or decontamination) may also be covered.

**2.6. Services** - In addition to the structure of the property, additional features, services and consequential losses can be insured. This depends on the relevant regulations and contracts and may include items such as loss of rent, clearing costs, damage costs, relocation and protection costs, or the costs of fixtures and fittings. Where these have to be assessed by valuers, it will be necessary to examine the contract as well as the regulations to determine what the valuer has to evaluate.

**2.7. Price Increases** - The changing costs of construction over time may lead to under or over insurance. Thus, an allowance should be made for such changes both from the date of insurance and between the damage and the reconstruction.

### 3. Recommendation

**3.1.** The insurable value should correspond to the loss the insured would suffer in the event of destruction, whether of all or just part of the property.

**3.2.** The valuer must carry out an assessment of at least the following points:

- (description of) the property, including its location, site development, services, and access
- (description of) the buildings, including indoor and outdoor facilities (recording their construction and dimensions, fittings and use), supported by a comprehensive photographic record
- where relevant, a description of adjacent property (especially with regard to the buildings and their use)
- use of the property (residential, commercial etc.)
- reference to relevant permissions (land use planning, planning permission, use permission, etc.)
- the condition of the property including an assessment of depreciation due to age and deterioration arising from damage, defects or overdue repairs
- specification of reconstruction costs and forecast necessary additional costs associated with reinstatement
- the position of the insured for VAT (Value Added Tax).

**3.3. Definition of “Insurable Value” as “Reacquisition Value”-** The costs of replacing the building after extensive damage may differ considerably from the ordinary construction costs of a new building. “Reacquisition costs” are the costs of reconstructing a building in the same location after damage. For this reason, the following points have to be considered when determining reacquisition costs (compared to construction costs):

- (i) In the case of damage, there may be no costs for site preparation, provision of services to the site or (subject to the circumstances), for example, foundations.
- (ii) After damage there are likely to be costs of demolition, site clearance, making safe and preparing to rebuild. There may be a need to remove asbestos and other materials subject to regulation.
- (iii) There will be costs associated with improving the energy performance of a qualifying building if, as a result of the fire, there are “major renova-

tions". *Energy Performance of Buildings Directive 2002/91/EC* requires energy performance renovation in the event of "major renovations", defined as "those where the total cost of the renovation related to the building shell and/or energy installations such as heating, hot water supply, air-conditioning, ventilation and lighting is higher than 25% of the value of the building, excluding the value of the land upon which the building is situated, or those where more than 25% of the building shell undergoes renovation" (Art. 6 and Recital 13).

- (iv) In general, the total cost of simultaneous construction of all stages is less than the reconstruction cost of a specific construction stage after damage.
- (v) The costs of installing services may differ.
- (vi) Financing costs may differ. The costs of pre-planning work and drafts may be less if permissions and plans already exist.

## 4. Assessment Method

**4.1.** The Cost Approach (or the Contractor's Method) is used to assess the new replacement cost and the depreciated replacement cost. Other assessment methods are only relevant if there is a need to determine the market or other value for insurance purposes.

**4.2.** Usually the underlying land does not need to be valued unless it is subject to an identified risk covered by the insurance policy (for example, flooding, contamination or a mudslide) in which case the valuer will need to consider it.

**4.3.** When determining the *depreciated replacement cost*, allowance should only be made for the depreciation arising from physical deterioration, but not in this case for functional or economic obsolescence as the object is to replace what may be physically lost. The assessment of depreciated replacement cost depends among other things on the building's age, its expected remaining life, its construction, its use and maintenance.

**4.4.** VAT is only taken into consideration if the insured is not entitled to recover input tax.

# **EVA5**

## **APPLICATION OF INVESTMENT VALUE (WORTH) FOR INDIVIDUAL INVESTORS**

### **CONTENTS**

- 1. Introduction**
- 2. Definitions**
- 3. Commentary**
- 4. Method of Assessment**

## 1. Introduction

EVA5 applies to assessment of the maximum price that an investor might pay to purchase a property, taking account of the benefits the specific investor will receive by holding it and his operational objectives.

## 2. Definitions

**2.1.** All bases of valuation in EVA5 are defined in EVS2 (Valuation Bases Other Than Market Value).

**2.2. *Useful Life of a Property:*** The period during which the property will be capable of effective use for its purpose.

## 3. Commentary

**3.1. Basis of value** - These valuations must be made under the basis of Worth or Investment Value (see EVS2). The valuation report, prepared in accordance with EVS5, must state this and make clear that it is prepared only for that investor (with his requirements and assumptions) and not for the assurance of third parties.

**3.2. Information** - The valuer needs to obtain the following information from the investor:

- any specific characteristics of his enterprise or investment portfolio that will have any influence on the future cash flows generated by the real property that is being valued
- the investor's investment criteria (such as a target rate of return or the duration of the investment)
- lease contracts
- expected budgets for financial performance
- licences
- land register and cadastral documents
- maintenance costs

and, also, usually from others, information as to:

- market data related to the property
- interest rates and expected changes

- potential for disposal of the property
- legal and development control issues affecting the property
- current and prospective inflation

### 3.3. Categories of Property

**3.3.1.** Investment properties can be assessed in three categories:

- (i) properties held as investments for their performance as an asset for generating income and/or capital gains;
- (ii) properties which are in the course of development;
- (iii) properties held for future development.

**3.3.2.** *Properties held as investments* will normally include those where construction work has been completed and which are owned for the purpose of letting, producing a rental income which is negotiated at arm's length with third parties. Sometimes, they may be held to produce an income from its direct use by the investor.

**3.3.3.** *Properties in the course of development* will include properties that have been acquired with vacant possession, with the intention of seeking an early arm's length letting to a third party irrespective of whether works of repair or improvement are required. Apart from properties where work is actually in progress, this category will also include any property where the start of work is imminent, all the appropriate consents and permits have been obtained and a building contract exchanged.

**3.3.4.** *Properties held for future development* will include those acquired with the intention of redevelopment at some future date (with or without any other properties which have not yet been acquired) and which are not in either of the other two categories.

## 4. Method of Assessment

**4.1.** To assess Worth or Investment Value, the valuer would usually use the Discounted Cash Flow method or equivalent techniques. On occasion, the residual method may be appropriate.

**4.2.** Cash flows and costs are to be estimated over the period that the investor is expected to hold the property, taking into account all factors that could affect them. Having assessed the income and costs with the risks for both, during the period when the property is to be held by the investor, the final item in the cash flow will be:

- for buildings held for leasing to third parties or for the investor's own use, the investor's expected receipt on the final sale of the property, or
- if the property is to be held by the investor until the end of its useful life, an assessment of the future market value, less selling costs, of the underlying land at that date where there are sound reasons (rather than unsubstantiated expectation) to suppose that changes in circumstances will lead to a change in its value in the market place, or
- if the property is to be sold by the investor before the end of its useful life, an assessment of its expected market value at the date of the future sale less selling costs.

**4.3.** Where a property is being or will be developed, the valuer will have to form a view as to the dates when permissions will be obtained, construction completed, the property let and the first rents achieved.

**4.4.** The discount rate applied to future income and costs will be that chosen by the investor, reflecting his requirements.

# GLOSSARY

## **Alternative Use Value**

The market value of the property without presuming the continuation of its present use.

## **Asset Value Method** – see **Depreciated Replacement Cost**

## **Basis of Valuation**

A methodology that can be used to implement a basis of value to determine a valuation from the available evidence.

## **Basis of Value**

“A statement of the fundamental measurement principles of a valuation on a specified date” (IVSC, International Valuation Standards 2007, pp. 84 and 337)

## **Depreciated Replacement Cost (DRC)** - in Germany, also known as the **Asset Value method**)

“The current cost of replacing an asset with its modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation.” (IVSC, 2007, pp. 108, 146, 257 and 351)

## **Directive**

EU legislative instrument. It is binding as to the result to be achieved, but leaves to the national authorities the choice of form and methods.

## **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.” (IASB, IAS 16, para 6).

## **Forced Sale Value**

The value that could be obtained for the property where, for whatever reason, the seller is under constraints requiring the disposal of the property.

## **Highest and Best Use**

“The most probable use of property which is physically possible, appropriately justified, legally permissible, financially feasible, and which results in the highest value of the property being valued.” (IVSC, 2007, pp. 28 and 368)

**Insurable Value**

The sum stated in the insurance contract applying to that property as the liability of the insurer where damage and financial loss is caused to the insured by a risk specified in the insurance contract occurring to that property.

**Investment Value (also called Worth)**

“The value of property to a particular investor, or a class of investors, for identified investment or operational objectives. This subjective concept relates specific property to a specific investor, group of investors, or entity with identifiable investment objectives and/or criteria.” (IVSC, 2007, pp. 88 and 377)

**Market Rent**

The estimated amount of rent at which the property should be leased on the date of valuation between a willing lessor and a willing lessee on the terms of the tenancy agreement in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

**Market Value**

The estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

**Marriage Value - see Synergistic Value****Mortgage Lending Value**

The value of the property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the mortgage lending value.

**Regulation**

EU legislative instrument. It is binding in its entirety and directly applicable in all Member States.

**Special Purchaser**

“A purchaser to whom a particular asset has Special Value because of advantages arising from its ownership that would not be available to general purchasers in the market.” (IVSC, 2007, p. 409)

**Special Value**

“An amount above the Market Value that reflects particular attributes of an asset that are only of value to a Special Purchaser.” (IVSC, 2007, p. 88)

**Synergistic Value (also known as Marriage Value)** - “An additional element of value created by the combination of two or more interests where the value of the combined interest is worth more than the sum of the original interests.” (IVSC, 2007, pp. 88 and 414)

**Valuation Date**

The date as at which the value is assessed and so, in principle, on or before the date the valuation report is finalised. It is not the date when the valuation report is signed.

**Worth** - see **Investment Value**

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- BUNDESVERBAND ÖFFENTLICH BESTELLTER UND VEREIDIGTER SOWIE QUALIFIZIERTER SACHVERSTÄNDIGER (BVS)  
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*Association of German Pfandbrief Banks*
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*Association of German Public Sector Banks*

## Greece

- ΣΩΜΑ ΟΡΚΩΤΩΝ ΕΚΤΙΜΗΤΩΝ (ΣΟΕ)  
*Body of Sworn-in Valuers of Greece (SOE)*

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*National Council of Surveyors*
- ASSOCIAZIONE GEOMETRI VALUTATORI ESPERTI (GEOVAL)  
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*Partnership of the Russian Society of Appraisers (PRSA)*
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*Professional Association of Valuation Companies of Spain*
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*General Council of Technical Architects of Spain*

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*Appraisers' Association of Turkey*

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- INSTITUTE OF REVENUES RATING AND VALUATION (IRRV)
- ROYAL INSTITUTION OF CHARTERED SURVEYORS (RICS)

**United States**

- APPRAISAL INSTITUTE (AI)





Market volatility from global banking issues linked to recessionary pressures poses a real challenge for valuers. Addressing this, up-to-date European Valuation Standards help all professionals reach consistent conclusions, assisting confidence in the marketplace.

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