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American Society of Appraisers
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550 W. Van Buren St.
Suite 1000
Chicago, IL 60607

T 312-335-4100
F 312-335-4400
www.appraisalinstitute.org

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International Valuation Standards Committee
12 Great George Street
London SW1P 3AD
United Kingdom

Re: Valuation of Owner-occupied Properties Under International Financial Reporting Standards

Dear Committee Members:

On behalf of the more than 27,000 members of the Appraisal Institute, American Society of Appraisers, and American Society of Farm and Rural Appraisers we thank you for this opportunity to respond to your August 2003 Consultation Paper, as referenced above. We are pleased to respond to what we believe is a most important statement of fundamentals that are of greatest importance in financial reporting to the United States and, we believe, all other countries of the world.

We strongly support the IVSC's activities in the areas of harmonization of valuation standards among all countries, and public disclosure of individual country differences where they may occur. We also support your activities with the International Accounting Standards Board and various other world bodies to increase their knowledge about and reflection of current market values in financial reporting.

We presume that your Paper will be added to IVSC's published materials when complete, and we offer the following comments and recommendations.

General Response to Consultation Paper

It is unclear from the Consultation Paper's ("Paper") objectives whether the Paper is intended for internal use by the IVSC or as a basis for external actions with IASB and/or other bodies. We recommend a fourth objective, "…to seek harmonization of views within valuation societies, and between international accounting and valuation standards, to aid in transparency in financial reporting, to provide another basis for determinations of materiality, and to avoid misunderstanding and misrepresentation in financial reporting."

In keeping with this objective, it appears that the Paper might be divided into separate documents, each with its concomitant objectives. The first document could be developed for consultation for valuers regarding valuation basis (or bases) and the role of depreciated replacement cost (DRC). The second could then be directed to Consultation for the users of valuation services, including IASB and other legislative and/or regulatory bodies. From our reading of the current exposure draft, it appears that corporate or other business users of valuation services, including accountants and other experts, may become confused with the issues concerning what are generally accepted valuation principles (GAVP) for the topics as discussed within the Paper.

Specific Recommendations

1. **Recommendation**: That an IVSC Consultation Paper be prepared on the topic of the use of valuation reports and valuation opinions by clients, accountants, auditors, regulatory agencies, other businesses, and the public at large.

   Discussion: The principal question that is raised by the issues in the draft Paper is, “To accomplish what?” When IASB raises questions of which methods and definitions are to be applied as they relate to valuers, often lost in the discussion is whether the attempt is to harmonize accounting standards with valuation standards, or the reverse. We believe that it is most timely that the questions of applicability and extent of market value reporting in financial statements be aided by IVSC’s research and experience, and that its viewpoints will be of significant assistance in furthering convergence of international and domestic accounting standards and those of the valuation profession.

2. **Recommendation**: That an IVSC Consultation Paper be prepared on the topic of “fair value” as compared and contrasted with “market value” as applied to financial reporting.

   Discussion: The IVSC paper should be a centerpiece in IVSC’s presentation of the relevancy of its standards and the professional work performed by valuers throughout the world. It is a crucial element in establishing why fair value is more subjective than frequently realized or asserted, and that fraud, abuse, lack of transparency, and misunderstanding are fostered when “fair” can be interpreted in many ways even within a common language. In our opinions, this paper should be a full and complete exposition of the value of market value and its superiority as a basis for financial reporting. Although this recommendation could be blended with our first recommendation into a single paper, we believe that a second paper would provide further explanation, and thus mutually reinforce the first.

3. **Recommendation**: That further clarifications be made in IVSC’s discussions of depreciated replacement cost, likely in the form of a Consultation Paper, so that DRC can be more fully understood as a valuation basis and as a “market value” replacement when market value cannot be determinably established and that the use of DRC can be supported under IVSC standards.

   Discussion: The Principle of Substitution provides for a cost approach in estimating market value. Historically DRC has been applied when the development of a market value opinion by other methods is not feasible and when DRC is otherwise qualified for use in financial reporting. There has been valid concern that one may be substituted for the other without proper qualification or foundation. However, this concern may be lessened when the methodology of DRC and the propriety of its application are better articulated in the context of international standards.

4. **Recommendation**: That the issue of “occupied” versus “vacant possession” of property as a premise for valuation be settled within the IVSC rather than allowing the issue to appear unclear and be established as an accounting matter.

   Discussion: The question raised by these diverging concepts may by necessity differ in certain countries because of local laws or conventions. To the extent that such differences must occur, they should be identified by the IVSC as differences from international standards, with appropriate publication. The issue itself is, as explained below, a matter of fundamental economic concepts embodied within the valuation process. To assure that the IVSC’s position is more clearly understood, revisions should be made to existing IVSC published standards and related materials, a separate Consultation Paper should be issued, or both.

Responses to the Paper

1. Do you agree that, in the absence of clearer direction in IAS 16, International Valuation Standards should be followed for the valuation of owner occupied property and for plant and machinery?

   Response: We recommend that IVS be applied for all valuations to be used for financial reporting under international accounting standards. We further recommend that a statement such as the following be prominently displayed as a part of the valuation report: “It is our understanding that ‘fair value’ as defined by international accounting standards is to be reported for the asset(s) valued herein. For this report, ‘fair value’ and ‘market value’ are considered synonymous and we take no responsibility for any other use of our value opinion.” Clearly, accountants must use their interpretations of accounting standards, but we believe that our recommendation will aid in fostering understanding and should help to educate those who do not realize or understand the differences between accounting’s use of “fair value” and the IVS definition of market value.

2. Do you agree that Fair Value means Market Value where there is an evidenced market for that property, or Depreciated Replacement Cost where the property is specialized or where there is no identifiable market?

   Response: Yes, but subject to the following: (a) recognition that “fair value” means “fair value” to accountants and most investment analysts, and that this does not automatically change because we define market value differently; and (b) better clarification of DRC as discussed above.

3. Does the word “surrogate” properly describe the required role of DRC?

   Response: No. The word ‘surrogate’ does not properly describe the required role of DRC. DRC is an alternative basis when market value is infeasible and a property is considered to have a value in the marketplace that cannot be developed through the use of other valuation methods. It is not an “arbitrary” basis that can be used at will, but methods used for DRC may expand beyond “cost of construction” methods when market replacement is considered. A succinct substitute for the quote in numbered paragraph 29 of your Paper might be, “DRC is a recognized valuation basis that may be used in special circumstances when market value as evidenced by market data and processed by the Cost Approach, Sales Comparison Approach, and/or Income Approach is impossible or infeasible, and in such circumstances is to be used as an alternative valuation basis only when international standards applicable to its use are supportably established and reported by the valuer."

4. Do you agree with that definition [of 'specialised properties']?

   Response. No. We do not agree with the definition and we believe it should be rephrased. The term "specialised properties" requires redefinition or better explanation. Houses of worship, public buildings, schools, and single-family dwellings are examples of "specialised" real estate, but each may have significant sales activity. For market value, the issue should not be solely how a property is designed; instead, the question is the extent of its markets and marketability. We urge the substitution of the terms "*limited market*" and *"non-market properties,"* with "specialised" used as a means of describing properties that typify reasons for limitations on a property's marketability. An obsolete factory may have a highest and best use for demolition and reuse of the land, and thereby have many sales that are available for comparison purposes. Note also that "property rights" are what are sold, not just the tangible objects of real estate or chattel items. Real property can be divided into interests that are themselves limited or without a market, even for real estate designed for general and common use.

5. Do you agree with that statement?

   Response: We believe that this caution is appropriate, subject to the above comments.

6. Are you satisfied that there is no contradiction between paragraphs 3.2 and 5.1.1 of the Guidance Note in respect of the treatment of Specialised Properties?

   Response: It appears that the attempt to blend the terms "specialised properties" and "limited market properties" has led to confusion. There are indeed many specialised properties for which ample market evidence can be gathered, if "specialised" refers to design. Thus, we recommend changes as discussed above.

7. Do you think that this category of property should be excluded from the definition?

   Response: Absolutely not. There is far more abuse that can be attached to the use of "specialised properties" as a definition than to the "limited market properties" terminology. The issues here are competency, honesty, adherence to ethical conduct, and professional performance of a valuer's responsibilities. Terminology does not alter those requirements. Unless a meaning of the term "specialised" is adopted that is not in common use in the United States, we believe that the use of the term can be highly misleading and will be commonly misunderstood by the users of valuation services. This is a reason for concern from those in the accounting profession who have personal experiences of unique design or property use that do not by themselves determine whether a property is non- or limited market.

8. Do you think that the definition of DRC should follow the requirement that the land element be reported at Market Value, or should the definition accord with DRC methodology under which land is shown at Market Value for Existing Use?

   Response: We believe the question is deeper than phrased. The Consistent Use Theory states that a property cannot be valued using one use for the valuation of land and another use for the improvements. Thus, the question should be, is market value for existing use (MVEU) appropriate or is it not. If MVEU is appropriate, then both the land and the improvements must be valued based upon a highest and best use premise conditioned upon the existing use. If MVEU is not appropriate, then the highest and best use for land and improvement is determined from market evidence and then applied consistently to the two components. In exceptional cases in which improvements have limited contribution to the whole, that contributory value will be recognized if market evidence supports such valuation contribution. Additionally, the IVSC should clarify when “reproduction cost” and “replacement cost” are appropriate and when they are not. One of the key issues is where under IVS does the valuer obtain the allowances for depreciation if a market is a limited market property.

9. Do you agree?

   Response: We believe the proffered argument dies of its own statement. If land value differs, an economic obsolescence adjustment to the improvements is a separate matter that methodologically indicates there should not be an expectation of numerical equivalence, even if it might happen due to unusual factors. We do not understand why a replacement (construction) cost concept is used for the comparison when the concept of “replacement” is subjective and, by itself, can produce significantly different results when changes of land utility are inserted into the analysis. Reproduction cost would appear to be the better construction cost method because the particular contributions of depreciation can be analyzed discretely rather than obscured into a proposed replacement structure concept that differs from the actual.

10. Do you consider that the basis for valuing the land element should be the same under DRC and the Cost Approach – i.e. at Market Value?

    Response: Not if MVEU is involved. If market value for normal market properties is compared with DRC for a limited-market property, it is possible that the DRC may involve analysis of various land use potentials. In some instances there may be no (or limited) reliable market data upon which to base the value opinion, but the assignment may require a value opinion. That opinion must be developed and reported in accordance with IVS, including the disclosure that no market value opinion could be developed and a supporting explanation of the basis for use of DRC. It is important to remember that a market replacement cost (not “construction cost” or “depreciated construction cost”) may be necessary when market data for vacant land is absent. In this circumstance, a market value basis for land may not be available.

11. If you consider that no change should be made to the current IVSC definition of DRC, then do you think that Guidance Note 8 (paragraphs 5.6-5.8, in particular), adequately explains the current

two-step approach – first, applying one DRC methodology (reflecting MVEU of land), and then reallocating the constituent parts (reflecting Market Value of land) for financial reporting?

Response: The process referenced has a theoretical problem that should be revisited. The purpose of MVEU is, in part, to make sure the balance sheet of the reporting entity is in conformance with that entity's operating statements. This is one of the most important reasons for market value reporting with a basis of MVEU. If market value of land is reported and it exceeds DRC, this objective is not met. The only way that the underlying market value can be realized is a destruction of the existing improvements and a substitution of a new higher and better use. This would conflict with the existing operations, especially the reflection of net revenues that may be attributable to the property in question. Further, there is a cost of demolition that is undisclosed as presently presented. It appear to us that it is better practice to: (a) value the property at market if possible; (b) when MVEU is permissible, perform a MVEU valuation and report both numbers; (c) when MVEU is applied, value the property (land and improvements) in the market, with highest and best use of land and improvements constrained to the identified current use.

12. Do you think that the two examples, A & B, in the addendum to Guidance Note 8, appropriately reflect the text in the Guidance Note and provide sufficient clarity?

    Response: No. The scale does not match the numerical example. Further, see discussions above for technical issues involved.

13. Do you think that reference to reproduction costs should be removed from the definition?

    Response: No. It should be better explained. It is a fundamental premise of economics that a replacement in the form of constructing a replica facility is one of the options that the market value individual would consider. The more that a valuer strays from that notion, the more subjective and potentially divergent (when compared with other valuers) the cost component becomes. We have already raised the question of how a supportable basis for deduction for depreciation is supported when the cost developed is, itself, subjective.

14. In describing the adoption of a DRC estimate for reporting purposes, do you consider that it should be described as a "methodology" or a "basis" or both?

    Response: The cost approach, wherever applied, is a methodology. The IVS establish market value and other than market value bases for valuations. It appears that DRC is used in market value situations when market value cannot be supportably developed. Thus, DRC is more closely akin to a limited valuation basis as an alternative within the context of market value reporting. Further, we believe that there may be other methods besides construction cost that can be applied within DRC.

15. Do you consider the DRC assessment to be a "valuation" or an "estimate"?

    Response: The valuation process develops many "estimates." It produces only one defined "value" and that value is an "opinion," subject to GAVP and applicable standards. An "estimate" may be equated with an "indication," and is not necessarily final. Sensitivity tests produce many estimates or potential indicators.

16. Do you think that the wording should read "obsolescence or optimisation" rather than "obsolescence and optimisation"?

    Response: We have difficulty with the term "optimisation" in the cost approach. Optimisation may occur in many forms, some of which may be financially feasible, while others are not. Obsolescence is a measurable amount that need not be subjective. Optimisation can vary with the "optimiser."

17. Do you consider "optimisation" to be a methodology and therefore an unnecessary reference within that definition?

    Response: See answer to Question 16.

18. Do you think that "optimisation" should be defined and the methodology more fully explained in Guidance Note 8?

    Response: See answer to Question 16.

19. Do you agree that the IVSC definition of DRC should include the following: *"In the case of plant and equipment, DRC should be based on an estimate of the current gross replacement cost less allowances for physical deterioration, and optimisation for obsolescence and relevant surplus capacity"*?

    Response: No. See above answers.

20. Do you consider that DRC is only applicable to valuations for financial reporting, i.e. for the purposes of International Financial Reporting Standards, or do you believe it to be applicable for valuations for other purposes?

    Response: The concept is applicable to many situations involving non- or limited-market properties. GN 8 could be clearer in this respect.

21. Do you agree that it is the directors/managers of the entity that must determine whether the entity is adequately profitable to support the DRC estimate?

    Response: Yes. It is important that the directors/managers establish the premise of property classifications such as investment, surplus, and continued use. However, IVS should establish what is to be done when a valuer disagrees with the classifications.

22. Do you agree that it is the directors/managers of the entity that must determine whether the entity is adequately profitable to support the DRC estimate?

    Response: See answer to Question 21.

23. Do you agree that the written down figure, assessed by the directors/managers, represents the asset's Value in Use?

    Response: We do not see any circumstances in which the directors/managers should develop an opinion of value for financial reporting purposes. "Market value for the existing use" and "market value" do not use a "Value-in-Use" premise. MVEU does assume a continuance of uses, subject to continued profitability, but this is also not value in use.

24. Do you consider that a DRC estimate should provide comfort as to the likely Market Value of the property asset if one existed?

    Response: The use of DRC as an alternative valuation basis is intended to meet the application requirements of "market value," but if valuers are drawn into the "well, it's not really market value, but we can say it's pretty close" argument, we fear that clients and other users of valuation services may overlook the difference between market and alternative concepts. This cannot aid the market, but can significantly increase potential legal exposure and liability for valuers.

25. Depending on your view as to the appropriate accounting concept, and noting that DRC takes no account of whether the property is occupied or not, does the DRC estimate provide adequate comfort as to a surrogate for Market Value?

    Response: We believe the preface to the question is subject to numerous interpretations and that an answer could be misleading. A probable answer may be taken from our above responses. It is, however, crucial that the issue of "vacant" or "occupied" possession be immediately clarified as it is applied under IVS.

Vacant or Occupied Possession

For your consideration, we believe that the status of occupancy in the valuation of real property is fundamentally a matter of identification of the interests or rights appraised. For a property that is leased, what is purchased and sold in the marketplace is a "leased fee" property and the tenants in possession own the rights conveyed by their lease contract and have a "leasehold estate." Whether there is a market value ascribable to either the leased fee or leasehold positions is a matter of market determination. In general, for a leasehold to have a market value it must have a favorable margin between the actual rent paid and the market or economic rent for the rights it enjoys. When a leased fee interest has a tenant with contract rents that exceed market rents, the margin is ascribable to the contract rights rather than real property rights and the margin may or may not have market value as a personal property right.

If a property is valued as a fee simple interest, there are no tenants in possession. Thus, there is no "occupancy" by others. When land is valued as a fee simple interest, this is the common premise. To be consistent, the improvements are also viewed as vacant or without occupancy, whether they are actually vacant or they are occupied by the owner. Thus, the economic benefit an owner receives as a part of such occupancy is reflected in earnings, personal satisfaction, or other non-real property benefits. If the benefit of occupancy were measured as a marginal addition to a property's market value with vacant possession, there would be a double counting of the benefit.

If a property were to be valued as a "fee simple" ownership and it were simultaneously presumed that the improvements were occupied (whether by the owner or by tenants), (a) there is a conflict with the "fee simple" premise; (b) there is no way to know what the impact on the actual rights appraised of the terms and status of occupancy by others may be; and (c) for owner occupied property there is a possibility that confusion (and possibly misleading practices) may occur in the reporting of net revenues.

We expect that the issues of leases and their treatment for accounting purposes will increase in the near future, both for owner-occupied and, in kind or through intra company transactions, for non-owner-occupied real estate. It is imperative that IVS reflect a basis that will be meaningful in the context of valuations for financial reporting and internally consistent with economic theory, legal premises, GAVP, and all published materials that comprise the IVS family.

Thank you for considering our comments and requests. A member of our staff will be in touch with your office shortly to arrange a time to discuss this issue in more detail. Should you have any questions, please contact Don Kelly, Vice President of Public Affairs, Appraisal Institute, at 202-298-5583 or dkelly@appraisalinstitute.org; Ted Baker, Executive Vice President, American Society of Appraisers, at 703-733-2019 or tbaker@appraisers.org; or Doug Slothower, Executive Vice President, American Society of Farm and Rural Appraisers, at 303-758-3513 or dslothower@agri-associations.org.

Sincerely,

Alan E. Hummel, SRA
President
Appraisal Institute

Eugene G. Kaczkowski, ASA
President
American Society of Appraisers

Max W. Evans, AFM, ARA
President
American Society of Farm and Rural Appraisers

Cc: Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Leslie F. Seidman
Board Member
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116