Valuology

Review of IVS published July 2019

In July 2019 the IVS issued its latest version of the International Valuation Standards. Unlike previous editions of the IVSs up to and including IVS 2013, no summary is provided of the major changes in this edition. We have made a side by side comparison and this document provides a summary of the significant changes we have spotted, together with what we think of them and advice on any actions that may be required in order to remain in compliance.

Change in Title and Revision Policy

The first change people may notice is that, contrary to expectation, this version is not called IVS 2019. In line with the IVSC's new policy of not including the year of issue in the title these are simply headlined the "International Valuation Standards (IVS) but with a footer on the cover indicating that they are effective from 31 January 2020. There is the normal proviso inside that earlier adoption is "permitted". Given that IVSC is a standard setting body without the ability to enforce the use or adoption of its standards, pronouncing effective dates is rather meaningless. Since adopters have their own processes for adopting each version, actual adoption dates may vary between organisations and jurisdictions. All that is needed is an identifier to distinguish each version, and using the date of publication avoided any confusion with an adoption date set by an individual adopter.

Up until now the IVSs have been mostly been updated every two years, except between 2007 and 2011 when the organisation went through a major restructuring and subsequent re-examination of the structure and content of the standards, and again between 2013 and 2017 when an announced 2015 edition was cancelled after an Exposure Draft had been issued. The IVSC has now decided to move to a "more flexible and responsive model". It proposes to update the IVSs with new or amended content up to two times a year. These new updates will be published in either July or January of each year, following a minimum three-month period of public consultation. Once the updates have been published within IVS they will become effective after six months (in either January or July). This does not necessarily mean IVS will be updated every six months, but the model allows for these updates as and when there is a clear market need.

While this may be a laudable objective, we do question if it is realistic given that the organisation is evidently struggling with following due process for the current update programme. For example, a summary of responses to comments received on Exposure Drafts is no longer published, and neither are the boards' deliberations on those comments made public. Both of these used to be done as a matter of course. Now, not all the responses received are even published on their website. Some responses to the amendments proposed in July 2018 have not been uploaded and, to date, no responses have been uploaded on the Exposure Draft on Non-Financial Liabilities issued in January 2019.

Since the credibility and authority of standards comes from following a transparent process in their creation, including reconciliation of any conflicting views, surely it is far more important that IVSC focus on getting this right first than potentially overloading its stretched resources with the pressure of an increasing number of projects?

Glossary

What has changed?

New definitions have been added for "Intended Use", "Intended User", "Valuation" and "Value"

Comment

The 2018 Exposure Draft proposed the inclusion of definitions for "Valuation", "Value", "Price" and "Cost", but the latter two have not been carried forward. Since the first edition of the IVSs, the distinction between price, cost and value had been explained due to the confusion that was evident over the usage of these terms in different markets and countries and to assist the appropriate translation of these concepts into languages other than English. This explanation was omitted from IVS 2017 but reintroducing only a definition of "value" does not address the problem that the original standards were addressing. The new definition of "value" is also unhelpful as it has been narrowed to apply only to an "*…estimated amount consistent with one of the bases of value set out in IVS 104*." This creates conflict with IVS 104 20.2 which states that compliance with IVS may require the valuer to use a basis of value that is not defined or mentioned in the IVS.

A proposal to introduce definitions for "Intended Use" and "Intended User" was included in the Exposure Draft issued in April 2019, alongside other proposed changes to the glossary. Since the publication date of this version of the IVS was less than a month after the closing date for comments on the most recent proposals, and it takes at least this long from Board approval for production of a version for publication, it does appear that due process has not been followed in respect of this change.

In any event, defining "Intended Use" and also including this in the required minimum contents of a valuation report in IVS 103 creates a tautology. "Purpose" or "Valuation Purpose" mean the same thing and are already included in the glossary and required to be identified in the Scope of Work and the Report. IVS 103 now requires both the Purpose and the Intended Use to be included in the report. "Intended User" was, and is still, explained in IVSs 101 and 103 so a definition in the glossary is unnecessary.

IVS 102 Investigations and Compliance

What has Changed?

There are changes to 20.4 and 20.7. The substance to the change in 20.4 is that the valuer "should" investigate and corroborate significant inputs provided by management, owners or third parties, rather than "may". The current paragraph also states that if the credibility or reliability of such information cannot be supported it should not be used. This has been changed to provide that "consideration should be given" as to whether it is used.

20.7 currently states that if the investigations included in the scope of work will not result in a credible valuation, or information to be provided by third parties is either unavailable or inadequate the valuation will not comply with the IVSs. Another condition has now been added, i.e. that if the limitations on investigations are so substantial that the valuer cannot sufficiently evaluate the inputs and assumptions the valuation will not comply with the IVSs.

Comment

The change to 20.7 was included in the Exposure Draft. It may have been thought necessary to add emphasis although it is just reiterating the two preceding examples of where a valuation would not be compliant using different words.

The changes to 20.4 did not appear in the Exposure Draft but since they are related to the same point being made by 20.7 this can be considered a change that better aligns the two paragraphs and not a new matter requiring consultation. The change to use the more imperative "shall" rather than "may" is consistent with the later statement that unless significant inputs can be verified the valuation would not be IVS compliant. However, the softening of the final proviso from a definitive statement that unsupported or unverifiable information should not be used to one that says its use should be considered rather contradicts the change from "may" to "shall".

IVS 103 Reporting

What has changed?

"Intended Use" has been added to the list of minimum contents required in a valuation report.

Comment

Since 30.1 (a) requires the matters in IVS 101 20.3 to be included, and this includes the purpose for which the valuation is required, this is an unnecessary duplication. Since in practical terms confirming the intended use is the same as confirming the intended purpose of a valuation there is no need for both terms to be used in either the Scope of Work or the Report.

IVS 105 Valuation Approaches and Methods 1

What has changed?

Two new paragraphs 10.9 and 10.10 have been added. 10.9 provides that a client and valuer may agree on the valuation approaches, methods and procedures the valuer will use or the extent of procedures the valuer will perform, but any such limitations may mean that the valuation does not comply with the IVS. 10.10 states that a valuation may be "limited or restricted" if the valuer is not able to employ the valuation approaches, methods and procedures that a reasonable and informed third party would perform, and this has a material effect on the outcome.

Comment

These paragraphs were proposed in the 2018 Exposure Draft, although have been slightly modified, presumably in response to comments received. The purpose of 10.10 is unclear. It is simply a statement of the obvious with no action required. Since limitations on the valuer's investigations and approach, and the action that must be taken by the valuer regarding these, are covered in IVSs 101, 102 and 103, both these additional paragraphs are superfluous and do not alter the procedures that should already have been followed to comply with the IVS.

IVS 105 Valuation Approaches and Methods 2

What has changed?

There have been significant additions to the material in section 50 relating to discounted cash flow (DCF) methods, which has been expanded from the current 31 to 40 paragraphs. It is difficult to summarise all these changes so, if you regularly use DCF, we recommend that you look at this section. However, the most significant effect of the change is the introduction of a series of imperative actions that the valuer "must" undertake when using the DCF method, e.g.:

- ***The valuer must document how the discount rate was derived and provide supporting evidence for all inputs used to derive it.***
- ***The valuer must consider the risk of achieving the forecast cash flow of the asset when developing the discount rate.***
- ***The valuer must consider the purpose for which any cash flow forecast was prepared and whether the forecast assumptions are consistent with the basis of value being applied.***

Comment

Technically there is nothing wrong with the amendments that have been made but we have the following concerns:

- Prior to 2017 the IVSC had always been clear that beyond describing methods that were commonly used for different types of asset or liability to assist understanding and consistency of application across different markets and countries it was not the role of the standards to prescribe those methods in detail. Standards must focus on requirements for the process and reporting of a valuation assignment that are required to help those who rely on the valuation understand it and prevent its misuse. Standards should be produced from the perspective of the users of valuations and concerned with protecting the public interest. They must not blur the line with detailed examination of different methods and techniques which can be used by valuers and which properly belong in valuer education programmes. Apart from confusing the wider public as to the purpose of the standards, detailed examination of methodology and mandatory rules for applying certain methods risks undermining the professionalism of valuers by limiting the exercising of professional judgement that is an essential component of valuation. It could also encourage those without the appropriate knowledge and understanding to use the IVSs as a recipe book to produce valuations.

- The IVSC as an organisation obviously has a role to play in identifying and promoting best practice, but previously methodological discussion had been published in the form of guidance or information papers issued separately from the standards. Indeed, the most constant comment received from member organisations and other stakeholders in every consultation about the scope and structure of the IVSs has been to further improve the distinction between mandatory standards and supporting guidance. This approach is also taken by other significant valuation standard setters, for example the Appraisal Foundation in the USA and the RICS. Including a mandatory standard with prescriptive conditions on how methods must be applied means that IVSC is now treading a path that it has hitherto avoided and that other prominent standard setters continue to avoid for good reason.

- There is now an even more disproportionate emphasis on DCF compared with other methods, which could lead to the perception that it is generally preferred to other methods. While this may be true in the experience of the current Board members this is not a safe

assumption to make given that the data required to produce a meaningful DCF is often not available in some markets.

- The use of imperative instructions to the valuer at different stages of undertaking a DCF valuation is inappropriate. We agree that in the majority of cases the actions required will be appropriate and represent best practice but given that the IVSs have to be applicable across the widest range of markets and cultures it "must" be accepted by the Board that there will be occasions when it is neither possible or appropriate to comply with the letter of the process described and that variations are possible.

IVS 105 Valuation Approaches and Methods 3

What has changed?

A new section 90 has been introduced, "Valuation Model". This describes a valuation model as the quantitative methods, systems, techniques and qualitative judgements used to estimate and document value. It can, therefore, range from a simple multiplication of two figures to a complex algorithm using multiple data sources. It sets rules for the valuer who must:

- ***keep appropriate records to support the selection or creation of the model,***
- ***understand and ensure the output of the valuation model, the significant assumptions and limiting conditions are consistent with the basis and scope of the valuation,***
- ***consider the key risks associated with the assumptions made in the valuation model,***
- ***ensure that the valuation complies with all other requirements contained within IVS.***

Comment

This proposal was not included in the 2018 Exposure Draft. A proposal to introduce a section on valuation models was included in the Exposure Draft issued in April 2019, but as indicated earlier, this consultation must still have been open when this version was approved, so due process has not been followed. The wording in the new standards differs from that in 2019 Exposure Draft, but not in a material way. The practical effect of this change is limited as IVS 102 already requires the valuer to keep a record of the key inputs, all calculations, investigations and analyses relevant to the final conclusion, so it is another example of unnecessary words being added to the standards.

IVS 200 Businesses and Business Interests

What has changed?

Section 130 on Capital Structure Considerations has been extended from one to twenty four paragraphs. We do not attempt to summarise this material but it now gives examples of different ownership interests and classes of equity and then examines three methods that can be used to estimate value of various classes of debt and equity - the current value method, the option pricing method and the probability-weighted expected return method.

Comment

This more detailed discussion is no doubt useful but is misplaced in the standards. It is another example of the objective of the standards being compromised. Instead of being a set of principles for the undertaking and reporting of valuation assignments, for use by valuers and those who use or rely on valuations alike, it is becoming a technical text book.

IVS 220 Non-Financial Liabilities

What has changed?

This is a completely new standard applying to the valuation of those liabilities that require a non-cash performance obligation to provide goods or services. Examples include contract liabilities, warranties, environmental liabilities, asset retirement obligations, certain contingent consideration obligations, loyalty programmes and certain litigation reserves and contingencies. It includes a mandatory requirement to apply the principles for determining discount rates, cash flows and risk margins in this standard when valuing a non-financial liability.

Comment

This standard was the subject of an Exposure Draft issued in January 2019 with a three month period for comments. We know that some comments were made because Valuology submitted one, but none are available on the IVSC website. Neither is there any record of the Board's discussions on comments received or a Basis of Conclusions issued to support the new standard. Comparison with the Exposure Draft shows that there have been some changes to the introduction but thereafter the changes are minimal. Certainly few of the concerns we expressed in our response to the Exposure Draft have been addressed.

Our overriding concern is that the focus is almost entirely on liabilities incurred in a business, notwithstanding that liabilities often attach to ownership of a tangible asset, such as property, plant or equipment. While considerable, and probably excessive, detail is provided on methods applicable to liabilities arising in a business, there is no discussion of liabilities that can attach to an interest in real estate, even though these clearly fall within the scope of "non-financial liabilities." Additionally, the numbering of this new standard within the Business Valuation 200 series is likely to lead to it being overlooked by those concerned with other asset types to which it may be applicable.

IVS 410 Development Property

What has changed?

There are two changes. First is the deletion from 90.1 of the caution that a residual value derived from the residual method may or may not equate to the market value of the development property in its current condition. The second is the addition of two paragraphs to the end of the standard under the sub heading of "Special Considerations for Secured Lending". 120.2 states the valuer should apply a minimum of two appropriate and recognised methods to valuing development property for each valuation project. 120.3 states that the valuer should provide a current "as is valuation" and an "as proposed" valuation.

Comment

These changes were proposed in the 2018 Exposure Draft. We indicated our objections to them in our comment letter. No reason was given for the deletion of the caveat concerning the outcome of a residual valuation not necessarily equating to market value. It may be that the Board considered the same could be said for any method of valuation, but the expert group that drafted the document on which this standard is based wanted it included because it had been presented with examples of inappropriate reliance on the residual method.

The new "presumptively mandatory" requirement to use two methods to determine the value of development property is wholly inappropriate. It quotes IVS 105 10.4 as justification, but the

selective extract provided in the new 120.2 overlooks and contradicts the whole of the statement in IVS 105 which is:

> *Valuers are **not required** to use more than one method for the valuation of an asset, particularly when the valuer has a high degree of confidence in the accuracy and reliability of a single method, given the facts and circumstances of the valuation engagement. However, valuers **should consider** the use of multiple approaches and methods and more than one valuation approach or method **should be considered and may be used** to arrive at an indication of value, particularly when there are insufficient factual or observable inputs for a single method to produce a reliable conclusion. (emphasis added)*

Apart from unjustifiably turning a reasonable "should consider" into a "presumptively mandatory" requirement to use two methods, no account is taken of the problems this will cause if there is not the data available to use more than one method, or the absurdity of using more than one method when one clearly provides the most relevant indication of value.

The new requirement to provide both an "as is" and an "as proposed" value is also inappropriate. While many lenders may want these two values, and instruct the valuer accordingly, the Board is overreaching its remit by interfering in the valuer/client relationship. Lenders may need values of development property on various different assumptions about the stage the development has reached depending on type of lending being considered. It is not appropriate for the IVS to dictate what these assumptions should be.

While inappropriate and unnecessary changes have been made to IVS 410, one error that was made in IVS 2017 has not been corrected. This is the incorrect use of the term "special assumption" in 90.8 (b) and 90.10. 90.10 also refers to something called "gross development value" which is not defined or discussed elsewhere. In both 90.8 (b) and 90.10 it is important that the assumptions made are those that would be made by a typical market participant. The term "special assumption" is only used where the assumption is either that the facts at the date of valuation have changed or is one that a typical market participant would not make.

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