IVSC Standards Board
1 King Street
LONDON
EC2V 8AU

By email to: commentletters@ivsc.org

2 June 2016

Dear Sirs

Response to Exposure Draft

IVS 2017: IVS 105 Valuation Approaches

Please find attached our comments on the above exposure draft.

The directors of Valuology have considerable experience of valuation standard setting generally and knowledge of the existing IVSs and their evolution.

If you would like any additional information in relation to our responses or comments, please do not hesitate to contact us

Yours faithfully,

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Comments on Exposure Draft of IVS 2017

IVS 105 Valuation Approaches and Methods

Answers to Questions in ED

1) **Do you agree that when selecting an appropriate valuation approaches and methods a valuer should consider the following?**

    a) **the appropriate bases of value, determined by the terms and purpose of the valuation assignment,**

    b) **the respective strengths and weaknesses of the possible valuation approaches and methods,**

    c) **the appropriateness of each method in view of the nature of the asset, and the approaches or methods used by participants in the relevant market,**

    d) **the availability of reliable information needed to apply the method(s), and**

    e) **if not, why? What considerations would you add to or remove from this list?**

    Yes. However, all of these are effectively covered by the requirements in the current IVS 102, which would be further strengthened if the minor amendments originally proposed by the Board to this standard in the 2015 ED were implemented. There is no justification for introducing a separate new standard which covers the same or similar requirements to one that already exists.

2) **Under each valuation approach, this exposure draft includes criteria for when the approach should be used. Do you agree with the criteria presented under each approach? If no, what changes would you make? Why?**

    No. For reasons see the General Comments on this draft standard.

3) **Are there areas of this chapter that you feel should be expanded upon in future board projects (eg, discount rates, discounts/premiums, etc)?**

    The IVSC could produce further guidance on a range of practical valuation considerations, although the degree of support for this will vary significantly. However, there should be no pretence that such material can be mandatory, and if developed it should be clearly separated from the standards so there can be no inference that by publishing such guides the IVSC is in anyway prescribing or limiting the methods that a valuer may use.

General Comments

It states in the Introduction to the ED:

"Since the issuance of IVS 2013, the Board received feedback from many stakeholders that the sections on valuation approaches comprising the market approach, income approach and cost approach were insufficiently detailed to meet current market needs. Furthermore, the Board felt the IVS content on valuation approaches and methods needed to be contained within the General Standards to highlight the mandatory nature of this part of the standard."

The occasion or source of this feedback is not provided. The responses received during consultation on the fundamental rewrite ahead of IVS 2011, on IVS 2013 and on the 2014 Structure and Scope Review are all available on the IVSC website. These certainly do not support the IVSs containing more detail on approaches and methods. Most VPOs expressed opposition to the IVSC publishing material that could be deemed educational in any form, some of them vehemently so. Although other respondents did consider IVSC could usefully provide more technical guidance on approaches and methods, most caveated this with the proviso that it should not be part of the IVSs, and could not be mandatory.

Notwithstanding the strongly expressed opposition to the IVSs including material on approaches and methods, the Board has previously considered that reference in the IVSs to the main valuation methods normally used for each class is important in order to achieve the aim of reducing diversity of practice. It also considered that a basic description of these was necessary, not to educate valuers on how to use them but to help those commissioning or relying on valuation understand, at a high level, what was involved in the interests of transparency. Basic descriptions also help promote consistency in the usage of valuation terminology, which helps avoid misunderstanding across borders. It is for this reason that the current IVSs include a very limited description of the principal valuation approaches and methods, either as part of the background information in the Framework, in relation to specific asset types or in the TIPs produced on the Cost Approach and Discounted Cash Flow.

It would be very surprising if a majority of the IVSC's constituents have now changed their view. Although comments on the contents of this proposed standard follow below, these are all subject to the overriding view that this proposed standard is ill founded and should be abandoned. If deemed necessary, any material on the detailed application of different approaches and methods should be issued outside of the standards, and be clearly stated as having no authoritative status in the application of the standards.

Introduction

Unlike the proposed IVS 104 this standard does not commence with a highlighted statement indicating that it is mandatory, nor are any requirements indicated. To assist comprehension of the standards there should be consistency in the way they are presented. This change of style may be a tacit acknowledgement that the content is incapable of being mandatory, as is indicated by the lack of clear requirements or use of imperative language in the text. Valuation methods evolve and the role of a professional valuer is to adopt the most appropriate method available at the time, which is why no other set of valuation standards has ever attempted to prescribe or limit the use of methods or approaches.

The draft is addressed to alternatively the “valuer” or the “professional” with even the “appraiser” making an appearance. Apart from the lack of consistency within this draft, this also indicates the unsuitability of the material for inclusion in the IVSs, which address the specification for an IVS compliant valuation, not actions that the individual preparing it should take. This distinction is important given that the IVSC has no enforcement powers over individual valuers. This is the domain of the VPOs.

Market Approach

In 20.1 it is stated that when reliable, verifiable and relevant market information is available, the market approach is the preferred valuation approach. The ED for IVS 2011 contained a similar statement, but this attracted very significant opposition both in the written responses and in the three roundtable consultations. This may be summarised that any such pronouncement by a standard setter, particularly one operating at a global level, could compromise the professional valuer’s responsibility to adopt the most appropriate method or approach based on the facts of the individual case and the market in which they operate. This applies to similar statements in the draft about other approaches being preferred.

Income Approach

In spite of the stated intention of providing more detail, this section only references DCF as an example of a method. In contrast the current IVS Framework also identifies the income capitalisation method and option pricing as methods under this approach.

Cost Approach

This section departs significantly from well-established principles and terminology used in the cost approach, as represented in the current and previous versions of the IVSs. If the Board believes that the current material is so fundamentally incorrect, it should identify a separate project to review this, not make such radical changes as part of a general review of the IVSs.

The Board should of course be aware that some concerns about the explanation of the cost approach in the standards arose in the course of the development of IVS 2011. This led to a dedicated project to review the guidance. A cross industry working group was established and, following the usual consultation protocols, TIP 2 was issued in late 2012. Like all such publications, it reflects the best consensus that could be reached between various contrasting views, and while a few may disagree with certain aspects, there is no obvious mandate for such a radical redefinition of what the approach represents and how it is implemented.

In paragraph 70.1 the current definition of the cost approach has been augmented with the words “unless undue time, inconvenience, risk or other factors are involved.” Although these words appear in the subsequent paragraph in the current IVS Framework, concatenating them with the definition in this draft has changed their context and meaning. The cost of an asset of “equal utility” will necessarily include the costs, if any, associated with time, inconvenience, risk or other factors, otherwise it would not be equal. Adding these words to the definition may lead to readers believing that having identified an alternative asset of equal utility, a separate adjustment is then necessary to establish the price that a buyer in the market would pay. If the current paragraph 63 is not included in its entirety, then these words should be deleted from 70.1.

Notwithstanding the inappropriate identification of circumstances when the Cost Approach should be used, 70.2 contains significant errors.

- In 70.2 a) the proviso that “the asset could be recreated quickly enough that a market participant would not be willing to pay a significant premium for the ability to use the subject asset immediately” is illogical and incorrect. The time taken to create an asset of equivalent utility is something that has to be taken into account in comparison with the subject asset. The type of specialised asset to which the cost approach is typically applied is often either unusual (if not unique), large or both. All of these factors would indicate that procuring a replacement “off the shelf” is unlikely and an extended time would be needed for an equivalent to be created.
- 70.2 c) makes no sense at all and contains very basic errors. The use of the cost approach to indicate value on a number of different bases is well established. Its identification as a means of estimating accounting Fair Value in IFRS 13 and ASU Topic 820 is testament to this. This error is compounded by suggesting that it is particularly appropriate for establishing “reinstatement value”. Reinstatement Value is normally associated with the insurance of buildings under a certain type of policy (see comments on the draft IVS 104, section 90). A reinstatement value in insurance terms is the cost of replacing the actual building, and has nothing at all to do with the cost approach which has the objective of establishing the economic value of an asset by making deductions to reflect all forms of obsolescence that exist between the replacement (which may not be the same design or specification as the subject) and the subject asset. If a valuer applied the cost approach to estimate the reinstatement cost of a building it would almost certainly result in significant underinsurance with the adverse consequences this would bring for all involved.

Paragraph 70.3 is equally flawed. The erroneous exclusion of the cost approach where there are time delays in creating a replacement is highlighted above. Secondly, the example in 70.3 b) is inappropriate; the cost approach is no more likely indicate whether a business valued as a going-concern might be more valuable on a liquidation basis than any other approach.

Cost Approach Methods

This section completely disregards current guidance on the cost approach, both in the IVSs and other literature.

In summary:

- Replacement cost is NOT a method but the current cost of a similar asset offering equivalent utility. It is therefore an alternative input to reproduction cost used in the cost approach

- Reproduction cost is NOT a method but the current cost of recreating a replica of the asset. It is therefore an alternative input to replacement cost used in the cost approach.

- Summation is a method that calculates the value of an asset by the addition of the separate values of its component parts. As the name implies it is an addition of the separate values of components which probably have been valued individually using different approaches and methods. It is not an example of the cost approach, unless every component has been valued using that approach. Even then, use of a method unrelated to cost may be required to reflect any effect on value of the aggregation of the individual assets into a single unit of valuation. It is questionable whether Summation can be correctly described as a valuation method, but it certainly cannot be presented as an example of the Cost Approach.

- In the current IVSs two methods are identified under the Cost Approach. One is Depreciated Replacement Cost (although confusingly in some countries this is simply known as the cost approach). The other is (portfolio) replication method, referenced in IVS 250. This is where a portfolio of illiquid financial instruments is valued by reference to the cost of assembling an alternative “synthetic” portfolio of liquid instruments that will produce the same cash flows with the same risk profile as the subject portfolio. This appears to have been overlooked.