Valuology

Red Book 2021/2022 review

The RICS published its latest edition of the *RICS Valuation - Global Standards* (the Red Book) at the end of November, with an effective date at the end of January 2022. Alongside it issued a "Basis for Conclusions" which summarises some of the comments received on the draft and the few minor changes that were made as result.

So what do we think?

Perhaps the most noteworthy change is that the Red Book is no longer red! Now it is predominantly different shades of grey, fortunately less than fifty. Since it appears that the sole publishing medium is by way of a downloadable PDF, the colour of the cover is no longer as obvious or as relevant as it was in the days of the physical hardcopy. However, newcomers may well be mystified as to where the moniker comes from. The "RICS Red Book Global Standards" remains the main approved reference to the publication and is used throughout the standards.

The fact we have mentioned the colour of the virtual cover at all illustrates that not much else of significance has changed. More significant are the changes that have not been made but which we feel should have been. Based on what we have heard from our clients and seen from reports that we review there are things in the current standards which are misunderstood and where changes would have helped. We will return to these later but first just highlight a few of the changes that have been made and which may be of interest.

Summary of Changes

Glossary: A new definition for ESG is included and the existing definitions of sustainability and valuation extended. This is consistent with the trend to turn the Glossary from a concise list of single sentence definitions into an extended discussion about the use of the word or term, supplementing or repeating guidance that appears elsewhere. Both the additions to the definitions of sustainability and valuation are simply restating points already made in the current standards so no practical change results.

PS1 – Compliance: New paragraphs have been added to PS1 5 which previously listed types of valuation advice which were exempt from the mandatory provisions in VPS 1-5. These include a somewhat convoluted explanation that a job may start off outside the scope of the Red Book but come within it as it progresses and that a valuation either complies with the Red Book or it does not. We thought these points were already obvious, but there may be some who thought otherwise.

PS2 – Competency: A sentence has been added to the beginning stating that members and firms must make sure that valuations are undertaken by competent individuals. This requirement is already in the Red Book so represents no change in practice.

VPS2 – Inspections, Investigations and Records: ESG has been added to sustainability as something valuers should take into account in their investigations. Indeed, every time the word sustainability appeared in the 2020 Red Book "and ESG" has been added in this edition, notwithstanding that these are neither synonyms nor distinct concepts. Rather curiously, the recently issued Guidance Note "*Sustainability and ESG in commercial property valuation and strategic advice*" which shares

the same effective date of 31 January 2022 with the Red Book, is not referenced at all. The Basis for Conclusions says that reference to this was not included as the GN would not have been published by the date of issue, notwithstanding the fact that it was actually published just a week later with the same effective date. Since valuers should be well aware of the impact of ESG policies on demand for the assets they are valuing anyway this should not involve any change in practice.

VPGA 1 – Financial Reporting: The guidance on valuations for financial statements in the current Red Book is extremely limited and in essence just says that such valuations must be prepared in accordance with the financial reporting standards adopted by the entity (i.e. their client). Brief reference is made to the International Financial Reporting Standards (IFRS) and the International Public Sector Financial Reporting Standards (IPSAS) but no other information on their requirements is included. The reason the Red Book first came into existence in the 1970s was to support consistency in valuations used in financial reporting and that was its only content for the next twenty years. No reason has been given for the omission of guidance on this subject from recent editions of the Red Book, but this has left a significant gap.

In the latest Red Book two additional paragraphs have been added on IFRS. One refers to a current consultation being undertaken on possible amendments to the disclosure requirements around fair value measurements in financial reports, which is unlikely to be finalised until well into next year, and not effective until 2023 at the earliest. The second is a reference to a revised accounting standard for leased assets that became effective in 2019. This did make substantial changes to the way in which lessees have to account for leased assets. However, to the best of our knowledge this is not an area in which many RICS valuers have had involvement as the method of measuring the liability represented by a lease is prescribed in the accounting standard.

Given that there are many other IFRS standards where valuation advice may be required from members but for which no guidance is provided, the addition of these two random topics results in an unbalanced summary of the many reasons for which valuations may be required in the preparation of financial statements and the different assumptions that are applicable .

Another change is to introduce a paragraph advising the valuer to include “reference of the basis of value definition, e.g. IFRS 13 or FRS 102, etc.” (sic). Apart from the poor syntax, these are not bases of value but examples of financial reporting standards which include details of how different valuation measurements must be reported. FRS 102 is a UK standard and reference to it in the RICS Global standards is inappropriate.

Our advice to any valuer instructed to produce a valuations for this purpose who feels they need help in understanding the appropriate assumptions and approaches required is to research other resources for guidance to ensure that they produce valuations that are suitable for the specific accounting purpose required. While other publications are available, in 2019 we published two books on the valuation approaches required under IFRS and some of the different standards applicable to smaller companies and the public sector in the UK. See https://www.valuology.org/store.

VPGA 4 Trade Related Property: The current paragraph 1.4 has been extended to provide more examples of property types which it may be appropriate to value by reference to the trading business in occupation. Self-storage, flexible workspace and “purpose-built investment student housing” are now specifically mentioned although, as currently, it is a matter for the valuer’s judgement in each case.

VPGA 8 Valuation of real property interests: There are a number of detailed changes, mainly to include ESG factors into the list of matters that a valuer may need to investigate or consider. However, as mentioned earlier, the new GN "*Sustainability and ESG in commercial property valuation and strategic advice*" provides more detailed and focussed guidance on these issues.

Conclusion: If you are correctly following and applying the Red Book and RICS Valuation Guidance at present you do not need to change anything. It may be worth noting that the Red Book no longer states in its title the year of issue, just the effective date. In your engagement letters and reports you only need to refer to the "RICS Red Book Global Standards". Without a date of issue being specified this is deemed by RICS to refer to the version current on the date of the report. If the client has specifically asked for compliance with the IVS it is also acceptable to refer to these only, see VPS1 3(n).

What has not changed?

As indicated in our introduction, there are things that could or should have been addressed which would be significantly more helpful to valuers in practice than the relatively minor tweaks that have been made.

Relationship with IVS

RICS needs to rethink and then clearly explain the relationship between the IVS and the RICS Standards. The IVSC is supported and financed by professional bodies, valuation firms and other bodies with an interest in valuation around the world. Those supporters see the benefit of global collaboration to agree and publish common principles and definitions for the delivery of professional valuation advice. However, the IVSC has no powers to enforce anyone to comply with its standards. That is a matter for bodies who decide to adopt or otherwise use them.

The RICS says in the Introduction to the Red Book:

> *"At its heart this volume adopts and applies the International Valuation Standards (IVS) published by the International Valuation Standards Council (IVSC). The IVS consist of mandatory requirements that must be followed in order to state that a valuation was performed in compliance with it."*

It reproduces the IVS in their entirety behind all the RICS material. If the RICS material were confined to the compliance and conduct requirements in PS1 and PS2 it would be clear that RICS members have to follow the IVS as they are an integral part of the Red Book. However, RICS has chosen to issue its own equivalent standards to IVS 101 -105, VPS 1-5. There is no problem with additional RICS requirements for which there is no IVS equivalent, but instead of relying on the IVS it rewrites them using different wording. While the overall intent of both the RICS VPS and its equivalent IVS may be the same, this opens the door to problems of interpretation. It would not be unreasonable for members of RICS to assume that its rules take precedence as they are the only body with the power to enforce compliance. However, if there was litigation with a client or regulator over whether the valuer had complied with the Red Book these inconsistencies have the potential to become material and could be exploited to influence the outcome of any dispute.

The problem is not confined to the VPSs. The IVS include eight "Asset Standards". Five of these cover subjects which are included among the ten VPGAs issued by the RICS. There are many

similarities between the IVS and RICS material but again they are far from identical. Another, IVS 410 *Development Property*, covers similar ground to the RICS Guidance Note "*Valuation of development property"*. The additional complication is that while RICS VPGAs and GNs are not mandatory (although they may reference mandatory requirements), all Standards in the IVS are now deemed to be mandatory and may only be departed from to comply with "legislative, regulatory or other authoritative requirements". And while RICS uses the word "should" to indicate that an action is recommended but not mandatory, the IVS have chosen to define it as meaning "presumptively mandatory" with strict conditions and limitations on when the prescribed action is not taken. This creates a further area of conflict and uncertainty.

The RICS needs to decide whether it is adopting the IVS unconditionally or whether it wishes to continue to produce its own comprehensive standards which are based on the principles in the IVS. To the best of our knowledge, after studying the standards of over 100 professional bodies around the world, the only one to unconditionally adopt the IVS by requiring its members to adhere to them as written is the Australian Property Institute. The API then issues supplementary guidance material on how the principles of the IVS are applied in the context of the Australian market and jurisdictional framework. Many more established professional bodies continue to produce their own standards which they describe as "consistent with" or "based on" the IVS, thereby maintaining control over the rules their members must follow. RICS currently issues two sets of standards covering the same activities but with material differences between them and then fails to indicate the circumstances under which one or the other takes precedence.

Related to this is the question of whether RICS is acting in the interests of its members or, more importantly, the clients they serve by unconditionally accepting every amendment to the IVS as though it were some form of higher authority. RICS may be actively involved in the development of the IVS and be a major financial supporter but it does not have control over what is finally decided. We are aware from our work that other organisations around the world which wish to have standards that comply with the IVS also insist on having a process under their control to review and approve new additions or amendments. This gives them the ability to opt out of or amend any amendment of the IVS which is incompatible with the legislative or market framework in which they operate. The IVS cannot possibly take account of every cultural, legal or market nuance around the world and therefore their limitations must be recognised. Neither is there any need for the adoption date to be the same as the effective date provided by the IVSC. That can only be for the adopter to determine.

In its Basis for Conclusions RICS acknowledges that some respondents (of which we were one) raised the question of the relationship between the RICS and IVS material in the Red Book. Its solution is to clarify this is by "communications" on the Red Book web page and via various RICS social media and web channels. This is not satisfactory. A problem does not go away by communicating it. It only goes away by fixing what causes it and making this clear in the standards themselves.

Assumptions and Special Assumptions

The distinction between these is poorly understood by many valuers. We frequently see either or both being incorrectly used in engagement letters and reports. We see "assumptions" being used to describe not just matters that it is reasonable to accept as being fact without verification but facts which are self-evident from inspection or from information supplied, and even valuation inputs determined by the valuer's judgement. We see "special assumptions" where no change in the status quo is envisaged or which are assumptions that most informed buyers in the market would make based on the relevant facts.

We believe this confusion is not helped by the two types of assumptions being conjoined in the list of matters to be included in the terms of engagement and report in VPS1 and VPS3 respectively. One deals with the extent of the valuer's investigations, the other with the basis of value reported and need to be separately dealt with in different parts of both the terms and the report. Neither does it help that there are incorrect examples of "special assumptions" given in at least four places in the IVS, underlining the point made above about the inappropriateness of automatically accepting and incorporating the IVS into the RICS standards.

While the current Red Book definitions are clear, we believe that the Red Book needs to make a better distinction between the two by not lumping them together and providing better examples where they apply in the context of the overall delivery of a compliant valuation.

Valuation Uncertainty

It is a great shame that the opportunity was not taken to rewrite VPGA 10 to reflect the excellent output from the RICS "Leaders' Forum" established in 2020 to advise on the reporting of material valuation uncertainty arising from the pandemic. Again in our experience there is still misunderstanding of when and why such caveats are required when reporting a valuation. Much of this stems from the period a few years ago when RICS inappropriately conflated warnings about a lack of reliable evidence to support the valuer's current opinion of value with the completely different issue of market risk, i.e. the risk (or opportunity) represented by values changing in the future. While the current VPGA 10 no longer makes this mistake, it still does not express what is required and when as clearly as the output from the Leaders' Forum.

What Next?

In the course of our work we come across many valuers who are at best ambivalent about the Red Book. Apart from being a professional obligation for RICS members, they generally accept that it is better to work to a recognised standard and doing so gives their work greater credibility. However, the frequency of updates, the very limited consultation periods now allowed and the ever growing volume of text all alienate the busy professional.

Following a major restructuring of the RICS management (predating the current reviews resulting from the Levitt report) a new advisory group of members is being formed to oversee the Red Book. If you agree with any the improvements we would like to see or, of course, have any bugbears of your own, now is the time to get to work on your keyboard and let RICS know at standards@rics.org.

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