

FOR RATIFICATION PURPOSE

(HKIS AGM 2017)

HKIS VALUATION Standards 2017



THE HONG KONG INSTITUTE OF
SURVEYORS

香港測量師學會

FOR RATIFICATION PURPOSE

(HKIS AGM 2017)

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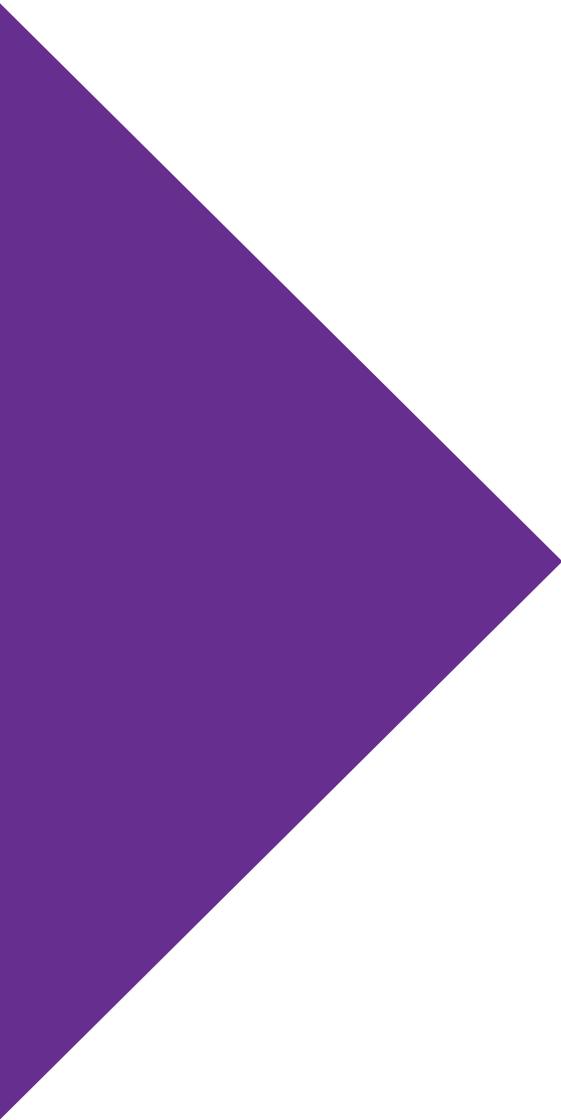
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PART A: INTRODUCTION

1. Background of the HKIS Valuation Standards ("the Standards")

1.1 'The HKIS Valuation Standards on Trade-related Business Assets and Business Enterprises' was first published in 2004 (the "HKIS BVS") to cater for the growing need of the general public for business *valuation reports* due to the prosperous development of the merger and acquisition activities in Hong Kong since late-1990s. The first issue of the HKIS BVS, which is a mandatory standard to our members, comprised 5 practice statements and 2 guidance notes.

1.2 'The HKIS Valuation Standards on Properties' was first published in 2005 (the "HKIS PVS") to cater for the growing need of the general public for a professional real property *valuation service* due to the development of a more sophisticated real property market in both Hong Kong and neighbouring regions when entering the 21st century. The first issue of the HKIS PVS, which is a mandatory standard to our members, comprised 8 valuation standards and 1 guidance note. There exists a separate Guidance Notes on Valuations of Properties for Mortgage Purpose, Second Edition, 2005, which is referred to by the HKIS PVS VS8.

1.3 'The HKIS Valuation Standards – 2012 Edition' was first published to cater for the drastic changes over in the capital market and the financial reporting standards in Hong Kong and a greater demand for various types of *valuation services* on different types of *property*. HKIS GPD believed that a unified and concise set of valuation standards, which was mandatory in nature, should be issued to cope with the changes.

1.4 Since the 2012 Edition of the *Standards*, there have been significant developments in International Valuation Standards ("IVS") published by the International Valuation Standards Council ("IVSC"), of which the HKIS is a Valuation Organisation Member. As the HKIS is committed to achieving the objective of securing a set of common valuation standards acceptable worldwide, the HKIS would therefore, wherever possible, adopt the standards set by the IVSC in *the Standards*. In the light of such development, the Valuation Standards Panel of the HKIS General Practice Division ("GPD") Council has decided to conduct a comprehensive review

of the *Standards* with a view to continuing to maintain the best professional standard in preparing *valuation reports*.

1.5 In preparing *the Standards*, the HKIS has taken into account opinions and advice given by members of the Securities and Futures Commission of Hong Kong ("SFC"), Hong Kong Institute of Certified Public Accountants and The Hong Kong Association of Banks wherever appropriate, and intends that *the Standards* shall be used by the *members* who deal with the *valuation of properties*.

1.6 The HKIS should endeavor to ensure that all information contained in *the Standards* is accurate, updated and complies with the laws, rules and regulations of Hong Kong. The HKIS reserves the rights to make any changes to *the Standards* from time to time as a result of any changes in law, rules and regulations, market practices, government policies, requirements of the Hong Kong Exchanges and Clearing Limited ("HKEx") or SFC and for any other reasons as the HKIS deems appropriate without further notice. The HKIS will publish an updated version of *the Standards* from time to time and *members* shall obtain an updated version of *the Standards* from the HKIS website at www.HKIS.org.hk. The HKIS accepts no responsibility and shall not be held responsible or liable for any losses or damages that *may* be suffered or incurred by any person or entity as a result of his or its relying on any information provided in *the Standards*. In the event that any *member* has queries or doubts arising out of or concerning the interpretation, application or implementation of *the Standards*, the *member should* write to the HKIS, in order to seek its view on such queries or doubts. *The Standards* shall be governed by and construed in accordance with the laws of Hong Kong. In the event that there is any inconsistency between the laws of Hong Kong and *the Standards*, the laws of Hong Kong shall prevail to the extent of such inconsistency.

2. Principal objectives of the Standards

2.1 The principal objectives of *the Standards* are to provide appropriate directions or guidance to *members* so that the *valuations/reports* prepared by them can achieve the highest standards of professionalism, integrity, clarity, reliability and

impartiality, and that the *valuations/reports* are prepared in accordance with the recognised bases that are appropriate for the purposes of their preparations.

2.2 The Standards define:

- (a) Criteria used to establish whether a *member* is appropriately qualified to act as a *valuer* (as defined in *the Standards*) and the steps suggested to assist them in dealing with any actual or perceived threat against their acting independently and impartially in preparing a *valuation/report*;
- (b) Matters to be considered by a *member* when agreeing to the terms and conditions of an engagement for a *valuation*;
- (c) *Bases of value, assumptions* and *material* considerations that *must* be taken into account when preparing a *valuation/report*;
- (d) Minimum contents required of a *report*; and
- (e) Matters to be disclosed if the *valuations/reports* may be relied upon by *third parties*.

2.3 The Standards do not:

- (a) instruct *members* on how to value in individual cases;
- (b) prescribe a particular format for *reports*: provided the mandatory requirements in *the Standards* are met, *reports* should always be appropriate and proportionate to the task; and
- (c) override standards specific to, and mandatory within, individual *jurisdictions*.

2.4 It is emphasised that although *the Standards* sets out the minimum standards that the *members* shall comply with in *valuations*, it remains the responsibility of an individual *member* to exercise his reasonable and professional judgement in a *valuation*, including but not limited to incorporating all relevant information into the *valuation reports*.

2.5 *The Standards* adopts in full and applies the International Valuation Standards (“IVS”) published by the International Valuation Standards Council (“IVSC”), included as part of *the Standards*.

2.6 The aim of *the Standards* is to engender confidence, and to provide assurance to *clients* and recognised users alike, that a *valuation* provided by a qualified *valuer* will be undertaken to the highest professional standards overall.

2.7 *The Standards* is required to be used and complied with by *members* who deal with a *valuation*. However, in the event that there is any conflict between *the Standards* and the standards of local practice overseas, *the Standards* should not be interpreted as imposing a lower standard than the standards adopted overseas and the *members* shall follow *the Standards* to the extent as much as is practicable.

2.8 It is the duty of all *members* carrying out valuation work to have knowledge of and be fully aware of the contents and requirements of *the Standards*, and to apply them.

3. Arrangement of the Standards

3.1 *The Standards* comprises General Valuation Standards (VS) and Valuation Guidance Note (VGN).

3.2 The General Valuation Standards (VS) are mandatory (unless otherwise stated) for all *members* providing *valuations* in writing. They define the parameters for compliance with the *Standards* and contain the specific requirements and related implementation guidance, directed to the provision of a *valuation* that is IVS-compliant.

3.3 The Valuation Guidance Notes (VGN) provide further implementation guidance in the specific instances listed. Thus, among the topics covered, they include *valuations* for specific purposes, and *valuations* of certain specific asset types, where particular issues and/or practical considerations expressly need to be taken into account. These VGNs embody ‘best practice’ – that is procedures that in the opinion of *HKIS* meet a high standard of professional competence. While not themselves mandatory, the VGNs do include links and cross references to the material in the VS that is mandatory. This is intended to assist *members* in identifying materials relevant to the particular *valuation* assignment they are undertaking.

3.4 *The Standards* contains a Glossary Section at Part B to enhance and maintain the professional

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standard of the *members* in preparing the *valuations/reports* in accordance with the requirements set out in *the Standards*.

4. Relationship to the financial reporting standards

4.1 The *Institute* considers that it is not appropriate to provide a direct link between *the Standards* and the financial reporting standards in Hong Kong. However, the *Institute* notes that in some instances *members* need to follow a set of procedures as required by the financial reporting standards to arrive at a value other than a *market value* to aid the auditors in the establishment or restatement of *financial statements*, such as 'value in use' or 'purchase price allocation in a business combination'. In this context, *members* need to disclose the set of procedures in the *report* and to follow *the Standards* whenever and wherever possible in preparing the *report*.

5. Effective date, amendments and additions

5.1 This HKIS Valuation Standards 2017 comes into effect on [30 December 2017] to replace the previous HKIS Valuation Standards 2012 Edition. *The Standards* shall apply to all *valuations* where the *valuation date* is on or after that date. Early adoption of these standards, after final approval, is encouraged.

5.2 The contents of *the Standards* are under regular review and any amendments and additions will be issued by the *HKIS* from time to time as required. Whenever *the Standards* has been amended, the effective date of the amended *Standards* will be updated.

6. Other information

6.1 In *the Standards*: (a) references to the masculine include, where appropriate, the feminine; and (b) words in the singular number include the plural and vice versa; and (c) headings are inserted for convenient reference only and have no effect in limiting or extending the language of the provisions to which they refer.

6.2 *The Standards* has been approved and published by the *HKIS* General Council as the guidance notes under Bye-Law 6.1 of Part VI Professional Conduct of Bye-Laws of the *HKIS*.

6.3 The *IVS 2017* are reproduced in full at the end of this *Standards*. They are adopted and applied through this *Standards*, with an effective date of [30 December 2017].

6.4 *Members* are reminded that *IVSC* reserves the rights to make further amendments to *IVS* at any time. Any consequential amendments to this *Standards*, if necessary in connection with any further amendments of *IVS*, will be made as soon as possible, but may not be reflected in hard copy versions of *the Standards*. *Members* are reminded to check, from time to time, for the most updated version of *the Standards* at the *HKIS* website www.HKIS.org.hk

6.5 If *members* or any other persons wish to comment or give their views on *the Standards*, they are welcomed to contact the Hong Kong Institute of Surveyors by writing to Room 1205-07, 12th Floor, Wing On Centre, No. 111 Connaught Road Central, Hong Kong or by e-mail to info@HKIS.org.hk.

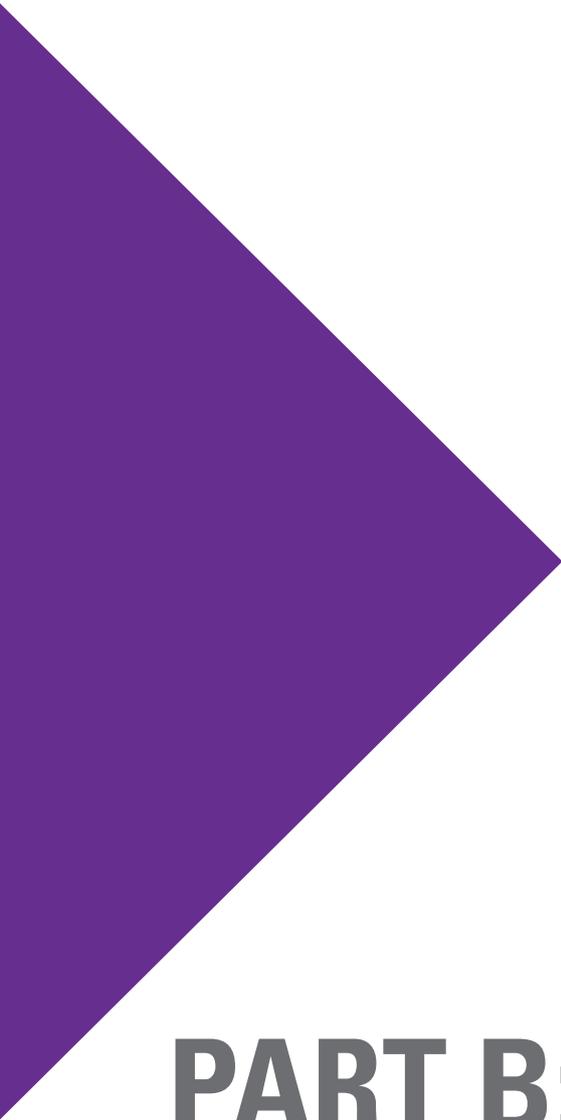
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PART B:
GLOSSARY OF TERMS
USED IN THE STANDARDS

1. This glossary defines terms used in *the Standards* that have a special or restricted meaning. Where a term defined below is used in *the Standards*, it is identified in the text of *italic* font. Words or phrases not in this glossary or not in *italic* font follow their common dictionary meanings.
2. HKIS believes that *members* who prepare a *report* shall possess specialised skills, experiences, expertise and knowledge. Also, *members* shall communicate the procedures to value and conclusions, in a manner that is clear and not misleading, to their *clients*, unless otherwise instructed. As such, it is advisable for the valuation profession to use commonly used terms, which definitions have been established clearly and consistently and have been widely applied in the profession to enhance consistency and to develop better communications.
3. In order to enhance and maintain the professional standard, HKIS has adopted certain definitions published by various institutions, including but not limited to IVSC, in *the Standards*. *Members* are highly recommended to adopt such definitions in the *reports* whenever necessary.
4. If any *member* wishes to adopt any definition that is materially different from the definition set out in *the Standards*, the *member* should set out such definition and the authoritative source of such definition clearly in the *report* and, where possible, *terms of engagement* in order to avoid misunderstandings, confusion and potential disputes.

appraisal	See <i>valuation</i> .
asset	Items that might be subject to a valuation engagement. Unless otherwise specified in the standard, this term can be considered to mean asset, group of assets, liability, group of liabilities, or group of assets and liabilities.
assumption	A supposition taken to be true. It involves facts, conditions or situations affecting the subject of, or approach to, a <i>valuation</i> that, by agreement, do not need to be verified by the <i>member</i> as part of the <i>valuation</i> process. Typically, <i>assumptions</i> are made where specific investigation by the <i>valuer</i> is not required in order to prove that something is true.
basis of value	A statement of the fundamental measurement assumptions of a <i>valuation</i> .
<i>client</i>	The person, persons, or entity for whom the <i>valuation</i> is performed, that agrees the <i>terms of engagement</i> or to which the <i>report</i> is addressed. This may include external <i>clients</i> (i.e. when a <i>valuer</i> is engaged by a <i>third-party client</i>) as well as internal <i>clients</i> (i.e. <i>valuations</i> performed for an employer).
cost approach	An approach that provides an indication of value using the economic principle that a buyer will pay no more for an <i>asset</i> than the cost to obtain an <i>asset</i> of equal utility, whether by purchase or construction.

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date of the report	The date on which the <i>valuer</i> signs the <i>report</i> .
date of valuation	See <i>valuation date</i> .
departure	Special circumstances where the mandatory application of <i>the Standards</i> may be inappropriate or impractical.
depreciated replacement cost (DRC)	The current cost of replacing an <i>asset</i> with its modern equivalent <i>asset</i> less deductions for physical deterioration and all relevant forms of obsolescence and optimisation.
directors	The individual(s) responsible for the management of a company, <i>firm</i> or entity. This also includes, where the context so admits, the corresponding officers charged with similar duties (for example, trustees) of an undertaking, enterprise or other organisation, which does not have directors.
equitable value	The estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.
fair value	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. (This definition derives from International Financial Reporting Standard IFRS 13.)
financial statements	Written statements of the financial position of a person or a corporate entity and formal financial records of prescribed content and form. These are published to provide information to a wide variety of unspecified third-party users. Financial statements carry a measure of public accountability that is developed within a regulatory framework of financial reporting standards and the law.
firm	The firm or organisation for which the <i>member</i> works, or through which the <i>member</i> trades. Closely connected companies within a group should normally be regarded as a single firm unless: (i) The companies are separate legal entities (ii) There are no directors, partners or employees in common between the companies (iii) There is no direct or indirect fee sharing between the companies and (iv) There is no access to information or common internal data sharing arrangements relating to the area of conflict.
income approach	An approach that provides an indication of value by converting future cash flows to a single current capital value.

inspection	A visit to a property or inspection of an <i>asset</i> , to examine it and obtain relevant information, in order to express a professional opinion of its value. However, physical examination of a non- <i>real estate asset</i> , e.g. a work of art or an antique, would not be described as ‘inspection’ as such .
investment property	Property that is land or a building, or part of a building, or both, held by the owner to earn rentals or for capital appreciation, or both, rather than for: <ul style="list-style-type: none"> (a) use in production or supply of goods or services, or for administrative purposes, or (b) sale in the ordinary course of business.
(the) Institute/HKIS	The Hong Kong Institute of Surveyors incorporated under the Hong Kong Institute of Surveyors Ordinance (Chapter 1148 – Laws of Hong Kong).
investment value, or worth	The value of an <i>asset</i> to the owner or a prospective owner for individual investment or operational objectives.
jurisdiction	The legal and regulatory environment in which a valuation engagement is performed. This generally includes laws and regulations set by governments (e.g. country, state and municipal) and, depending on the purpose, rules set by certain regulators (e.g. banking authorities and securities regulators).
market approach	An approach that provides an indication of value by comparing the subject <i>asset</i> with identical or similar <i>assets</i> for which price information is available.
market rent (MR)	The estimated amount for which an interest in real property should be leased on the <i>valuation date</i> between a willing lessor and willing lessee on appropriate lease terms in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.
market value (MV)	The estimated amount for which an asset or liability should exchange on the <i>valuation date</i> between a willing buyer and a willing seller in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.
marriage value	An additional element of value created by the combination of two or more <i>assets</i> or interests where the combined value is more than the sum of the separate values.
may	The word “may” describes actions and procedures that <i>valuers</i> have a responsibility to consider. Matters described in this fashion require the <i>valuer’s</i> attention and understanding. How and whether the <i>valuer</i> implements these matters in the valuation engagement will depend on the exercise of professional judgement in the circumstances consistent with the objectives of <i>the Standards</i> .

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member	Any member under the membership of Honorary Grade, Professional and Technical Grade or any affiliate as referred to in the Constitution of the Hong Kong Institute of Surveyors from time to time.
method of valuation	<i>A method of valuation</i> is a procedure, or series of steps, to arrive at the value specified in the <i>basis of valuation</i> . Example of such methods include market comparison method, the investment method, the residual method, discounted cash flow method and the profits method.
must	The work “must” indicates an unconditional responsibility. The <i>valuer</i> must fulfill responsibilities of this type in all cases in which the circumstances consistent with the objectives of <i>the Standards</i> .
real estate	Land and all things that are a natural part of the land (e.g. trees, minerals) and things that have been attached to the land (e.g. buildings and site improvements) and all permanent building attachments (e.g. mechanical and electrical plant providing services to a building), that are both below and above the ground.
report	Unless otherwise specified in <i>the Standards</i> , this term can be considered to mean “ <i>valuation report</i> ”, “ <i>valuation review report</i> ” or both.
should	<p>The word “should” indicates responsibilities that are presumptively mandatory, The <i>valuer must</i> comply with requirements of this type unless the <i>valuer</i> demonstrates that alternative actions which were followed under the circumstances were sufficient to achieve the objectives of <i>the Standards</i>.</p> <p>In the rare circumstances in which the <i>valuer</i> believes the objectives of <i>the Standards</i> can be met by alternative means, the <i>valuer must</i> document why the indicated action was not deemed to be necessary and/or appropriate.</p> <p>If a standard provides that the <i>valuer</i> “should” consider an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.</p>
significant and/or material	<p>Assessing significance and materiality require professional judgement. However, that judgement <i>should</i> be made in the following context:</p> <ul style="list-style-type: none">• Aspects of a <i>valuation</i> (including inputs, <i>assumptions</i>, <i>special assumptions</i>, and methods and approaches applied) are considered to be significant/material if their application and/or impact on the <i>valuation</i> could reasonably be expected to influence the economic or other decisions of users of the <i>valuation</i>, and judgements about materiality are made in light of the overall valuation engagement and are affected by the size or nature of the subject <i>asset</i>.• As used in these standards, “material/materiality” refers to materiality to the valuation engagement, which <i>may</i> be different from materiality considerations for other purposes, such as <i>financial statements</i> and their audits.

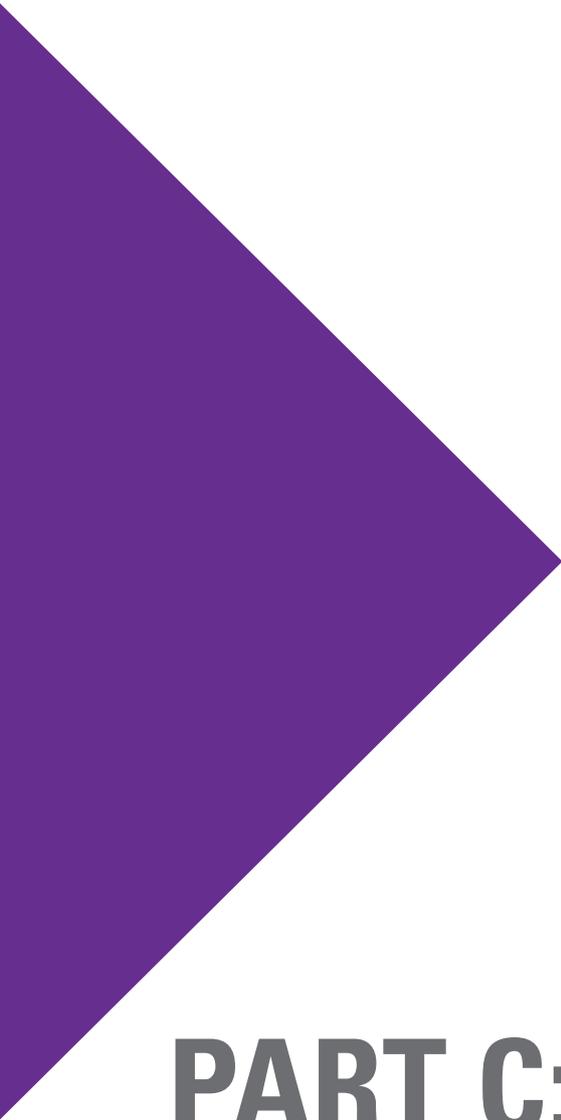
special assumption	An <i>assumption</i> that either assume facts that differ from the actual facts existing at the <i>valuation date</i> or that would not be made by a typical market participant in a transaction on the <i>valuation date</i> .
special purchaser	A particular buyer for whom a particular <i>asset</i> has a <i>special value</i> because of advantages arising from its ownership that would not be available to other buyers in a market.
special value	An amount that reflects particular attributes of an <i>asset</i> that are only of value to a <i>special purchaser</i> .
specialised property	A property that is rarely, if ever, sold in the market, except by way of a sale of the business or entity of which it is part, due to the uniqueness arising from its specialised nature and design, its configuration, size, location or otherwise. Examples include refineries, power stations, docks, specialised manufacturing facilities, public facilities, churches, museums, so on and so forth.
(the) Standards	The HKIS Valuation Standards.
sustainability	Sustainability is, for the purpose of this <i>Standards</i> , taken to mean the consideration of matters such as (but not restricted to) environment and climate change, health and well-being and corporate responsibility that can or do impact on the <i>valuation</i> of an <i>asset</i> . In broad terms it is a desire to carry out activities without depleting resources or having harmful impacts. [Note: There is, as yet, no universally recognised and globally adopted definition of 'sustainability', and therefore <i>members should exercise caution over the use of the term without additional explanation.</i>]
synergistic value	the result of a combination of two or more assets or interests where the combined value is more than the sum of the separate values.
terms of engagement	Confirmation in writing of the conditions that either the <i>member</i> proposes, or that the <i>member</i> and <i>client</i> have agreed shall apply to the undertaking and reporting of the <i>valuation/valuation review</i> .
third party	Any party, other than the <i>client</i> , who <i>may</i> have an interest in the <i>valuation</i> or its outcome.
trading stock	Stock held for sale in the ordinary course of business, for example, in relation to property, land and buildings held for sale by builders and development companies.

valuation	<p>An opinion of the value of an asset or liability, at a specified date, given in writing. Unless limitations are agreed in the <i>terms of engagement</i>, this will be provided after an <i>inspection</i>, and any further investigations and enquiries that are appropriate, having regard to the nature of the <i>asset</i> and the purpose of the <i>valuation</i>.</p> <p>The wording “估價” and “估值” in Chinese bears the same meaning of <i>valuation</i> throughout this <i>Standards</i>.</p>
valuation date	The date on which the opinion of value applies. The valuation date <i>should</i> also include the time at which it applies if the value of the type of <i>asset</i> can change materially in the course of a single day.
valuation method	See <i>method of valuation</i> .
valuation report	The means in writing of providing the <i>client</i> with the final conclusion of a <i>valuation</i> or <i>appraisal</i> .
valuation reviewer	A professional <i>valuer</i> engaged to review the work of another <i>valuer</i> . As part of a valuation review, that professional <i>may</i> perform certain valuation procedures and/or provide an opinion of value.
valuer	<p>The <i>member</i> who is undertaking / undertook a <i>valuation</i>.</p> <p>Unless proven otherwise by evidence, the valuer of a <i>valuation</i> is identified as:</p> <ul style="list-style-type: none"> (a) the <i>member</i> who appears as the signatory of the <i>report</i>; or (b) in case condition (a) above does not apply; the <i>member</i> who has the Vicarious Liability under the Rules of Conduct of <i>HKIS</i>. <p>For the <i>valuer</i> who is qualified to undertake a <i>valuation</i>, see VS2 – Qualifications of a Valuer.</p>
weight	The amount of reliance placed on a particular indication of value in reaching a conclusion of value (e.g. when a single method is used, it is afforded 100% weight).
weighting	The process of analysing and reconciling differing indications of values, typically from different methods and/or approaches. This process does not include the averaging of <i>valuations</i> without reasons, which is not acceptable.
worth	See <i>investment value</i>

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PART C:
GENERAL VALUATION
STANDARDS

VS 1

Compliance with International Valuation Standards and HKIS Valuation Standards

All members, whether practicing individually or working on behalf of his firm, who provide a valuation in writing are required to comply with the International Valuation Standards and HKIS Valuation Standards.

1.1.0 Mandatory Application

1.1.1 All members, wherever practising, must comply with the general valuation standards (designated by prefixes VS) in Part C of the Standards. For practical convenience, the term “members” include both “member” and “affiliate” as defined in the Constitution of HKIS from time to time.

1.1.2 The Standards is of mandatory application to any member of HKIS involved in undertaking or supervising valuation services by the provision of valuation advice in writing.

1.1.3 The phrase ‘undertaking or supervising valuation services’ includes any person who is responsible for, or accepts responsibility for, analysing and communicating an opinion of value in writing. This may include individuals who produce but do not sign valuation reports within their organization, and conversely individuals who sign by way of supervision or assurance but do not produce valuation reports within their organisation.

1.1.4 For the avoidance of doubt, where – exceptionally – valuation advice is provided wholly orally, the principles set out in this volume should still be observed to the fullest extent possible. Members are reminded that the mere fact that advice is provided orally does not mean that it is therefore provided without liability – the valuer’s responsibilities and obligations will always depend on the facts and circumstances of the individual case.

1.1.5 Except as otherwise stated, valuations of real property for secured lending should be prepared in accordance with VGN 4 - Valuations of Real Properties for Secured Lending published by the HKIS from time to time

1.2.0 Compliance with International Valuation Standards

1.2.1 HKIS recognises that International Valuation Standards Council (IVSC) as the setter of International Valuation Standards (IVS), which comprise internationally accepted valuation principles and definitions. The Standards adopts and applies the IVS, setting out specific requirements for, together with additional guidance on their practical implementation. The IVS effective from 1 July 2017 are set out in full as Part E at the end of the Standards.

1.2.2 Where there is an express requirement in relation to an individual valuation assignment that the valuation complies with the IVS, and this needs to be made clear both in the terms of engagement and in the report, then the form of endorsement in VS 4 Terms of Engagement paragraph 4.3.2(n) and VS 9 Reporting paragraph 9.2.3(k) may be adopted. Or otherwise, the general form of endorsement that the valuation will be / has been undertaken in accordance with the HKIS Valuation Standards may be used.

1.2.3 Members are reminded that where a statement is made that a valuation will be or has been undertaken in accordance with the IVS, it is implicit that all relevant individual IVS standards are complied with. Where a departure from IVS is necessary, this should be clearly explained.

1.3.0 Compliance with other valuation standards

1.3.1 It is recognised that a member may be requested to provide a report that complies with standards other than the Standards. This will normally arise in relation to the particular requirements that apply within individual jurisdictions. It is perfectly proper for members to comply with such requirements, which may include a basis of value not listed in VS 5 below, provided it is absolutely clear which standards are being adopted.

1.3.2 In these cases, a statement must be included in the terms of engagement and in the report that the named standards have been complied with. If the compliance is mandatory in the jurisdiction concerned,

i.e. because of statutory, regulatory or other authoritative requirements, then this does not preclude the *valuation* still being declared as performed in accordance with *the Standards* and – if appropriate – with the IVS.

1.3.3 Where the compliance with other valuation standards is voluntary, i.e. not falling within paragraph 1.3.2 above, this will involve a *departure* – see section 1.5.0 below. Note that compliance with such standards cannot override the mandatory requirements of **VS 1, 2 and 3**, which *members must* at all times observe.

1.3.4 Where the *valuation* involves *assets* in two or more countries or states with different valuation standards, the *member must* agree with the *client* which standards will apply to the instruction.

1.4.0 VS 4 - 10 Exceptions

1.4.1 All valuation advice in writing given by *members* is subject to at least some of the requirements of *the Standards* - there are no exemptions. Similarly, where valuation advice is given wholly orally, the principles set out in the *Standards should* still be observed to the fullest extent possible. Thus **VS 1, 2 and 3** are mandatory in all cases. In other words, they apply to all *members* whatever type of valuation activity they are engaged in.

1.4.2 However, given the sheer diversity of activity undertaken by *members*, and the diversity of jurisdictional contexts in which *valuations* and valuation advice are delivered, there is a need for differentiation between particular types of assignment where the mandatory application of the **VS 4 – 10** may be unsuitable or inappropriate. Even though not mandatory in certain circumstances, the adoption of the relevant standards is nevertheless encouraged where not precluded by the specific requirement or context. These exceptions regarding **VS 4 – 10** are set out at greater length below. However, it is not practical to set out every possible scenario – thus in cases of doubt, it is safer to regard **VS 4 – 10** as mandatory.

1.4.3 *Valuers should* be aware that exceptions are not usually specific to individual cases but

cover particular categories or aspects of valuation activity. In such cases *members* are reminded that they *must* not state that the *valuation* was performed in accordance with the IVS.

1.4.4 The areas of exception in relation to **VS 4 – 10** are where a *member* is:

1.4.4.1 Providing an agency or brokerage service in respect of the acquisition or disposal of one or more *assets*

This exception covers the provision of advice in the expectation of, or in the course of, an agency instruction to acquire or dispose of an interest in an *asset*. It also covers advice on whether a given offer *should* be made or accepted. It is recognized that any *member*, who may not be a Corporate Member from the General Practice Division, *may* provide agency or brokerage services to his *client*. It is perfectly proper for all *members* to provide their opinions on the values of subject *assets* in the course of agency services, **provided that the term “valuation” must not be used in any communications with the client.** However, the exception does not cover a purchase report that includes a *valuation*.

1.4.4.2 Acting or preparing to act as an arbitrator, independent *valuer*, expert witness or mediator

When *members* act in a capacity of arbitrators, independent *valuers*, expert witnesses and mediators for resolution of certain disputes such as rent review, exceptions of **VS 4 – 10** will apply since they *may* have to comply with certain statutory and/or other mandatory requirements imposed as a result of their appointment. However, when a *member* acts as an independent *valuer* or expert witness, the *member* shall, wherever practicable and with no conflict with their terms of appointment, follow the requirements set out in *the Standards*. The exception setting out in this paragraph does not apply in circumstances where the value is not yet in dispute, for example, when a *report* is required as part of the process of settling a different matter, such as a matrimonial separation dispute.

In Hong Kong, *members* are reminded that they *must* follow the Code of Conduct for Expert Witnesses as set out in Appendix D

of The Rules of The High Court (Chapter 4A – Laws of Hong Kong) when a *member* acts as an expert witness.

1.4.4.3 Performing statutory functions

This exception applies where the relevant statutory provisions will define the task and also frequently govern the manner in which it is to be carried out. The emphasis in this exception is on the word function, i.e. the performance of a statutory role or duty involving the exercise or enforcement of powers that are expressly defined or recognised in legislation, normally involving the formal appointment of an individual to that specific role. The mere fact that a *valuation* is being provided in accordance or compliance with, or consequence of, legislation is not the point. For example, the provision of a *valuation* for inclusion in a statutory return to a tax authority, which involves compliance with the law but not the exercise or enforcement of it, does not fall within this exception.

1.4.4.4 Providing *valuations* to a *client* purely for internal purposes, without liability, and without communication to a *third party*

The internal purposes exception is designed to recognise that there are occasions where advice is sought from a *valuer* by a *client* – often by a regular portfolio valuation *client* – that will be without liability, and will not be released to *third parties* (for example, in connection with proposed asset management initiatives or proposed acquisitions). Where *members* undertake such work, it is vital that the *terms of engagement* and the advice itself in writing are quite explicit about the prohibition on disclosure to any other party and/or use for any other purpose and about the exclusion of liability. Such advice often does not attract an additional fee and this element of the valuation service may or may not be explicitly referred to in the *terms of engagement* for a regular portfolio *valuation*. The mere fact that the provider of the *valuation* is an internal *valuer* does not bring the valuation assignment within the exception – the focus here is on the ‘internal only’ purpose of the *valuation* and not the process or means of its delivery. It is therefore possible for an external *valuer* to provide an ‘internal purposes’ *valuation*, though where that is done, the need for the *terms of engagement* and advice in writing

to be absolutely clear about non-disclosure to *third parties*, and about the exclusion of liability, becomes even more crucial.

1.4.4.5 Providing valuation advice expressly in preparation for, or during the course of, negotiations or litigation, including where the *valuer* is acting as advocate.

The negotiation exception covers valuation advice on the probable outcome of current or impending negotiations, or requests for figures to be quoted in connection with such negotiations. It therefore recognises that:

- Although there may not yet be an unresolved dispute, the advice is being provided expressly in preparation for, or during the course of, negotiations that may lead either to agreement or the creation of an unresolved dispute, triggering (where the context allows it) a formal process of resolution (e.g. reference to the courts, to arbitration, etc.).
- The negotiation advice may, and often will, extend to advice on matters such as tactics and/or probable outcomes and/or options to achieve resolution without recourse either to litigation or to other formal procedures.

The litigation exception recognises that:

- There is a formal dispute in existence, however it arises, and the proceedings will therefore be subject to any relevant legislation, regulation, rules or court directions that may be in place or issued, which will always take precedence over *the Standards*.
- Advice given to a *client* may extend to various matter going beyond the provision of advice on value, for example advice on tactics and/or the probable outcome of litigation and/or options regarding settlement of the dispute or mitigation of costs.

1.4.5 For all exceptions, the fact that **VS 4 – 10** are not mandatory does not mean that they are simply to be ignored – as a matter of good practice they *should* be followed where not precluded by the specific requirement or context.

1.4.6 The exceptions shall not apply if a *client* specifically requires a *report* to be prepared in accordance with the requirements set out in *the Standards*. Further, even if a *report* is

prepared under the condition that it shall comply with certain statutory or other mandatory requirements, *the Standards* will also apply, subject to such amendments as may be necessary to meet with those statutory or other mandatory requirements.

1.5.0 Departures

1.5.1 No *departure* is permitted from **VS 1**, where a *valuation* in writing is provided, or **VS 2 and 3** in *the Standards*, which are mandatory in all circumstances.

1.5.2 If separately and independently from either the specific exceptions set out above or any assignment falling within the scope of **section 1.3.0** above, there are special circumstances where it is considered inappropriate to comply, in whole or in part, with **VS 4 – 10**, then these *must* be confirmed and agreed with the *client* as a *departure* and a clear statement to that effect included in the *terms of engagement*, *report* and any published reference to it.

1.5.3 A clear statement in writing of any *departures*, if any, together with details of, and reasons for them, and the *client's* agreement, *must* be given in the *terms of engagement* and the *report*.

1.5.3 For the avoidance of doubt:

- If the *valuation* falls to be provided in compliance with prescribed statutory or legal procedures or other authoritative requirements, then provided those requirements are mandatory in the particular context or *jurisdiction*, compliance does not by itself constitute a *departure* – though the requirement to do so *must* be made clear.
- For most valuation purposes, one of the *bases of value* specified in **VS 5** will be appropriate. Where another basis is used, this *must* be clearly defined and stated in the *report*. If adoption of that basis is mandatory in the particular context or *jurisdiction*, then adoption does not by itself constitute a *departure*, though the mandatory requirement to do so *must* be made clear. *HKIS* does not

encourage the voluntary use of a *basis of value* not defined in **VS 5**, and will always regards such voluntary use as involving a *departure* from *the Standards*.

1.5.4 When statutory, legal, regulatory, or other authoritative requirements *must* be followed that differ from some of the requirements within *the Standards*, a *member* *must* follow the statutory, legal, regulatory, or other authoritative requirements. Such a *valuation* has still been performed in overall compliance with *the Standards*. (Also see **section 1.3.0** above)

1.5.5 The requirement to depart from *the Standards* pursuant to legislative, regulatory or other authoritative requirements takes precedence over all other requirements from *the Standards*.

1.5.6 Most other professional bodies, or *firms'* internal policies and procedures will impose additional requirements on the *member* rather than contradict to *the Standards*. Such requirements *may* be followed in addition to *the Standards* without being seen as *departures* or exceptions as long as all of the requirements in *the Standards* are fulfilled.

1.5.7 If a *member* is asked to perform an assignment that departs from *the Standards* or calls for something less than, or different from, the work normally performed in compliance with *the Standards*, the *member* *should* accept and perform such services only when the following conditions are satisfied:

- The *member* determines that the instructions will not mislead all the intended users;
- The *member* determines that the *valuation* is not so limited to the extent that the results are no longer reliable and credible for the intended purpose and use of the *valuation*; and
- The *member* advises the *client* that the instructions for the assignment which involve a *departure* from *the Standards* *must* be disclosed in full in the *report*.

1.5.8 A *member* who makes a *departure* will be required to justify the reasons for this *departure* to the *HKIS* (or the disciplinary bodies of the *Institute* set up on its behalf or the GPD Council who has commenced

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investigation for such purpose) *should* the *departure* be called into question. If the *HKIS* is not satisfied with the reason(s) provided and/or the manner in which the *departure* is declared or made, it is entitled to take appropriate disciplinary actions under Rules of Conduct.

1.5.9 Each *valuation* to which *the Standards* applies *must* be prepared by, or under the supervision of, an appropriately qualified *valuer*, who is also a Corporate Member of the GPD Council of *HKIS*. Other than complying with the requirements set out in *the Standards*, in each and every case of preparing a *report*, it is the ultimate responsibility of the *member*, and not the *client* or other intended users, to determine whether any *departures* from *the Standards* are reasonable and justifiable

1.6.0 Regulation: monitoring compliance with the Standards

1.6.1 As a self-regulatory body, *HKIS* has a responsibility to monitor and seek assurance of compliance by its *members* with *the Standards*. It has the right under its by-laws to seek information from *members*. The procedures under which such powers will be exercised in relation to *valuations* are set out at www.HKIS.org.hk/en/HKIS_constitution.php.

VS 2

Qualifications of a Valuer / Valuation Reviewer

- 2.1.0** As it is fundamental to the integrity of the valuation process, all *members* practising as *valuers* / *valuation reviewers* must have the appropriate experiences, skills and judgements for the task in question and *must* always act in a professional and ethical manner free from any undue influence, bias or conflict of interest.
- 2.2.0** **Testing on Qualification Requirement**
The testing of whether a *member* is appropriately qualified to accept responsibility for, or supervise the input into a *valuation* / valuation review involves satisfying the following criteria:
- a Corporate Member from the General Practice Division of the HKIS;
 - sufficient current local, national and international (as appropriate) knowledge of the asset type and its particular market, and the skills and understanding necessary, to undertake the *valuation*/ valuation review competently;
 - compliance with any country or state legal regulations governing the rights to undertake the *valuation*/valuation review; and
 - compliance with the requirements on qualified *valuer* imposed by the General Practice Division of the HKIS from time to time.
- 2.2.1** A qualified *valuer* *must* be a Corporate Member from the General Practice Division of the HKIS, but the Professional Membership from the General Practice Division of the HKIS does not of itself imply that a Corporate Member has the practical experience of *valuation* in a particular sector or market: this *must* always be verified by appropriate confirmation.
- 2.2.2** If the *member* does not have the required level of expertise to deal with some aspect of the valuation assignment properly, then he or she *should* decide what assistance is needed. With the express agreement of the *client* where appropriate, the *member* *should* then commission, assemble and interpret relevant information from other professionals, such as specialist valuers, accountants and lawyers.
- 2.2.3** The personal knowledge and skills requirements *may* be met in aggregate by more than one *member* within a *firm*, provided that each meets all the other requirements of *the Standards*.
- 2.3.0** In conducting real property *valuations* for incorporation or reference in prospectuses and circulars and *valuations* in connection with takeovers or mergers and acquisitions in Hong Kong, a qualified *valuer* *must* be on the HKIS List of the Property Valuers for such purposes as published by the HKIS from time to time.
- 2.4.0** The *client's* approval *must* be obtained if the *member* proposes another *firm* to provide some or all the *valuations* that are the subject of the instruction.
- 2.5.0** Where more than one *valuer* has undertaken or contributed to the *valuation*, a list of those *valuers* *must* be retained with the working papers, together with a confirmation that each named *valuer* has complied with the requirements of VS 1.
- 2.6.0** A *member* responsible for supervision (See VS 1 paragraph 1.1.3) *must* be able to demonstrate:
- an appropriate level of supervision throughout all stages of the valuation instruction, suitably evidenced and capable of standing up to scrutiny and challenge at a later date, particularly where the valuation assignment involves remote locations and/or more than one *jurisdiction*
 - an acceptance of responsibility and accountability for the *valuation report* and its content, and the ability to explain and defend it if challenged – it is essential that the process is not seen as one simply of approving automatically without proper consideration.
- 2.7.0** The attention of *members* is drawn to the definitions of types of *valuers* given below. *Members* *must* exercise reasonable judgement to make sure that they meet the requirements laid down below when accepting instructions for preparing *valuation reports* for various purposes as referred to in *the Standards*.
- 2.7.1** **Internal Valuer**
An 'Internal Valuer' is a *valuer* who is in

the employ of either the enterprise that owns the *assets*, or the accounting *firm* responsible for preparing the enterprise's financial records and/or *reports* and has no significant financial interest in the company or organisation that he works at. A significant financial interest refers to a person, his family members or associates entitling (individually or collectively) to exercise, or control the exercise of, 5% or more of the voting power at any general meeting of the *client's* company or group.

2.7.2 External Valuer

An 'External Valuer' is a *valuer* who, together with any associates, has no material links with the *client*, an agent acting on behalf of the *client* or the subject of the assignment

2.7.3 Independent Valuer

An 'Independent Valuer' is an External Valuer and who can fulfill all the requirements set out in **section 3.2.0 of VS 3** of the *Standards*.

2.7.4 Joint Valuers

The term 'Joint Valuers' *should* only be used on those occasions where two (or more) *valuers* are jointly (and severally) appointed to provide a *valuation*. In such cases a single *valuation report* may be provided carrying the signatures of the Joint Valuers together with their names and addresses.

VS 3

Ethics, Professionalism and Conflict of Interests

As it is fundamental to the integrity of the valuation process, all *members practising as valuers must always act in a professional and ethical manner from any undue influence, bias or conflict of interest.*

3.1.0 Professional and ethical standards

3.1.1 *HKIS members operate to the highest professional and ethical standards. Thus the criteria for HKIS membership and for qualification and practice as a valuer meet or exceed the standards for the conduct and competency of professional valuers promoted by the IVSC.*

3.1.2 *As well as being required to conform to these high-level principles and requirements, all HKIS members are subject to additional – and in many cases more stringent – requirements as set out below. Observance is monitored and enforced through HKIS Bye-laws and Rules of Conduct.*

3.1.3 *The requirements set out in this Standards are expressly focused on members undertaking valuation work, i.e. opinions of value prepared by a member having the appropriate technical skills, experience and knowledge of the subject of valuation, the market and the purpose of the valuation.*

3.1.4 *Members must at all times act with integrity and avoid any actions or situations that are inconsistent with their professional obligations. Members must not allow conflicts of interest to override their professional or business judgement and obligations, and must not divulge confidential information. All members are bound by the HKIS Rules of Conduct. More detail is available at www.HKIS.org.hk/en/HKIS_rules.php.*

3.2.0 Independence, objectivity, confidentiality and the identification and management of conflicts of interests

3.2.1 *Members must use reasonable care and judgements to achieve and maintain independence and objectivity in a valuation. A member must not offer, solicit, or accept any gift, benefit, compensation,*

or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

3.2.2 *Independence and objectivity are inextricably linked to the proper observance of the confidentiality of information and to the wider issue of the identification and management of conflicts of interest.*

3.2.3 *Valuers should recognise two fundamental requirements on conflicts of interest:*

- a) *No member shall advise or represent a client where doing so would involve a conflict of interest or a significant risk of a conflict of interest, other than where all of those who are or may be affected have provided their prior Informed Consent defined in paragraph 3.2.8 below. (The affected party can only give Informed Consent if the person explaining the position to them is entirely transparent, and also that the person explaining the position is sure that the party affected understands what they are doing – including the risks involved and any alternative options available- and is doing it willingly). Informed Consent may be sought only where the member is satisfied that proceeding despite a conflict of interest is in the interests of all the those who are or may be affected.*
- b) *Members should keep records of the decisions made in relation to whether to accept (and where relevant, to continue) individual professional assignments, the obtaining of Informed Consent, and any measures taken to avoid conflicts of interest arising.*

3.2.4 *Bringing the required levels of independence and objectivity to bear on individual assignments, respecting and maintaining confidentiality, and identifying and managing potential or actual conflicts of interest are of crucial importance. Valuation work often has a particular complexity or sensitivity concerning such matters and it is a requirement that members act strictly in accordance with the following general valuation standards and valuation-specific criteria.*

3.2.5 *For some purposes, statutes, regulations, rules of regulatory bodies or client's special requirements may set out specific criteria*

that the *member must* meet (i.e. they are additional to the general requirements below) in order to achieve a defined state of independence. Frequently such additional criteria provide a definition of the acceptable level of independence and may use terms such as 'independent expert', 'expert valuer', 'independent valuer', 'standing independent valuer' or 'appropriate valuer'. It is important that the *member* confirms compliance with these criteria both when confirming acceptance of the instruction and in the *report*, so that the *client* and any *third party* relying on the *report* can be assured that the additional criteria have been satisfied.

3.2.6 Three common types of conflict of interests which may arise in a *valuation* are identified as follows:

- a) **Party Conflict** – a situation in which the duty of a *member* or his *firm* to act in the interests of a *client* or other party in a professional assignment conflicts with a duty owed to another *client* or party in relation to the same or a related professional assignment.
- b) **Own Interest Conflict** – a situation in which the duty of a *member* or his *firm* to act in the interests of a *client* in a professional assignment conflicts with the interests of that same *member* or his *firm*.
- c) **Confidential Information Conflict** – a conflict between the duty of a *member* to provide *material* information to one *client*, and the duty of that *member* or his *firm* to another *client* to keep that same information confidential.

The above is only three common types and it is not possible to set out every possible scenario. *Members* are reminded they have their absolute duty of care to identify and avoid any actual or potential conflicts of interests. *Members should* always consider whether the proposed course of action might:

- Reasonably be perceived to imply a lack of integrity;
- Cause embarrassment to the profession; or
- Mean that you are unable to advise and represent each *client* objectively and independently.

If there is a material risk of the proposed course of action having such an effect, the *member must* not proceed. A *member must* disclose to his *firm* on any actual or potential conflict of interests.

3.2.7 Where a conflict of interest or a significant risk of one exists, a *member should* only consider proceeding with the work (and seek Informed Consent defined in 3.2.8 below from all relevant affected party in order to proceed) if the *member* are reasonably satisfied that all of the relevant *clients'* (or other parties') interests will be served by the *member* or his *firm* doing the work (as opposed to another *firm* doing it). A *member should* not seek Informed Consent in order to proceed because his *firm's* interest are served by doing so. Obtaining Informed Consent is a process that requires proper considerations, professional judgements, and careful executions with every affected party.

3.2.8 An Informed Consent means a consent given willingly by a party who may be affected by a conflict of interest, that party having demonstrated to the *member* that the party understands:

- a) that there is a conflict of interest or a significant risk of a conflict of interest;
- b) the facts known by the *member* or his *firm* that are material to the conflict of interest;
- c) what that conflict of interest is or may be; and
- d) that a conflict of interest may affect the ability of the *member* or his *firm* to advise or act fully in the interests of a *client*.

3.2.8.1 Giving Informed Consent is the way in which a party who might be affected adversely by a conflict of interests acknowledges the existence for that risk, but instructs the *member* to proceed despite that risk. The affected party can only give Informed Consent if the person explaining the position to them:

- is entirely transparent about any material factors; and
- is sure that the party affected understands what they are doing (including the risks involved and any alternative options available) and is doing it willingly.

3.2.8.2 The fact that the affected parties are willing to give Informed Consent does not mean that the *member* or his *firm* has to proceed. The *member* or his *firm must* still exercise professional judgement and decide whether it is the correct thing to do and be sure that they will not cause professional embarrassment to the *member*, his *firm* or

the profession by proceeding where there is a conflict of interest.

3.2.8.3 In obtaining Informed Consent to a conflict of interest (or a significant risk of one) the *member should* consider and discuss with the affected parties:

- i) all of the matters set out in the definition of Informed Consent; and
- ii) what precautions *should* be taken in the conduct of the *valuation* to protect them.

3.2.8.4 In seeking to obtain Informed Consent, the effect is that the degree of sophistication and nature of the party concerned *must* be reflected in the information provided in order to be satisfied that the party has understood what they are doing and is giving Informed Consent willingly. A large corporate entity is likely to appreciate more readily the risks involved in giving Informed Consent, whereas a small business or individual person who rarely employs professionals may require greater detail to understand the position.

3.2.8.5 There may be reasons to believe that the party affected does not have sufficient understanding of the issues to make an informed decision on the implications of what is required. In such a case, the instruction *should* be declined, unless the prospective *client* has taken advice from an independent and suitably qualified professional (for example, a lawyer or an accountant) about the situation before instructing the *member* or his *firm* to proceed despite a conflict of interests.

3.2.8.6 A decision to proceed with a *valuation* by obtaining Informed Consent *should* be recorded in the *terms of engagement* and the *report*.

3.2.8.7 Communications with the affected parties from whom Informed Consent is obtained *should* also be auditable. This is because in the event of a complaint, an investigation, or a civil claim, the onus will be on the *member* or the *firm* to show that Informed Consent was obtained. If such communications are not made in writing, it *may* be difficult for Informed Consent to be proved, particularly after some time has passed, or if the account of those communications from the *member* or his *firm* is contested. Therefore if Informed Consent is obtained in a meeting or by

telephone, communication in writing *should* be sent as soon as possible afterwards, noting the content and conclusion of the discussion. To avoid risk of criticism, this proof *should* not be that consent was obtained, but that Informed Consent was obtained, as defined above.

3.2.8.8 It is for the *member* or his *firm* to decide what type of document to use in each context in order to achieve Informed Consent as defined above. The explanation given about the conflict of interests (or significant risk of it) needs to be fair and accurate, and appropriate given the degree of sophistication of the person signing it, and the party signing it needs to do so freely, demonstrating an understanding of the situation.

3.2.8.9 To comply with the requirements for obtaining Informed Consent, the prospective *client must* be told, and understand, the nature of the competing interest. If it is not possible to achieve that without breaching a duty of confidentiality owed to another *client* or party, it will mean that the *member* or his *firm* cannot proceed with the new *valuation*.

3.2.8.10 Parties who may be affected by a conflict of interest include the instructing party and, if practical to obtain an Informed Consent, other third parties who may rely upon the *valuation*. In case it is not practical to obtain an Informed Consent from third parties who may rely upon the *valuation*, *members should* only consider proceeding with the work if satisfied that all the relevant parties' interests will be served as opposed to another firm doing it.

3.2.9 One of the greatest challenges in acting with a conflict of interest is predicting with certainty what the effect of the conflict of interest, even if managed carefully, might have on the *member's* ability to advise and represent each *client*. This uncertainty reinforces the importance of considering carefully whether it is prudent to decline the *valuation* in question rather than seeking Informed Consent to proceed.

3.2.10 Even where a conflict of interest (or a significant risk of a conflict of interests) does not exist at the outset of a *valuation*, it can arise during the lifetime of the *valuation*. This means that conflict of interest *must* be

considered and applied – and appropriate records made – not only when new *valuations* are being considered, but also as the *valuations* progress.

3.2.11 A *member* or his *firm* who obtained the Informed Consent may still be required to justify to *HKIS* the reasons to proceed with the *valuation*.

3.2.12 Any information in a *valuation* should be taken as confidential, unless:

- a) such information comes from a reliable source in the public domain;
- b) such information has been publicized and such information was intended to be publicized by all the relevant affected parties; or
- c) all the relevant affected parties have given their prior Informed Consents to the disclosure of such information.

There is a general duty to treat information relating to a *client* as confidential where that information becomes known as a result of the professional relationship and is not in the public domain. Information gathered in the course of valuation work may be market sensitive and this duty is therefore of special importance.

3.2.13 In particular, great care *must* be exercised not to breach confidentiality when reporting to *clients* in regard to compliance with **VS 9** concerning reference to the 'key inputs used'. The duty of confidentiality will always take precedence over the duty of disclosure, subject to legal override.

3.2.14 The risk of disclosure of confidential information is also a material factor that the *valuer* should consider in identifying whether or not there is a potential conflict of interest, or the Confidential Information Conflict above. It is sometimes necessary to disclose some details of the *valuer's* involvement in the subject of the *valuation*. If an adequate disclosure cannot be made without breaching the duty of confidentiality, then the instruction *should* be declined.

3.2.15 The duty of confidentiality is continuous and ongoing, and includes current, past and even potential *clients*.

3.2.16 While it is not possible to provide a definitive list of situations in a *valuation* context where a threat to a *member's* independence or

objectivity *may* arise, the following *should* always be regarded as presenting a potential or actual threat and therefore requiring action as specified in paragraph 3.2.7 above:

- Acting for the buyer and the seller of a property or *asset* in the same transaction;
- Acting for two or more parties competing for an opportunity;
- Valuing for a lender where advice is also being provided to the borrower or the broker;
- Valuing a property or *asset* previously valued for another *client* of the same *valuer* or *firm*;
- Undertaking a *valuation* for *third-party* consumption where the *valuer's* *firm* has other fee-earning relationships with the *client*; and
- Valuing both parties' interests in a leasehold transaction.

Members are also reminded that the interest of any *third parties* in the *valuation*, and the reliance they *may* place on it, will also be a relevant consideration.

3.2.17 A threat to the *member's* objectivity can arise where the outcome of a *valuation* is discussed before its completion with either the *client* or another party with an interest in the *valuation*. While such discussions are not improper, and indeed may be beneficial to both the *member* and the *client*, the *member* *must* be alert to the potential influence that such discussions may have on his or her fundamental duty to provide an objective opinion. Where such conversations take place, the *member* *must* make a record in writing of any meetings or discussions, and whenever the *member* decides to alter a provisional *valuation* as a result, the grounds for doing so *must* also be carefully noted.

3.2.18 The *member* *may* need to discuss various matters, such as the verification of facts and other relevant information (for example, confirming the outcome of rent reviews or clarifying the boundaries of a property), before forming a preliminary opinion of value. At any stage in the valuation process such discussions give the *client* an opportunity to understand the *member's* viewpoint and evidence. It is expected that the *client* would disclose facts or information, including information about transactions in the property or *asset*, relevant to the valuation task.

3.2.19 In providing a *client* with preliminary advice, or a draft *report* or *valuation* in advance of its completion, the *member* must state that:

- 1) The opinion is provisional and subject to completion of the final *report*;
- 2) The advice is provided for *client's* internal purposes only; and
- 3) Any draft is on no account to be published or disclosed.

If any matters of fundamental importance are not reflected, their omission *must* be declared.

3.2.20 Where discussions with a *client* occur after the provision of preliminary material or opinions, it is important that such discussions do not, and can be shown not to, lead to any perception that the *member's* opinion has been influenced by those discussions, other than to correct inaccuracies or incorporate any further information provided.

3.2.21 To demonstrate that the discussions have not compromised the *member's* independence the file notes of discussions with the *client* on draft *reports* or *valuations* should include:

- The information provided, or the suggestions made, in relation to the *valuation*;
- How that information was used to consider a change in *material* matters or opinions; and
- The reasons why the *valuation* has or has not been changed.

3.2.22 If requested, this record *should* be made available to auditors or any other party with a legitimate and material interest in the *valuation*.

3.3.0 Maintaining strict separation between advisers

3.3.1 In case an Informed Consent has been obtained for 'Party Conflict' or 'Confidential Information Conflict', a *member* or his *firm* *must* make arrangements to separate the advisers of the *firm*. Any arrangement (colloquially known in some *jurisdictions* as a 'Chinese wall') that is established *must* be robust enough to offer no chance of information or data passing from one set of advisers to another. This is a very strict test; taking 'reasonable steps' to operate an effective separation is not sufficient.

3.3.2 Accordingly, any arrangement set up and agreed to by affected *clients* *must* be overseen by a 'compliance officer' as described below, and *must* satisfy all of the following requirements:

- a) the individual(s) acting for conflicting *clients* *must* be different – note that this extends to secretarial and other support staff;
- b) such individuals or teams *must* be physically separated, at least to the extent of being in different parts of a building, if not in different buildings altogether;
- c) any information or data, however held, *must* not be accessible to 'the other side' at any time and, if in writing, *must* be kept secure in separate, locked accommodation to the satisfaction of the compliance officer, or another senior independent person, within the *firm*;
- d) The compliance officer or other senior independent person:
 - i) *should* oversee the setting up and maintenance of the arrangement while it is in operation, adopting appropriate measures and checks to ensure it is effective
 - ii) *must* have no involvement in either of the instructions and
 - iii) *should* be of sufficient status within the organisation to be able to operate without hindrance.
- e) There *should* be appropriate education and training within the *firm* on the principles and practices relating to the management of conflicts of interest.

3.3.3 Effective arrangements are unlikely to work without considerable planning, as their management needs to be an established part of a *firm's* culture. It will therefore be more difficult, and often impossible, for smaller *firms* or offices to operate them.

3.4.0 Professionalism

3.4.1 Competence

3.4.1.1 *Valuations* *must* be prepared by an individual or *firm* having the appropriate technical skills, experience and knowledge of the subject of the *valuation*, the market(s) in which it trades and the purpose of the *valuation*.

3.4.1.2 If a *member* does not possess all of the necessary technical skills, experience and knowledge to perform all aspects of a *valuation*, it is acceptable for the *valuer* to seek assistance from specialists in certain aspects of the overall assignment, providing this is disclosed in the *terms of engagement* and the *report*.

3.4.1.3 A *member* must have the technical skills, experience and knowledge to understand, interpret and utilize the work of any specialists.

3.4.1.4 Details of the qualification requirements of a *member* in performing a *valuation* are discussed in **VS 2**.

3.4.2 Suitability

3.4.2.1 Consistent with the various requirements set out in the *Standards* and to ensure that all relevant matters have been, or will be, adequately covered, it is fundamental that by the time any *valuation* in writing is concluded, but prior to the issue of the *report*, all the matters *material* to the *report* have been fully brought to the *client's* attention and appropriately documented. This is to ensure that the *report* does not contain any revision of the initial *terms of engagement* of which the *client* is unaware.

3.4.2.2 *Members* should take care that they understand their *clients'* needs and requirements fully, and appreciate that there will be occasions when they *may* need to guide *clients* to choose the most appropriate advice for the given circumstances.

3.4.2.3 The standards for minimum *terms of engagement* are set out in **VS 4**. Where **VS 4** is not mandatory, appropriate *terms of engagement* should nevertheless be prepared to suit the specific case. It is acknowledged, given the sheer diversity of valuation activity undertaken by *members*, and the diversity of jurisdictional contexts in which *valuations* and valuation advice are delivered, that *terms of engagement* will be commensurate to the *client's* needs – but in all cases *members* must ensure that all matters *material* to the *report* have been brought to the *client's* attention.

3.4.2.4 As disputes *may* arise many years after the completion of a *valuation*, it is essential that the agreement of the *terms of engagement* is

contained in, or evidenced by, comprehensive documentation maintained in a recognised and acceptable business format.

3.4.2.5 If a *member* is asked to perform an assignment that departs from *the Standards* or calls for something less than, or different from, the work normally performed in compliance with *the Standards*, the *member* should accept and perform such services only when the following conditions are satisfied:

- The *member* determines that the instructions will not mislead all the intended users;
- The *member* determines that the *valuation* is not so limited to the extent that the results are no longer reliable and credible for the intended purpose and use of the *valuation*; and
- The *member* advises the *client* that the instructions for the assignment which involve a *departure* from *the Standards* must be disclosed in full in the *report*.

3.5.0 Disclosures where the public has an interest or upon which third parties may rely

3.5.1 Disclosure requirements

3.5.1.1 Certain types of *valuation* may be relied on by parties other than the *client* that either commissioned the *report* or to whom it is addressed. Examples of this type of *valuation* would include those for:

- a published financial statement
- a stock exchange, or similar body publication, prospectus or circular
- investment schemes, which may take a number of forms in individual *jurisdictions*
- takeovers or mergers.

Where the *valuation* is of an *asset* that has previously been valued by the *valuer*, or the *valuer's* *firm* for any purpose, the following disclosures *must* be made in the *terms of engagement*, in the *report*, and in any published reference to the *valuation*, as the case *may* be, as set out later below:

- the relationship with the *client* and previous involvement
- rotation policy
- time as signatory
- proportion of fees.

3.5.2 Reliance by third parties

3.5.2.1 Where reliance may be placed on a *valuation* by a *third party* who or which is identifiable from the outset, the disclosures in accordance with this section *must* be made promptly to that party before the *valuation* is undertaken. In addition to those disclosures there *must* also be disclosure of any circumstances where the *valuer* or the *firm* will gain from the appointment beyond a normal fee or commission. This gives *third parties* the opportunity to object to the appointment if they feel that the *member's* independence and objectivity may be compromised.

3.5.2.2 However, in many cases the *third parties* will be a class of individuals, for example, the shareholders of a company, where disclosure at the outset to all interested *third parties* would clearly be impractical. In such cases the earliest practical opportunity for disclosure will be in the *report* or any published reference to it. A greater onus thus lies on the *member* to consider, before accepting the instruction, whether those *third parties* relying on the *valuation* will accept that any involvement requiring disclosure does not unduly compromise the *member's* objectivity and independence. See **section 3.7.0** below for further detail about disclosures in relation to specific categories of *valuation*.

3.5.2.3 *Valuations* in the public domain, or which will be relied on by *third parties*, are frequently subject to statute or regulation. There are often specific stipulations that the *member must* meet in order to be deemed suitable to provide a truly objective and independent view. Where that is not the case, the onus is on the *member* to ensure that there is an awareness of potential conflicts and other threats to independence and objectivity.

3.5.2.4 *Members* are reminded to notice the applicable law on the reliance of a *valuation* by *third parties* in different *jurisdiction*.

3.5.3 The relationship with the *client* and previous involvement

3.5.3.1 Although the requirement for the *member* to act with independence, integrity and objectivity as described above is clear, it does not necessarily require disclosure of all the working relationships between the

member and the *client*. In cases of doubt it is recommended that a disclosure is made.

3.5.3.2 To expose any potential conflict of interest where the *member*, or the *member's firm*, has been involved with the purchase of one or more *assets* for the *client* within the period of 12 months preceding the date of instruction or date of agreement of the *terms of engagement* (whichever is earlier) or a specific longer period prescribed or adopted in a particular *jurisdiction*, the *member must* disclose in relation to those *assets*:

- receipt of an introductory fee or
- negotiation of that purchase on behalf of the *client*.

3.5.3.3 In considering the disclosures required, it is necessary to identify the '*client*' and '*firm*'.

3.5.3.4 There are many different relationships that *may* be considered to fall within the identification of the *client* and *firm*. To be consistent with the minimum *terms of engagement* (see **VS 4**) and reporting (see **VS 9**), the *client* is the entity that agrees the *terms of engagement* or to which the *report* is addressed while the *firm* is the entity that is identified in the confirmation of the *terms of engagement* and the *report*.

3.5.3.5 Closely connected companies within a group *should* properly be regarded as a single *client* or *firm*. However, due to the often complex nature of modern business it is frequently the case that the other entities have only a remote legal or commercial connection with the *client* for which the *member's firm* also acts. There *may* also be practical difficulties in identifying such relationships, for example, between the associates of the *member's firm* in other countries or states and the *client*. Sometimes it is the *member's* commercial relationship with a party other than the *client* that could create a perceived threat to independence.

3.5.3.6 The *member* is expected to make reasonable enquiries proportionate to the circumstances: it is not necessary to establish every potential relationship that there *may* be, provided the *member* adheres to the principles of the *Standards*.

3.5.3.7 The following are examples of where the disclosure requirements will relate to and include parties other than the entity giving the valuation instruction:

- subsidiaries of an instructing holding company
- where instructions are from a subsidiary company, those other companies

connected by the same holding company or

- a *third party* issuing valuation instructions as agent for different legal entities, for example, the managers of a property fund.

3.5.3.8 Similar considerations apply in identifying the extent of the *member's firm* for disclosure purposes, where there may be separate legal entities in different locations and/or undertaking different types of work. It may not be relevant to include all organisations connected with the *firm* undertaking the *valuation* where the activities are remote or immaterial – for example, they do not involve the provision of *asset* valuation or similar advice. *Members* should note the definition of *firm* in Glossary of Terms Used in the Standards.

3.5.4 Rotation policy

3.5.4.1 The obligation to disclose the *firm's* rotation policy will arise only where the *member* has provided a series of *valuations* over a period of time. Where it is a first or one-off instruction, it is not necessary to comment on any general rotation policy.

3.5.4.2 Where the *member* responsible for the *valuation* in accordance with this standard holds that responsibility for many years, familiarity with either the *client* or the *asset* valued could lead to the perception that the *member's* independence and objectivity has been compromised. This may be addressed by arranging for the rotation of the *member* who accepts responsibility for the *valuation*.

3.5.4.3 The method by which a *firm* arranges for any rotation of those responsible for *valuations* is for the *firm* to decide, after discussion with the *client* if appropriate. However, *HKIS* recommends that the individual responsible for signing the *report*, no matter the standing of that *member* in the *firm*, has that responsibility for a limited number of years. The exact period will depend on:

- the frequency of *valuation*
- any control and review procedures in place such as 'valuation panels', which assist both the accuracy and objectivity of the valuation process and good business practice.
- *HKIS* considers it good practice, albeit not mandatory, to rotate *valuers* at intervals not exceeding seven years.

3.5.4.4 If a *firm* is of insufficient size to rotate the signatory, or to have in place 'valuation

panels', other arrangements could be made to comply with the principles of this standard. For example, where the same valuation instruction is undertaken on a regular basis, an arrangement for the *valuation* to be periodically reviewed at intervals not greater than seven years by another *member* would assist in demonstrating that the *member* is taking steps to ensure that objectivity is maintained and thus may retain the confidence of those relying on the *valuation*.

3.5.5 Time as signatory

3.5.5.1 The purpose of this requirement is to provide any *third party* with information on the length of time that a *member* has continuously been the signatory to *valuations* for the same purpose. It also requires a similar disclosure as to the length of time the *member's firm* has been carrying out *valuations* of that *asset* for the same *client*, and the extent and duration of their relationship.

3.5.5.2 In relation to the *member*, the disclosure should relate to the continuous period of responsibility for the *valuation* up to the *date of the report*. It is possible that the *member* was the signatory to previous *reports* for the same purpose, but due to the *firm's* rotation policy (as set out earlier) there was a period of time when the *member* did not have that responsibility. There is no requirement to include that earlier period in the disclosure.

3.5.5.3 The *member* is not required to provide a comprehensive account of all work ever undertaken by the *member's firm* for the *client*. A simple, concise statement that discloses the nature of other work done and the duration of the relationship is all that is required.

3.5.5.4 If there is no relationship other than the valuation instruction in question, a statement to that effect should be made.

3.5.6 Previous involvement

3.5.6.1 The purpose of this requirement is to expose any potential conflict of interest where the *member*, or the *member's firm*, has valued the *asset* for the same purpose, or has been involved with the purchase of the same *asset* for the *client* either within the period of 12 months preceding the *valuation date* or within such other period and criteria as may be prescribed or adopted in a particular state or country.

3.5.6.2 Where the *valuation* is provided for inclusion in a published document in which the public has an interest, or upon which *third parties* may rely, the *member should* make the following disclosures:

- a) where a *valuation* is of an *asset* that has previously been valued by the *member* or the *member's firm*, for the same purpose:
 - in the *terms of engagement*, a statement about the *firm's* policy on the rotation of the *valuer* responsible for the *valuation* and
 - in the *report*, and published reference to it, a statement of the length of time the *valuer* has continuously been the signatory to *valuations* provided to the *client* for the same purpose as the *report* and, in addition, the length of time the *valuer's firm* has continuously been carrying out the *valuation* instruction for the *client*
- b) the extent and duration of the relationship of the *valuer's firm* with the *client* for any purpose
- c) where the *report*, and any published reference to it, includes one or more *assets* acquired by the *client* within the period applicable under **paragraph 3.5.6.1** immediately above, and the *member* or *member's firm*, has in relation to those *assets*:
 - received an introductory fee or
 - negotiated that purchase on behalf of the *client*a statement *should* be made to such effect including, wherever relevant, endorsement of the *report* in accordance with **paragraph 3.5.7** immediately below.

3.5.7 Proportion of fees

3.5.7.1 A statement *should* be made that the proportion of the total fees payable by the *client* during the preceding year relative to the total fee income of the *member's firm* during the preceding year are minimal, significant or substantial.

3.5.7.2 A proportion of fees less than 5% *may* be considered to be 'minimal'. Between 5% and 25% *may* be considered to be significant, and above 25% is substantial.

3.5.8 Other disclosures

3.5.8.1 Care *should* be taken to make sure that, in addition to the various disclosures required under **VS 4 to VS 10**, all other disclosures required for a particular *valuation* or purpose are made. Disclosure requirements that may require more specific information related to the

purpose of the *valuation* include:

- material involvement
- the status of the *member*
- specific requirements as to independence
- knowledge and skills of the *member*
- extent of investigations
- management of any conflicts of interest
- the *valuation* approach
- disclosures required by any regulatory body governing the purpose of the *valuation*.

3.6.0 Reviewing another valuer's valuation

3.6.1 A *valuer* may quite properly be requested to review all or part of a *valuation* prepared by another *valuer* in circumstances that include the following, though the list is not exhaustive:

- assisting the consideration of risk assessment
- providing comment on a published *valuation*, for instance in a takeover situation
- commenting on *valuations* produced for use in legal proceedings
- assisting an audit enquiry.

3.6.2 It is important to make a clear distinction between a critical review of a *valuation* and an audit of a *valuation* or an independent *valuation* of a property or *asset* included in another *valuer's report*.

3.6.3 In carrying out any review the *member* is expected, by reference to the *valuation date* and to the facts and circumstances relevant to the *asset* at the time, to:

- form opinions as to whether the analysis in the work under review is appropriate
- consider whether the opinions and conclusions are credible and
- consider whether the *report* is appropriate and not misleading.

3.6.4 The review *must* be undertaken in the context of the requirements applicable to the work under review, and the *member must* develop and report opinions and conclusions together with the reasons for any disagreement.

3.6.5 A *member must* not undertake a critical review of a *valuation* prepared by another *valuer* that is intended for disclosure or publication, unless the *member* is in possession of all the facts and information upon which the first *valuer* relied. This paragraph does not apply to any legal proceedings or any investigation carried out by HKIS, regulatory authorities or other affected parties.

3.7.0 Responsibility for the valuation

- 3.7.1** For the avoidance of doubt, once the various preliminary issues above have been adequately addressed, each assignment to which these valuation standards apply *must* be prepared by, or under the supervision of, an appropriately qualified, and named, *valuer* who accepts responsibility for it.
- 3.7.2** Where the *valuation* has been prepared with input from other *members* or *valuers*, or a separate *valuation report* on some specific aspect is incorporated, the resultant *valuation* remains the responsibility of the named *valuer* under **paragraph 3.7.1** above, but the others involved *may* be acknowledged ensuring that any statements expressly required under **VS 9 - Reporting** are made.
- 3.7.3** *HKIS* does not allow a *valuation* to be prepared by a '*firm*' (even though this is permitted by the IVS). However, the use of 'for and on behalf of' under the responsible *valuer's* signature is an acceptable substitution.
- 3.7.4** *Members* are discouraged from referring to any *valuation* or *report* as either 'formal' or 'informal', as these terms may give rise to misunderstanding, particularly regarding the extent of investigation and/or *assumptions* that the *member* may or may not have undertaken or made.
- 3.7.5** *Members must* exercise great caution before permitting *valuations* to be used for purposes other than those originally agreed. It is possible that a recipient or reader will not fully appreciate the restricted character of the *valuation* and of any qualifications in the *report*, and that it *may* be misquoted out of context. Furthermore a conflict of interest may potentially arise that would not have been relevant to the original assignment. It is essential therefore that the *terms of engagement* and the reporting appropriately address this risk.

VS 4

Terms of Engagement

4.1.0 General principles

4.1.1 Normally the *terms of engagement* will be settled between the *client* and the *valuer* when instructions are first received and accepted (the initial confirmation of instructions). However, it is recognised that a valuation assignment *may* range from a single *asset* to a substantial portfolio, thus the extent to which all the minimum *terms of engagement* can be confirmed at the outset could also vary.

4.1.2 *Valuers should* take care to ensure that they understand their *clients'* needs and requirements fully, and appreciate that there will be occasions when they *may* need to guide *clients* to choose the most appropriate advice for the given circumstances.

4.1.3 In brief, the *terms of engagement should* convey a clear understanding of the valuation requirements and process and *should* be couched in terms that can be read and understood by someone with no prior knowledge of the subject *asset*, nor of the valuation process.

4.1.4 The format and detail of the proposed *valuation report* is a matter to be agreed between the *valuer* and the *client* and recorded in writing in the *terms of engagement*. It *should* always be proportionate to the task and – as for the *valuation* itself – be professionally adequate for the purpose. For clarity, the standards expressly to be met when issuing a *valuation report* are set out in **VS 9**. These generally mirror the requirements set out here, but with some additional detail.

4.1.5 Whenever the *valuer* or *client* identifies that a *valuation* may need to reflect an actual or anticipated marketing constraint, details of that constraint *must* be agreed and set out in the *terms of engagement*. The term 'forced sale value' *must* not be used.

4.1.6 By the time the *valuation* is concluded, but prior to the issue of the *report*, all relevant matters *must* have been fully brought to the *client's* attention and appropriately documented. This is to ensure that the *report* does not contain any revision of the initial

terms of engagement of which the *client* is unaware.

4.2.0 Terms of engagement format

4.2.1 *Firms* may have a standard form of *terms of engagement* or standing *terms of engagement* in place that may include several of the minimum terms required by *the Standards*. The *valuer may* need to amend such a form to refer to those matters that will be clarified at a later date.

4.2.2 Although the precise format of the *terms of engagement* may vary – for example, some 'in-house' *valuations* may have standing instructions or other internal policies or procedures – *valuers must* prepare *terms of engagement* in writing for all valuation work. The risks that can potentially arise if queries are subsequently raised and the parameters for the valuation assignment are insufficiently documented cannot be over-emphasised.

4.3.0 Terms of engagement (scope of work)

4.3.1 *Terms of engagement must* address the following matters.

- a) **Identification and status of the *valuer***
- b) **Identification of the *client(s)***
- c) **Identification of any other intended users**
- d) **Identification of the *asset(s)* being valued**
- e) **Valuation (financial) currency**
- f) **Purpose of the *valuation***
- g) **Basis(es) of value adopted**
- h) ***Valuation date***
- i) **Nature and extent of the *valuer's* work – including investigations – and any limitations thereon**
- j) **Nature and source(s) of information upon which the *valuer* will rely**
- k) **All *assumptions* and *special assumptions* to be made**
- l) **Format of the *report***
- m) **Restrictions on use, distribution and publication of the *report***
- n) **Confirmation that the *valuation* will be undertaken in accordance with the *IVS* and/or *HKIS Valuation Standards***
- o) **The basis on which the fee will be calculated**
- p) **A statement setting out any limiting conditions have been agreed.**

4.3.2 Each heading is considered in more detail below. The text in bold specifies the key principles. The accompanying text specifies how the principles are to be interpreted and implemented in individual cases.

a) Identification and status of the *valuer*

Include a statement confirming:

- that the *valuation* will be the responsibility of a named individual *valuer*. **HKIS does not allow a *valuation* to be prepared by a 'firm'.**
- that the *valuer* is in a position to provide an objective and unbiased *valuation*.
- whether or not the *valuer* has any material connection or involvement with the subject *asset* or the other parties to the valuation assignment. **If there are any other factors that could limit the *valuer's* ability to provide an impartial and independent *valuation*, such factors *must* be disclosed.**
- that the *valuer* is competent to undertake the valuation assignment. **If the *valuer* needs to seek material assistance from others in relation to any aspect of the assignment, the nature of such assistance and the extent of reliance *must* be clear, agreed and recorded.**

(i) The use of 'for and on behalf of' a *firm* is an acceptable substitution by an identified signatory when issuing a *report*. If the *valuation* has been undertaken by a *member* under the supervision of an appropriately qualified *valuer*, the *valuer* fulfilling the supervisory function *must* ensure, and be satisfied, that the work undertaken meets the same minimum standards as if he or she had been solely responsible for the task.

(ii) For some purposes the *valuer* may be required to state if he or she is acting as an internal or external *valuer*. Where the *valuer* is obliged to comply with additional requirements regarding independence, **VS 3 section 3.2.0** will apply.

(iii) In considering the extent of any material involvement, whether past, current or possible future

involvement, the *valuer must* state such involvement in the *terms of engagement*. Where there has not been any previous material involvement, a statement to that effect *must* be made in the *terms of engagement* and *valuation report* (see **VS 9 paragraph 9.2.3 (a)**). More extensive guidance on independence and objectivity is given in **VS 3 section 3.2.0**.

(iv) With regard to the competence of the *valuer*, the statement *may* be limited to confirmation that the *valuer* has sufficient current local, national and international (as appropriate) knowledge of the particular market, and sufficiently developed skills and understanding to undertake the *valuation* competently. It is not necessary to provide any details. Where the provisos in **VS 3 section 3.2.0** apply, an appropriate disclosure is to be made.

b) Identification of the *client(s)*

Confirmation of those for whom the valuation assignment is being produced is important when determining the form and content of the *report* to ensure that it contains information relevant to their needs. **Any restriction on those who may rely upon the valuation assignment *must* be agreed with the *client* and recorded.**

(i) Requests for *valuations* will frequently be received from representatives of the *client*, in which event the *valuer should* ensure that the *client* is correctly identified. This is particularly relevant where:

- the request is made by the *directors* of a company, but the *client* is the company and the *directors* have a separate legal standing or
- the *valuation* is required for loan purposes and, although commissioned by the borrower or an entity acting for the lender (for example, a service management company), the *report* may be for the lender, its subsidiaries, or members of a syndicate, for example, so it is imperative to identify the true *client* or
- the *valuation* is required for estate

management or estate-related revenue filings and, although commissioned by a financial adviser or an attorney, the *report* may be for the estate, the true *client*.

c) Identification of other intended users

It is important to understand whether there are any other intended users of the *valuation report*, their identity, and their needs, in order to ensure that the *report* content and format meets those users' needs.

- (i) The *valuer* must state whether or not any parties other than the *client* may rely upon the *valuation*.
- (ii) In many cases, it will only be the *valuer's client* who is seeking reliance upon the *valuation*. Agreeing to extend reliance to *third parties* may significantly increase the risks to the *valuer*.
- (iii) As a default position, *valuers* should confirm that they do not permit *third party* reliance on the *valuation report* in their *terms of engagement*. Any permitted reliance on the *valuation* by a *third party* should be carefully considered and the terms on which reliance is permitted should be documented. Particular care needs to be taken to ensure that the *valuer* does not unwittingly become exposed to the risk of *third parties* claiming that a duty of care has been extended to them, and that any relevant terms of business (such as limitations on liability) apply to *third parties* who are permitted to rely on a *valuation*. *Valuers* should consider taking legal advice in this regard.
- (iv) *Valuers* should exercise care in considering whether assignment of the valuation engagement contract (as distinct from permitting *third parties* to rely upon it) is to be permitted, as doing so may expose *valuers* to additional risks. *Valuers* should ensure that the terms of their professional indemnity insurance provides the requisite cover where assignment is permitted.

d) Identification of the *asset(s)* being valued:

The subject *asset* in the valuation assignment must be clearly identified, taking care to distinguish between an asset or liability and an interest in or rights to use that asset or liability as the case may be. If the *valuation* is of an *asset* that is used in conjunction with other *assets*, it will be necessary to clarify whether those *assets* are:

- included in the valuation assignment
- excluded but assumed to be available or
- excluded and assumed not to be available.

If the *valuation* is of a fractional interest held in an *asset*, it will be necessary to clarify the relationship of the fractional interest being valued relative to all other fractional interests and the obligations of the fractional interest ownership, if any, to other fractional interest owners.

Particular regard must be had to the identification of portfolios, collections and groups of properties. It is essential to consider 'lotting' or 'grouping'; the identification of different property or *asset* categories; and any *assumptions* or *special assumptions* relating to the circumstances under which the properties, assets, liabilities or collections may be brought to the market.

- (i) The legal interest in each *asset* must be stated. Clarification is essential to distinguish between the characteristics of the *asset* in its entirety and the particular right or interest that is being valued.
- (ii) When valuing an interest in real property that is subject to a tenancy, it may be necessary to identify any improvements undertaken by tenants and to clarify whether or not these improvements are to be disregarded on renewal, or review, of the lease, or even if they may give rise to a compensation claim by the tenant when vacating the *real estate*.
- (iii) When valuing a fractional (percentage of the whole) ownership interest in a real property, the *valuer* also needs

to identify the degree of control represented by the percentage interest being valued and any rights held by the other fractional interest ownerships that encumber the marketability of the interest being valued (such as a first right of purchase in the event the ownership being valued is to be sold).

- (iv) Where there is doubt about what constitutes a single property or *asset*, the *valuer* must 'lot', or group, the properties for *valuation* in the manner most likely to be adopted in the case of an actual sale of the interest(s) being valued. However, the *valuer* must always discuss the options with the *client* and must confirm the approach adopted in the *terms of engagement* and subsequently in the *valuation report*.

e) Valuation (financial) currency

The currency in which the *valuation* of the *asset* is to be expressed must be established.

This requirement is particularly important for valuation assignments involving *assets* in more than one *jurisdiction* and/or cash flows in multiple currencies.

- (i) If a *valuation* has to be translated into a currency other than that of the country in which the *asset* is located, the basis of the exchange rate must be agreed.

f) Purpose of the *valuation*

The purpose for which the *valuation* assignment is being prepared must be clearly identified and stated as it is important that *valuation* advice is not used out of context or for purposes for which it is not intended.

The purpose of the *valuation* will also typically influence or determine the *basis(es) of value* to be used.

- (i) If the *client* declines to reveal the purpose of the *valuation*, *valuers* should be aware that it may be

difficult to comply with all aspects of *the Standards*. If the *valuer* is willing to proceed with the *valuation*, the *client* must be advised in writing that this omission will be referred to in the *report*. In this case the *report* must not be published or disclosed to *third parties*.

- (ii) If an unusually qualified *valuation* is to be provided, the *terms of engagement* must state that it is not to be used for any purpose other than that originally agreed with the *client*.

g) Basis(es) of value adopted

The *valuation basis* must be appropriate for the purpose of the *valuation*. The source of the definition of any *basis of value* used must be cited or the basis explained. This requirement does not apply to a *valuation* review where no opinion of value is to be provided and the reviewer is not required to comment on the *basis of value* used.

- (i) Where a *valuation* basis is expressly defined in *the Standards* (including IVS-defined bases), that definition must be reproduced in full. Where the definition is supplemented by a detailed conceptual framework or other explanatory material, it is not necessary to reproduce that framework or explanation. However, there is discretion to reproduce it should the *valuer* consider that it assists the *client* to understand more fully the reasoning behind the *basis of value* adopted.

- (ii) For certain specific purposes, such as financial reporting under the International Financial Reporting Standards, or in consequence of individual jurisdictional requirements, the adoption of a specific *basis of value* may be stipulated. In all other cases the appropriate *basis(es)* is essentially a matter for the *valuer's* professional judgment.

- (iii) It is recognised that for some purposes a projected value may be required in addition to a current *valuation*. Any

such projection *should* comply with the applicable jurisdictional and/or national standards. See **VS 8 section 8.4.0**.

h) **Valuation date**

The **valuation date** may be different from the date on which the **valuation report** is to be issued or the date on which investigations are to be undertaken or completed. Where appropriate, these dates *should* be clearly distinguished.

- (i) The specific *valuation date* will need to be agreed with the *client* – an *assumption* that the *valuation date* is the *date of the report* is not acceptable.
- (ii) Where, exceptionally, the advice being provided relates to a future date, see **VS 8 section 8.4.0** and **VS 9 paragraph 9.2.3(f)**, regarding the reporting requirements.

i) **Nature and extent of the valuer's work – including investigations – and any limitations thereon**

Any limitations or restrictions on the *inspection, inquiry and/or analysis* for the purpose of the valuation assignment *must* be identified and recorded in the *terms of engagement*.

If relevant information is not available because the conditions of the assignment restrict the investigation, then if the assignment is accepted, these restrictions and any necessary *assumptions* or *special assumptions* made as a result of the restriction *must* be identified and recorded in the *terms of engagement*.

- (i) A *client* may require a restricted service; for example, a short timescale for reporting *may* make it impossible to establish facts that would normally be verified by *inspection*, or by making normal enquiries. A restricted service will also include any limitations on *assumptions* made in accordance with **VS 8**. It is accepted that a *client* *may* sometimes require this level of service, but it is the duty of the *valuer* to discuss the requirements and

needs of the *client* prior to reporting. Such instructions, when related to *real estate*, are often referred to as 'drive-by', 'desk-top' or 'pavement' *valuations*.

- (ii) The *valuer* *should* consider if the restriction is reasonable, with regard to the purpose for which the *valuation* is required. The *valuer* *may* consider accepting the instruction subject to certain conditions, for example that the *valuation* is not to be published or disclosed to *third parties*.

- (iii) If the *valuer* considers that it is not possible to provide a *valuation*, even on a restricted basis, the instruction *should* be declined.

- (iv) The *valuer* *must* make it clear when confirming acceptance of such instructions that the nature of the restrictions and any resulting *assumptions*, and the impact on the accuracy of the *valuation*, will be referred to in the *report*. (See also **VS 9**)

- (v) **VS 7** contains general requirements with regard to *inspections*.

j) **Nature and source(s) of information upon which the valuer will rely**

The nature and source of any relevant information that is to be relied upon and the extent of any verification to be undertaken during the valuation process *must* be identified, agreed and recorded.

For this purpose, 'information' is to be interpreted as including data and other such inputs.

- (i) Where the *client* will provide information that is to be relied on, the *valuer* has a responsibility to state that information clearly in the *terms of engagement* and, where appropriate, its source. In each case the *valuer* *must* judge the extent to which the information to be provided is likely to be reliable, being mindful to recognise and not to exceed the limitations of their qualification and expertise in this respect.

(ii) The *client* may expect the *valuer* to express an opinion (and, in turn, the *valuer* may wish to express an opinion) on social, environmental and legal issues that affect the *valuation*. The *valuer* must therefore make clear in the *report* any information that *must* be verified by the *client's* or other interested parties' legal advisers before the *valuation* can be relied on or published.

k) All assumptions and special assumptions to be made

All assumptions and special assumptions that are to be made in the conduct and reporting of the valuation assignment must be identified and recorded:

- Assumptions are matters that are reasonable to accept as fact in the context of the valuation assignment without specific investigation or verification. They are matters that, once stated, are to be accepted in understanding the valuation or other advice provided.
- A special assumption is an assumption that either assumes facts that differ from the actual facts existing at the valuation date or that would not be made by a typical market participant in a transaction on the valuation date.

Only assumptions and special assumptions that are reasonable and relevant having regard to the purpose for which the valuation assignment is required should be made.

(i) Special assumptions are often used to illustrate the effect of changed circumstances on value. Examples of special assumptions include:

- that a proposed building had actually been completed on the valuation date
- that a specific contract was in existence on the valuation date which had not actually been completed
- that a financial instrument is valued using a yield curve that is different from that which would be used by a market participant.

(ii) Further guidance on assumptions and special assumptions, including the case of projected values (i.e. future state of the asset or of any factors relevant to its valuation) can be found in VS 8.

(iii) HKIS recognises the 'Value for Sale under Repossession' (VSR) as a valuation under special assumptions on actual or potential marketing constraints, but not as a basis of value.

l) Format of the report

The valuer must establish the format of the report and how the valuation will be communicated.

(i) VS 9 sets out the mandatory reporting requirements. Where – exceptionally – it is agreed that any of the minimum reporting contents are to be excluded they may be treated as departures, provided they are agreed in the terms of engagement, are appropriately referred to in the valuation report, and do not result in a report that is misleading and/or professionally inadequate for its purpose.

(ii) A report prepared in accordance with this standard and with VS 9 must not itself be described as a certificate or statement, the use of such language implying either a guarantee or a level of certainty that is often inappropriate. However, a valuer may use the term 'certified', or similar words, within the body of a report where it is known that the valuation is to be submitted for a purpose that requires formal certification of a valuation opinion.

(iii) Valuers should be aware that the terms 'certificate of value', 'valuation certificate' and 'statement of value' have specific meanings in certain countries or states in designating statutory documents. One common factor is that these documents require a simple confirmation of price or value, without any requirement to understand the context, fundamental assumptions or analytical processes behind the figure provided. A valuer who has previously provided a valuation or advised on a transaction

involving the *asset* may prepare such a document where the *client* is required to provide it by statute.

- (iv) Where necessary for the purpose of brevity, *members* may provide a separate summary of values, provided that it is part of a *valuation report* prepared for the required same purpose and complying fully with *the Standards*, and clearly cross referenced and stated as such.

m) Restrictions on use, distribution and publication of the report

Where it is necessary or desirable to restrict the use of the valuation advice or those relying upon it, the restrictions **must** be clearly communicated.

- (i) The *valuer* **must** state the permitted use, distribution and publication of the *valuation report*.
- (ii) Restrictions are only effective if notified to the *client* in advance.
- (iii) The *valuer* **should** keep in mind that any insurance that protects against claims for negligence under professional indemnity insurance (PII) policies may require the *valuer* to have particular qualifications, and to include certain limiting clauses in every *report* and *valuation*. If this is the case the relevant words **should** be repeated, unless the insurers agree to either a modification or a complete waiver. If in doubt, *valuers* **should** refer to their insurance policy before accepting instructions.
- (iv) Some *valuations* will be for purposes where the exclusion of *third party* liability is either forbidden by law or by an external regulator. In other cases, it will be a matter for clarification or agreement with the *client*, having regard also to the judgment of the *valuer*.
- (v) Particular care **should** be taken in relation to valuation assignments in connection with secured lending to address *third party* liability issues.

- n) Confirmation that the *valuation* will be undertaken in accordance with the IVS and/or HKIS Valuation Standards

The *valuer* **should** provide:

confirmation that the *valuation* will be undertaken in accordance with the *International Valuation Standards (IVS)* and that the *valuer* will assess the appropriateness of all *significant* inputs

or (depending on *clients'* particular requirements)

confirmation that the *valuation* will be undertaken in accordance with the *HKIS Valuation Standards*, which incorporate the IVS.

In both cases an accompanying note and explanation of any *departures* from the IVS or *the Standards* **must** be included. Any such *departure* **must** be identified, together with justification for that *departure*. A *departure* would not be justified if it results in a *valuation* that is misleading.

- (i) There is no material difference in outcome between the respective forms of endorsement above, which *may* be used according to the particular requirements of the valuation assignment. Some *clients* will expressly wish to have confirmation that the *valuation* has been undertaken in accordance with the IVS, and it is naturally in order for this to be given. In all other cases confirmation that the *valuation* has been undertaken in accordance with the *HKIS Valuation Standards* carries with it the dual assurance of compliance with the IVS technical standards and with the *HKIS Valuation Standards* overall.
- (ii) References to the *HKIS Valuation Standards* without reference to the year of issue will be taken to mean the version of the *HKIS* standards operative at the *valuation date*, provided that it is on or before the *date of the report*. Where a 'projected value' is to be provided (i.e. relating to a date after the *date of the report*) the *date of the report* will be the deciding

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factor as to the version that applies.

(iii) The statement of compliance *should* draw attention to any *departures* (see **VS 1 section 1.5.0**). Where a *departure* is made that is not mandatory, it will not be possible to confirm compliance with the IVS.

(iv) Where other valuation standards – specific to a particular *jurisdiction* – will be followed, this *should* be confirmed as a part of agreement in the *terms of engagement*.

o) The basis on which the fee will be calculated

The level of the fee is a matter to be settled with the *client*, unless there is a fee basis prescribed by an external body that binds both parties. *HKIS* does not publish any scale of recommended fees.

p) A statement setting out any limiting conditions that have been agreed

The issues of risk, liability and insurance are closely linked. The *valuer* *should* keep in mind that any insurance that protects against claims for negligence under professional indemnity insurance (PII) policies may require the *valuer* to have particular qualifications, and to include certain limiting clauses in every *report* and *valuation*. If this is the case the relevant words *should* be repeated, unless the insurers agree to either a modification or a complete waiver. If in doubt, *valuers* *should* refer to their insurance policy before accepting instructions.

4.4.0 Valuation to reflect marketing constraints

4.4.1 Both the *client* and the *valuer* shall agree to the actual or anticipated marketing constraint as set out in the *terms of engagement* (see paragraph 4.3.2 (k) above).

4.4.2 The term 'forced sale value' *must* not be used as it is not a recognised *basis of value*; rather 'forced sale' is a description of the situation under which the transfer takes place.

4.4.3 The *Institute* recognises the 'Value for Sale under Repossession' is a *valuation* to reflect

marketing constraints but not a *basis of value*.

4.5.0 Valuation to be carried out with restricted information

Prior to the issue of a *report*, a *valuer* shall confirm in writing with the *client* the basis of restricted information, its nature and its possible implications upon the *valuation report*.

4.6.0 Valuation engagement to conduct a critical review of another valuer's valuation

4.6.1 A *member* *must* not undertake a critical review of a *valuation* prepared by another *valuer* that is intended for disclosure or publication, unless the *member* is in possession of all the facts and information upon which the first *valuer* relied.

4.6.2 Subject to the following requirements, a *valuation reviewer* *may*, on the instruction of the *client*, conduct the critical review on the basis of agreed-upon procedures for the *client's* internal reference:-

- (a) The *client* in the *terms of engagement* agrees that the nature and scope of the procedures are adequate for his purpose.
- (b) The *valuation reviewer* in the *terms of engagement* and his valuation review report discloses the limitation he has in conducting his valuation review.
- (c) The *valuation reviewer* in the *terms of engagement* and his valuation review report states that should additional documents and facts be available to him at a later date, he *may* reserves the right to amend his findings and conclusions in his valuation review report.
- (d) The *valuation reviewer* in the *terms of engagement* and his valuation review report states that the valuation review report shall not be disclosed to a third party or published to the public.

4.6.3 This section does not apply to *reports* prepared for any legal proceedings where a *member* *may* be required to comment on a *report* prepared by a *valuer* representing or acting on behalf of the opposing party in legal proceedings.

4.6.4 This section does not apply to situations where the GPD Council commences an investigation to a *valuer*.

- 4.6.5 This section does not apply to situations where complaints from the public has been received by the *HKIS* or come to its attention, or the *HKIS* has, for some reasons, commenced a disciplinary investigation to determine whether a *valuation/report* prepared by a *member* complies with the requirements set out in *the Standards*.
- 4.7.0 Valuation engagement for financial and accounts reporting and valuation to be included or disclosed in the financial statements
- 4.7.1 A *valuer* is required to reach an agreement with the *client* in the *terms of engagement* on the working relationship with the *client's* auditor. This *may* include such details as the way and the extent of releasing working papers and data to the *client's* auditor, to avoid unnecessary disputes with the *client* and the *client's* auditor thereafter.
- 4.7.2 It is a good practice to have a meeting with the *client* and their auditor to understand and to agree on the scope of work prior to proposing and entering an engagement with the *client*.

VS 5

Bases of Value

5.1.0 General principles

5.1.1 The *valuer* must ensure that the *basis of value* adopted is appropriate for, and consistent with, the purpose of the *valuation*.

5.1.2 If one of the *bases of value* defined in the *Standards* (including IVS-defined bases) is used, then it *should* be applied in accordance with the relevant definition and guidance, including the adoption of any *assumptions* or *special assumptions* (see VS 8) that are appropriate.

5.1.3 If a *basis of value* not defined in the *Standards* (including IVS-defined bases) is used, it *must* be clearly defined and stated in the *report*, which *must* also draw attention to the fact that it is a *departure* if use of the basis in the particular valuation assignment is voluntary and not mandatory. Where a *departure* is made that is not mandatory, compliance with IVS is not possible.

5.1.4 A *basis of value* is a statement of the fundamental measurement *assumptions* of a *valuation*. It describes the fundamental premises on which the reported values will be based. It is critical that the *basis of value* be appropriate to the terms and purpose of the valuation assignment, as a *basis of value* may influence or dictate a *valuer's* selection of methods, inputs and *assumptions*, and the ultimate opinion of value.

5.1.5 For some valuation assignments, particularly in relation to specific *jurisdictions* within which there may be mandatory requirements, another *basis of value* may be specified (for example, in legislation) or appropriate (*members should* note that IVS 104 gives some illustrative examples at paragraph 20.1 (b)). Where this is so, the *valuer* must define clearly the basis adopted and, in any case where adoption of the basis is other than mandatory, explain in the *report* why use of a basis reproduced in the *Standards* (including any *jurisdiction*-specific supplement to these standards) is considered inappropriate (see VS 1 section 1.3.0)..

5.1.6 As markets continue to develop and advance, and as *clients'* needs continue to

grow in terms of sophistication, additional demands are being placed on *valuers* to provide advice involving some element of prediction or forecast. Great care is needed to ensure that such advice is not misunderstood or misrepresented, and that any sensitivity analysis is carefully presented so as not to undermine the *basis of value* adopted.

5.1.7 *Valuers* are cautioned that the use of an unrecognised or bespoke *basis of value* without good reason could result in breach of the requirement that the *valuation report* should not be ambiguous or misleading.

5.2.0 Bases of Value

5.2.1 The following bases are defined in the International Valuation Standards and International Financial Reporting Standards (see IVS 104 paragraph 20.1(a)) and most are in common use, albeit that they may not be universally adopted in all markets:

- a) IVS-defined bases of value:
 1. Market Value (section 5.3.0)
 2. Market Rent (section 5.4.0)
 3. Equitable Value (section 5.5.0)
 4. Investment Value/Worth (section 5.6.0)
 5. Synergistic Value (section 5.7.0)
 6. Liquidation Value (section 5.8.0) and
- b) IFRS-defined bases of value:
 1. Fair Value (section 5.9.0)

Particular care is necessary to ensure that, where used, *synergistic value* is fully understood by the *client*.

5.2.2 While there are many different *bases of value* used in *valuations*, most have certain common elements: an assumed transaction, an assumed date of the transaction and the assumed parties to the transaction.

5.2.3 Depending on the *basis of value*, the assumed transaction could take a number of forms:

- a) a hypothetical transaction,
- b) an actual transaction,
- c) a purchase (or entry) transaction,
- d) a sale (or exit) transaction, and/or
- e) a transaction in a particular or hypothetical market with specified characteristics.

- 5.2.4 The assumed date of a transaction will influence what information and data a *valuer* consider in a *valuation*. Most *bases of value* prohibit the consideration of information or market sentiment that would not be known or knowable with reasonable due diligence on the measurement/*valuation date* by participants.
- 5.2.5 Most *bases of value* reflect *assumptions* concerning the parties to a transaction and provide a certain level of description of the parties. In respect to these parties, they could include one or more actual or assumed characteristics, such as:
- hypothetical,
 - known or specific parties,
 - members of an identified/described group of potential parties,
 - whether the parties are subject to particular conditions or motivations at the assumed date (e.g. duress), and/or
 - an assumed knowledge level.
- 5.2.6 The *valuer* has responsibility for ensuring that the *basis of value* adopted is consistent with the purpose of the *valuation* and appropriate to the circumstances – this responsibility is subject to compliance with any mandatory requirements, such as those imposed by statute. It is important that the basis to be adopted is discussed and confirmed with the *client* and any intended users, if applicable, at the outset in any case where the position is not straightforward. However, regardless of instructions and input provided to the *valuer*, the *valuer should not use a basis of value* that is inappropriate for the intended purpose of the *valuation* (for example, if instructed to use a IVS-defined *basis of value* for financial reporting purposes under IFRS, compliance with *the Standards* may require the *valuer* to use a *basis of value* that is not defined or mentioned in *the Standards*).
- 5.2.7 *Valuers* are responsible for understanding the regulation, case law and other interpretive guidance related to all *bases of value* used.
- 5.2.8 It is important to note that *bases of value* are not necessarily mutually exclusive. For example, the *worth* of a property or *asset* to a specific party, or the *equitable value* of a property or *asset* in exchange between two specific parties, may match the *market value* even though different assessment criteria are used.
- 5.2.9 Because bases other than *market value* may produce a value that could not be obtained on an actual sale, whether or not in the general market, the *valuer must* clearly distinguish the *assumptions* or *special assumptions* that are different from, or additional to, those that would be appropriate in an estimate of *market value*. Typical examples of such *assumptions* and *special assumptions* are discussed in **VS 8**.
- 5.2.10 *Valuers must* ensure in all cases that the *basis of value* is reproduced or clearly identified in both the *report* and, if possible, the *terms of engagement* (scope of work). If, after engagement, the *valuer* considers that a *basis of value* agreed in advance with the *client* is likely to be inappropriate, the revised *basis of value must* be discussed and agreed with the *client* and, as far as possible, the intended users, prior to the conclusion of the valuation assignment and delivery of the *report*.
- 5.2.11 A *valuer may* be legitimately instructed to provide valuation advice based on other criteria, and therefore other *bases of value* may be appropriate. In such cases the definition adopted *must* be set out in full and explained. Where such a basis differs significantly from *market value* it is recommended that a brief comment is made indicating the differences.
- ### 5.3.0 Market Value
- 5.3.1 *Market value* is defined in IVS 104 paragraph 30.1 as:
- ‘the estimated amount for which an asset or liability should exchange on the *valuation date* between a willing buyer and a willing seller in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.’
- 5.3.2 The definition of *market value must* be applied in accordance with the following conceptual framework:
- “The estimated amount” refers to a price expressed in terms of money payable for the *asset* in an arm’s length market transaction. *Market value* is the most probable price reasonably obtainable

in the market on the *valuation date* 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. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of value available only to a specific owner or purchaser.

- b) "An asset or liability should exchange" refers to the fact that the value of an asset or liability is an estimated amount rather than a predetermined amount or actual sale price. It is the price in a transaction that meets all the elements of the *market value* definition at the *valuation date*.
- c) "On the *valuation date*" requires that the value is time-specific as of a given date. Because markets and market conditions may change, the estimated value may be incorrect or inappropriate at another time. The valuation amount will reflect the market state and circumstances as at the *valuation date*, not those at any other date.
- d) "Between a willing buyer" refers to one who is motivated, but not compelled to buy. This buyer is neither over eager nor determined to buy at any price. This buyer is also one who purchases in accordance with the realities of the current market and with current market expectations, rather than in relation to an imaginary or hypothetical market that cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than the market requires. The present owner is included among those who constitute "the market".
- e) "And a willing seller" is neither an over eager nor a forced seller 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 *asset* at market terms for the best price attainable in the open market after proper marketing, whatever that price may be. The factual circumstances of the actual owner are not a part of this consideration because the willing seller is a hypothetical owner.
- f) "In an arm's length transaction" is one between parties who do not have a particular or special relationship, e.g. parent and subsidiary companies or landlord and tenant, that *may* make the price level uncharacteristic of the market or inflated. The *market value* transaction is presumed to be between unrelated parties, each acting independently.
- g) "After proper marketing" means that the *asset* has been exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable in accordance with the *market value* definition. The method of sale is deemed to be that most appropriate to obtain the best price in the market to which the seller has access. The length of exposure time is not a fixed period but will vary according to the type of *asset* and market conditions. The only criterion is that there must have been sufficient time to allow the *asset* to be brought to the attention of an adequate number of market participants. The exposure period occurs prior to the *valuation date*.
- h) "Where the parties had each acted knowledgeably, prudently" presumes that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the *asset*, its actual and potential uses, and the state of the market as of the *valuation date*. Each is further presumed to use that knowledge prudently to seek the price that is most favourable for their respective positions in the transaction. Prudence is assessed by referring to the state of the market at the *valuation date*, not with the benefit of hindsight at some later date. For example, it is not necessarily imprudent for a seller to sell *assets* in a market with falling prices at a price that is lower than previous market levels. In such cases, as is true for other exchanges in markets with changing prices, the prudent buyer or seller will act in accordance with the best market information available at the time.

i) "And without compulsion" establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.

5.3.4 *Market value* is a *basis of value* that is internationally recognised and has a long-established definition. It describes an exchange between parties that are unconnected and are operating freely in the marketplace and represents the figure that would appear in a hypothetical contract of sale, or equivalent legal document, at the *valuation date*, reflecting all those factors that would be taken into account in framing their bids by market participants at large and reflecting the highest and best use of the *asset*. The highest and best use of an *asset* is the use of an *asset* that maximises its productivity and that is possible, legally permissible and financially feasible.

5.3.5 *Market value* is understood as the value of an asset or liability estimated without regard to costs of sale or purchase (or transaction) and without offset for any associated taxes or potential taxes. The definition, however, does not preclude the consideration of taxes and transaction costs in the calculations. *Valuers* always have to exercise reasonable judgements on the impact of relevant taxes and transaction costs in their valuation models.

5.3.6 The concept of *market value* presumes a price negotiated in an open and competitive market where the participants are acting freely. The market for an *asset* could be an international market or a local market. The market could consist of numerous buyers and sellers, or could be one characterised by a limited number of market participants. The market in which the *asset* is presumed exposed for sale is the one in which the *asset* notionally being exchanged is normally exchanged.

5.3.7 The *market value* of an *asset* will reflect its highest and best use (see section 5.12.0). The highest and best use is the use of an *asset* that maximises its potential and that is possible, legally permissible and financially feasible. The highest and best use may be for continuation of an *asset's* existing use or for some alternative use. This is determined by the use that a market participant would have in mind for the *asset* when formulating the price that it would be willing to bid.

5.3.8 The nature and source of the valuation inputs *must* be consistent with the *basis of value*, which in turn *must* have regard to the valuation purpose. For example, various approaches and methods *may* be used to arrive at an opinion of value providing they use market-derived data. The *market approach* will, by definition, use market-derived inputs. To indicate *market value*, the *income approach* *should* be applied, using inputs and *assumptions* that would be adopted by participants. To indicate *market value* using the *cost approach*, the cost of an *asset* of equal utility and the appropriate depreciation *should* be determined by analysis of market-based costs and depreciation.

5.3.9 The data available and the circumstances relating to the market for the *asset* being valued *must* determine which *valuation method* or methods are most relevant and appropriate. If based on appropriately analysed market-derived data, each approach or method used *should* provide an indication of *market value*.

5.3.10 The *valuation* process requires *members* to conduct adequate and relevant research, to perform competent analyses, and to draw informed and supportable judgements. In this process, *valuers* do not accept data without questions but *should* consider pertinent market evidence, trends, comparable transactions, and other information. Where market data is limited, or essentially non-existent, the *valuer* *must* make proper disclosure of the situation and *must* state whether the estimate is in any way limited by the inadequacy of data.

5.3.11 *Market value* does not reflect attributes of an *asset* that are of value to a specific owner or purchaser that are not available to other buyers in the market (*special value*). Such advantages may relate to the physical, geographic, economic or legal characteristics of an *asset*. *Market value* requires the disregard of any such element of value because, at any given date, it is only assumed that there is a willing buyer, not a particular willing buyer.

5.3.12 Notwithstanding the disregard of *special value*, where the price offered by prospective buyers generally in the market would reflect an expectation of a change in the circumstances of the *asset* in the future,

the impact of that expectation is reflected in *market value*. Examples of where the expectation of additional value being created or obtained in the future may have an impact on the *market value* include:

- the prospect of development where there is no current permission for that development and
- the prospect of *marriage value* arising from merger with another property or *asset*, or interests within the same property or *asset*, at a future date.

5.3.13 The impact on value arising by use of an *assumption* or *special assumption* should not be confused with the additional value that might be attributed to an *asset* by a *special purchaser*.

5.3.14 As changing conditions are characteristics of markets, *valuers must* consider whether the available data reflects and meets the criteria for *market value*. However, if the interest being valued is incapable of being disposed of in the market, *market value may* not be an appropriate basis to use.

- (a) Periods of rapid changes in market condition are typified by rapidly changing prices, a condition commonly referred to as disequilibrium. A period of disequilibrium *may* continue over a period of years and can constitute the current and expected future market condition. In other circumstances, rapid economic change may give rise to erratic market data. If some sales are out of line with the market, the *valuer* will generally give them less *weight*. It *may* still be possible for the *valuer* to judge from available data where the realistic level of the market is. Individual transaction prices may not be evidence of *market value*, but analysis of such market data *should* be taken into consideration in the valuation process.
- (b) In poor or falling markets there may or may not be a large number of “willing sellers.” Some, but not necessarily all, transactions may involve elements of financial (or other) duress or conditions that reduce or eliminate the practical willingness of certain owners to sell. *Valuers must* take into account, as far as possible, relevant factors in such market conditions and attach such *weight* to individual transactions that they believe proper to reflect the market. Liquidators

and receivers are normally under a duty to obtain the best price in property disposals. Sales, however, may take place without proper marketing or a reasonable marketing period. *Valuers must* judge such transactions to determine the degree to which they meet the requirements of the *market value* definition and the *weight* that such data *should* be given.

5.3.15 When assessing the *market value* of a property, any encumbrances such as mortgage, debenture or other charges against it *should* be disregarded.

5.3.16 A *client* may wish to include the ‘hope value’ of a property in its *market value* and the ‘hope value’ refers to the situation that the market has an expectation that the circumstances affecting the property may have a positive change in the future. Examples of the ‘hope value’ include:

- (a) The prospect of having re-development opportunity where in fact there is no current permission of re-development granted for that real property.
- (b) The realisation of ‘*marriage value*’ arising from merger with another real property or interests within the same real property.
- (c) The prospect of positive cash flows of a business enterprise which though at present records a negative equity in the balance sheet.

However, the amount of hope value *must* be limited to the extent that it would be reflected in offers made by prospective purchasers in a general market under a rational environment which means with market-evidence. Should the *valuer* be instructed to report a *marriage value* or *synergistic value* which is a basis other than *market value*, for example, he is required to distinguish clearly from *market value*.

5.3.17 *Valuers should* not mix up the concept of ‘highest and best use’ with ‘hope value’. ‘Hope value’ not only includes a particular synergy in a purchase so long as it is reflected in the open market, but also the prospect of obtaining approval or lease modification as the case may be. The proposed use from which the ‘hope value’ is derived conforms with the ‘highest and best use’ in the sense that the proposed use is legally allowable when there is a reasonable prospect (as reflected in the market of at least 50%

chance) that the regulation, zoning, deed restriction, etc. can be changed to permit the proposed use.

5.4.0 IVS-Defined Basis of Value – Market Rent

5.4.1 Market rent is defined in IVS 104 paragraph 40.1 as:

‘the estimated amount for which an interest in real property should be leased on the *valuation date* between a willing lessor and a willing lessee on appropriate lease terms in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.’

5.4.2 Market rent may be used as a *basis of value* when valuing a lease or an interest created by a lease. In such cases, it is necessary to consider the contract rent and, where it is different, the *market rent*.

5.4.3 Contract Rent is the rent payable under the terms of an actual lease. It may be fixed for the duration of the lease, or variable. The frequency and basis of calculating variations in the rent will be set out in the lease and *must* be identified and understood in order to establish the total benefits accruing to the lessor and the liability of the lessee.

5.4.4 The conceptual framework supporting the definition of *market value* shown above can be applied to assist in the interpretation of *market rent*.

5.4.5 Market rent will vary significantly according to the terms of the assumed lease contract. The appropriate lease terms will normally reflect current practice in the market in which the property is situated, although for certain purposes unusual terms may need to be stipulated. Matters such as the duration of the lease, the frequency of rent reviews and the responsibilities of the parties for maintenance and outgoings will all affect the *market rent*. In certain countries or states, statutory factors may either restrict the terms that may be agreed, or influence the impact of terms in the contract. These need to be taken into account where appropriate.

5.4.6 In calculating *market rent*, the *valuer must* consider the following:

a) in regard to a *market rent* subject to

a lease, the terms and conditions of that lease may be the appropriate lease terms unless those terms and conditions are illegal or contrary to overarching legislation, and

b) in regard to a *market rent* that is not subject to a lease, the assumed terms and conditions are the terms of a notional lease that would typically be agreed in a market for the type of property on the *valuation date* between market participants.

5.4.7 In some circumstances the *market rent may* have to be assessed based on terms of an existing lease (e.g. for rental determination purposes where the lease terms are existing and therefore not to be assumed as part of a notional lease). The existing lease term or the reference to the existing lease term *must* be stated in the *report*.

5.4.8 If the lease term is not specified, the estimated amount excludes a rent inflated or deflated by special terms, considerations or concessions and the “appropriate lease terms” are terms that would typically be agreed in the market for the type of property on the *valuation date* between market participants. An indication of *market rent should* only be provided in conjunction with an indication of the principal lease terms that have been assumed.

5.4.9 Market rent will normally be used to indicate the amount for which a vacant property may be let, or for which a let property may re-let when the existing lease terminates.

5.4.10 *Valuers must* therefore take care to set out clearly the principal lease terms that are assumed when providing an opinion of *market rent*. If it is the market norm for lettings to include a payment or concession by one party to the other as an incentive to enter into a lease, and this is reflected in the general level of rents agreed, the *market rent should* be considered to be expressed on this basis. The nature of the incentive assumed *must* be stated by the *valuer*, along with the assumed lease terms. In a rental determination where an existing lease is in place, *valuers may* have to determine and agree with the *client* and the intended users whether any incentives will be provided in the assumed lease term, and the estimated amount *may* have to be adjusted accordingly.

5.5.0 IVS-Defined Basis of Value – Equitable Value

5.5.1 *Equitable value* is defined in IVS 104 paragraph 50.1 as:

‘the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.’

5.5.2 *Equitable value* requires the assessment of the price that is fair between two specific, identified parties considering the respective advantages or disadvantages that each will gain from the transaction. In contrast, *market value* requires any advantages or disadvantages that would not be available to, or incurred by, market participants generally to be disregarded.

5.5.3 *Equitable value* is a broader concept than *market value*. Although in many cases the price that is fair between two parties will equate to that obtainable in the market, there will be cases where the assessment of *equitable value* will involve taking into account matters that have to be disregarded in the assessment of *market value*, such as certain elements of *synergistic value* arising because of the combination of the interests.

5.5.4 Examples of the use of *equitable value* include:

- a) determination of a price that is equitable for a shareholding in a non-quoted business, where the holdings of two specific parties may mean that the price that is equitable between them is different from the price that might be obtainable in the market, and
- b) determination of a price that would be equitable between a lessor and a lessee for either the permanent transfer of the leased *asset* or the cancellation of the lease liability.

5.6.0 IVS-Defined Basis of Value – Investment Value/Worth

5.6.1 *Investment value (Worth)* is defined in IVS 104 paragraph 60.1 as:

‘the value of an *asset* to a particular owner or prospective owner for individual investment or operational objectives.’

5.6.2 *Investment value* is an entity-specific *basis of value* that measures the value of the benefits of ownership to the current owner or to a prospective owner, recognizing that these may differ from those of a typical market participant. Although the value of an *asset* to the owner may be the same as the amount that could be realised from its sale to another party, this *basis of value* reflects the benefits received by an entity from holding the *asset* and, therefore, does not involve a presumed exchange. *Investment value* reflects the circumstances and financial objectives of the entity for which the valuation is being produced. It is often used for measuring investment performance.

5.6.3 In some instances, the owner of the *asset* may instruct the *valuer* to use a target rate of return to test or analyse the financial performance of the *asset* to the owner, and that target rate of return is not market-derived. Such instructions *should* be disclosed by the *valuer* in the *valuation report*.

5.7.0 IVS-Defined Basis of Value – Synergistic Value

5.7.1 *Synergistic Value* is defined in IVS 104 paragraph 70.1 as:

‘the result of a combination of two or more *assets* or interests where the combined value is more than the sum of the separate values.’

5.7.2 If the synergies are only available to one specific buyer then *synergistic value* will differ from *market value*, as the *synergistic value* will reflect particular attributes of an *asset* that are only of value to a specific purchaser. The added value above the aggregate of the respective interests is often referred to as “*marriage value*.”

5.8.0 IVS-Defined Basis of Value – Liquidation Value

5.8.1 Liquidation Value is defined in IVS 104 paragraph 60.1 as:

‘the amount that would be realised when an *asset* or group of *assets* are sold on a piecemeal basis.’

5.8.2 Liquidation Value *should* take into account the costs of getting the *assets* into saleable condition as well as those of the disposal activity. Liquidation Value can be determined under two different premises of value:

- a) an orderly transaction with a typical marketing period (see section 5.14.0), or
- b) a forced transaction with a shortened marketing period (see section 5.15.0).

5.8.3 A *valuer* must disclose which premise of value is assumed.

5.9.0 Fair Value (IFRS)

5.9.1 *Fair value* (the definition adopted by the International Accounting Standards Board (IASB) in IFRS 13) 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.’

5.9.2 The guidance in IFRS 13 includes an overview of the *fair value* measurement approach.

5.9.3 The objective of a *fair value* measurement is to estimate the price at which an orderly transaction to sell the *asset* or to transfer the liability would take place between market participants at the measurement date under current market conditions. It is thus sometimes described as a ‘mark to market’ approach. Indeed the references in IFRS 13 to market participants and a sale make it clear that for most practical purposes the concept of *fair value* is consistent with that of *market value*, and so there would ordinarily be no difference between them in terms of the valuation figure reported.

5.9.4 A *fair value* measurement requires an entity to determine all of the following:

- the particular *asset* or liability that is the subject of the measurement (consistently with its unit of account)
- for a non-financial *asset*, the valuation premise that is appropriate for the measurement (consistently with its highest and best use)
- the principal (or most advantageous) market for the *asset* or liability
- the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the *assumptions* that market participants would use when pricing the *asset* or liability and the level of the *fair value* hierarchy within which the inputs are categorised.

5.9.5 *Valuers* undertaking *valuations* for inclusion in *financial statements* should familiarise themselves with the relevant requirements.

5.10.0 Value for Sale Under Repossession (VSR)

5.10.1 Value for sale under repossession (the word repossession means the action of regaining possession especially the seizure of collateral securing a loan that is in default) refers to the price that might reasonably be expected to realise within a defined period of time (the period shall be agreed upon between Lender and *valuer*) from the sale of a real property in the market under repossession by the lender or receiver, on an “as is” basis, taking into account the unique quality of the real property and the existence of any specific demand as well as factors which might adversely affect the marketability of the real property due to market perception of increased risk or stigma, justified or otherwise.

5.10.2 The underlying *basis of value* of VSR is *market value*, but subject to *special assumptions* on actual or hypothetical marketing constraints which cause the perception of increased risk of stigma. The marketing constraint *must* be agreed with the lender prior to reporting. An example of the marketing constraint includes the anticipated time frame for completion of a transaction which strikes a balance between the Lender’s liquidity need and the reasonable care to the mortgagor, but which may be considered as inadequate for the real property to be presented in the market.

5.10.3 A *special assumption* that simply refers to a time limit for disposal without stating the reasons for that limit would not be a reasonable *assumption* to make. Without a clear understanding of the

reasons for the constraint, the *valuer* would be unable to determine the impact that it may have on marketability, sale negotiations and the price achievable, or to provide meaningful advice.

5.10.4 A marketing constraint *should* not be confused with a forced sale. A constraint may result in a forced sale, but it can also exist without compelling the owner to sell.

5.10.5 While a *valuer* can assist a lender in determining a price that should be accepted in marketing constraints, this is a commercial judgement of the lender whether a discounted price to the *market value* will be accepted. A *valuer should* make a qualification in the *report* on the reliance of VSR.

5.10.6 To provide an estimate of the VSR, the *valuer should*:

- (1) agree with the *lender* or receiver on the details of the actual or anticipated marketing constraints that might have impact on the *market value* whilst taking into account the unique quality of the real property and the existence of any specific demand;
- (2) ascertain whether the constraint arises from an inherent feature of the *asset*, or of the interest being valued, or from the particular circumstances of the *client*, or some combination of all of these;
- (3) estimate the *market value* of the real property;
- (4) analyse and apply adjustment(s) to the *market value* of the real property by taking into account the negative impacts and to arrive at the value for sale under repossession independently; and
- (5) make a qualification in the *report* on the reliance of the VSR.

5.10.7 When value for sale under repossession is reported, it *should* always be clearly distinguished from *market value*. Should a *special assumption* be adopted in arriving at the value for sale under repossession, the *valuer* is required to comply with the requirement set out in *the Standards*.

5.11.0 Premise of Value/Assumed Use

5.11.1 A Premise of Value or Assumed Use describes the circumstances of how an asset or liability is used. Different *bases of value* may require a particular Premise of Value or allow the consideration of multiple Premises of Value.

Some common Premises of Value are:

- a) highest and best use,
- b) current use/existing use,
- c) orderly liquidation, and
- d) forced sale.

5.12.0 Premise of Value – Highest and Best Use

5.12.1 Highest and best use is the use, from a participant perspective, that would produce the highest value for an *asset*. Although the concept is most frequently applied to non-financial *assets* as many financial *assets* do not have alternative uses, there may be circumstances where the highest and best use of financial *assets* needs to be considered.

5.12.2 The highest and best use must be physically possible, (where applicable), financially feasible, legally allowed and result in the highest value. If different from the current use, the costs to convert an *asset* to its highest and best use would impact the value.

5.12.3 The highest and best use for an *asset* may be its current or existing use when it is being used optimally. However, highest and best use may differ from current use or even be an orderly liquidation.

5.12.4 The highest and best use of an *asset* valued on a stand-alone basis may be different from its highest and best use as part of a group of *assets*, when its contribution to the overall value of the group *must* be considered.

5.12.5 The determination of the highest and best use involves consideration of the following:

- a) To establish whether a use is physically possible, regard will be had to what would be considered reasonable by participants.
- b) To reflect the requirement to be legally permissible, any legal restrictions on the use of the *asset*, e.g. town planning/zoning designations, need to be taken into account as well as the likelihood that these restrictions will change.
- c) The requirement that the use be financially feasible takes into account whether an alternative use that is physically possible and legally permissible will generate sufficient return to a typical market participant, after taking into account the costs of conversion to that use, over and above the return on the existing use.

5.13.0 Premise of Value – Current Use/Existing Use

5.13.1 Current use/existing use is the current way an asset, liability, or group of assets and/or liabilities is used. The current use may be, but is not necessarily, also the highest and best use.

5.14.0 Premise of Value – Orderly Liquidation

5.14.1 An orderly liquidation describes the value of a group of *assets* that could be realised in a liquidation sale, given a reasonable period of time to find a purchaser (or purchasers), with the seller being compelled to sell on an as-is, where-is basis.

5.14.2 The reasonable period of time to find a purchaser (or purchasers) may vary by *asset* type and market conditions.

5.15.0 Premise of Value – Forced Sale

5.15.1 The term “forced sale” is often used in circumstances where a seller is under compulsion to sell and that, as a consequence, a proper marketing period is not possible and buyers may not be able to undertake adequate due diligence. The price that could be obtained in these circumstances will depend upon the nature of the pressure on the seller and the reasons why proper marketing cannot be undertaken. It may also reflect the consequences for the seller of failing to sell within the period available. Unless the nature of, and the reason for, the constraints on the seller are known, the price obtainable in a forced sale cannot be realistically estimated. The price that a seller will accept in a forced sale will reflect its particular circumstances, rather than those of the hypothetical willing seller in the *market value* definition. A “forced sale” is a description of the situation under which the exchange takes place, not a distinct *basis of value*. (See **VS 8 Section 8.3.0**).

5.15.2 A forced sale typically reflects the most probable price that a specified property is likely to bring under all of the following conditions:

- a) consummation of a sale within a short time period,
- b) the *asset* is subjected to market

conditions prevailing as of the *date of valuation* or assumed timescale within which the transaction is to be completed,

- c) both the buyer and the seller are acting prudently and knowledgeably,
- d) the seller is under compulsion to sell,
- e) the buyer is typically motivated,
- f) both parties are acting in what they consider their best interests,
- g) a normal marketing effort is not possible due to the brief exposure time, and
- h) payment will be made in cash.

5.16.0 Entity-Specific Factors

5.16.1 For most *bases of value*, the factors that are specific to a particular buyer or seller and not available to participants generally are excluded from the inputs used in a market-based *valuation*. Examples of entity-specific factors that may not be available to participants include:

- a) additional value or reduction in value derived from the creation of a portfolio of similar *assets*,
- b) unique synergies between the *asset* and other *assets* owned by the entity,
- c) legal rights or restrictions applicable only to the entity,
- d) tax benefits or tax burdens unique to the entity, and
- e) an ability to exploit an *asset* that is unique to that entity.

5.16.2 Whether such factors are specific to the entity, or would be available to others in the market generally, is determined on a case-by-case basis. For example, an *asset* may not normally be transacted as a standalone item but as part of a group of *assets*. Any synergies with related *assets* would transfer to participants along with the transfer of the group and therefore are not entity-specific.

5.16.3 If the objective of the *basis of value* used in a *valuation* is to determine the value to a specific owner (such as *Investment value/Worth* discussed in paras 5.6.1 and 5.6.2), entity-specific factors are reflected in the *valuation* of the *asset*. Situations in which the value to a specific owner may be required include the following examples:

- a) supporting investment decisions, and
- b) reviewing the performance of an *asset*.

5.17.0 Synergies

5.17.1 “Synergies” refer to the benefits associated with combining *assets*. When synergies are present, the value of a group of assets and liabilities is greater than the sum of the values of the individual assets and liabilities on a stand-alone basis. Synergies typically relate to a reduction in costs, and/or an increase in revenue, and/or a reduction in risk.

5.17.2 Whether synergies *should* be considered in a *valuation* depends on the *basis of value*. For most *bases of value*, only those synergies available to other participants generally will be considered (see discussion of Entity-Specific Factors in paragraphs 5.16.1 – 5.16.3).

5.17.3 An assessment of whether synergies are available to other participants *may* be based on the amount of the synergies rather than a specific way to achieve that synergy.

5.18.0 Transaction Costs

5.18.1 Most *bases of value* represent the estimated exchange price of an *asset* without regard to the seller’s costs of sale or the buyer’s costs of purchaser and without adjustment for any taxes payable by either party as a direct result of the transaction.

5.18.2 The definitions, however, does not preclude the consideration of taxes and transaction costs in the calculations. *Valuers* always have to exercise reasonable judgements on the impact of relevant taxes and transaction costs in their valuation models.

VS 6

Valuation Approaches and Methods

6.1.0 General Principles

6.1.1 *Valuers* are responsible for adopting, and as necessary justifying, the valuation approaches and the valuation methodologies used to fulfil individual valuation assignments. These *must* always have regard to:

- the nature of the asset (or liability)
- the purpose, intended use and context of the particular assignment and
- any statutory or other mandatory requirements applicable in the *jurisdiction* concerned.

6.1.2 *Valuers should* also have regard to recognised best practice within the valuation discipline or specialist area in which they practice, although this should not constrain the proper exercise of their judgment in individual valuation assignments in order to arrive at an opinion of value which is professionally adequate for its purpose.

6.1.3 Unless expressly required by statute or by other mandatory requirements, no one valuation approach or single *valuation method* necessarily takes precedence over another. In some *jurisdictions* and/or for certain purposes more than one approach may be expected or required in order to arrive at a balanced judgment. In this regard, the *valuer must* always be prepared to explain the approach(es) and method(s) adopted.

6.1.4 Although no formal, universally recognised definition of valuation approach exists, the term is generally used to mean the overall manner in which the valuation task is undertaken in order to determine the value of the particular asset or liability. The term *valuation method* is generally used to refer to the particular procedure, or technique, used to assess or calculate the result.

6.1.5 *Valuations* are required of different interests in different types of *assets* for a range of different purposes. Given this diversity, the approach to the estimation of value in one case may well be inappropriate in another, let alone the actual method(s) or technique(s) used. Using the working definition in

paragraph 6.1.4 above, the overall valuation approach is usually classified into one of three main categories:

- The *market approach* is based on comparing the subject *asset* with identical or similar *assets* for which price information is available, such as a comparison with market transactions in the same, or closely similar, type of *asset* within an appropriate time horizon.
- the *income approach* is based on capitalisation or conversion of present and predicted income (cash flows), which may take a number of different forms, to produce a single current capital value. Among the forms taken, capitalisation of a conventional market-based income or discounting of a specific income projection can both be considered appropriate depending on the type of *asset* and whether such an approach would be adopted by market participants.
- the *cost approach* is based on the economic principle that a purchaser will pay no more for an *asset* than the cost to obtain one of equal utility whether by purchase or construction.

The three approaches are all based on the economic principles of price equilibrium, anticipation of benefits or substitution.

6.1.6 Underlying each valuation approach and *valuation method* is the need to make such comparisons as are practically possible, since this is the essential ingredient in arriving at a market view. It may well be possible to arrive at a valuation opinion by adopting more than one approach and one method or technique, unless statute or some other mandatory authority imposes a particular requirement. Great care *must* be exercised when relying on the *cost approach* as the primary or only approach, as the relationship between cost and value is rarely direct.

6.1.7 *Valuation methods* may include a range of analytical tools or techniques as well as different forms of modelling, many of which involve advanced numerical and statistical practices. In general, the more advanced the method, the greater the degree of vigilance needed to ensure there is no internal inconsistency, for example, in relation to the *assumptions* adopted.

- 6.1.8** It must be emphasised that the *valuer* is ultimately responsible for selection of the approach(es) and method(s) to be used in individual valuation assignments, unless statute or other mandatory authority imposes a particular requirement.
- 6.1.9** The goal in selecting valuation approaches and methods for an *asset* is to find the most appropriate method under the particular circumstances. No one method is suitable in every possible situation. The selection process *should* consider, at a minimum:
- a) the appropriate basis(es) of value and premise(s) 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, and
 - d) the availability of reliable information needed to apply the method(s).
- 6.1.10** *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. Where more than one approach and method is used, or even multiple methods within a single approach, the conclusion of value based on those multiple approaches and/or methods *should* be reasonable and the process of analysing and reconciling the differing values into a single conclusion, without averaging, *should* be described by the *valuer* in the *report*.
- 6.1.11** While this standard includes discussion of certain methods within the *Cost*, *Market* and *Income approaches*, it does not provide a comprehensive list of all possible methods that *may* be appropriate. *Members may*
- use a method not defined or mentioned in *the Standards* or *IVS* but can still claim compliance with *the Standards*.
- 6.1.12** When different approaches and/or methods result in widely divergent indications of value, a *valuer should* perform procedures to understand why the value indications differ, as it is generally not appropriate to simply weight two or more divergent indications of value. In such cases, *valuers should* reconsider the guidance in para 6.1.9 to determine whether one of the approaches/methods provides a better or more reliable indication of value.
- 6.1.13** *Valuers should* maximize the use of relevant observable market information in all three approaches. Regardless of the source of the inputs and *assumptions* used in a *valuation*, a *valuer must* perform appropriate analysis to evaluate those inputs and *assumptions* and their appropriateness for the valuation purpose.
- 6.1.14** Although no one approach or method is applicable in all circumstances, price information from an active market is generally considered to be the strongest evidence of value. Some *bases of value* may prohibit a *valuer* from making subjective adjustments to price information from an active market. Price information from an inactive market may still be good evidence of value, but subjective adjustments *may* be needed.
- 6.2.0 Market Approach**
- 6.2.1** The *market approach* provides an indication of value by comparing the *asset* with identical or comparable (that is similar) *assets* for which price information is available.
- 6.2.2** The *market approach should* be applied and afforded *significant weight* under the following circumstances:
- a) the subject *asset* has recently been sold in a transaction appropriate for consideration under the *basis of value*,
 - b) the subject *asset* or substantially similar *assets* are actively publicly traded, and/or
 - c) there are frequent and/or recent observable transactions in substantially similar *assets*.

- 6.2.3** Although the above circumstances would indicate that the *market approach should* be applied and afforded *significant weight*, when the above criteria are not met, the following are additional circumstances where the *market approach may* be applied and afforded *significant weight*. When using the *market approach* under the following circumstances, a *valuer should* consider whether any other approaches can be applied and weighted to corroborate the value indication from the *market approach*:
- Transactions involving the subject *asset* or substantially similar *assets* are not recent enough considering the levels of volatility and activity in the market.
 - The *asset* or substantially similar *assets* are publicly traded, but not actively.
 - Information on market transactions is available, but the comparable *assets* have *significant* differences to the subject *asset*, potentially requiring subjective adjustments.
 - Information on recent transactions is not reliable (i.e., hearsay, missing information, synergistic purchaser, not arm's-length, distressed sale, etc.).
 - The critical element affecting the value of the *asset* is the price it would achieve in the market rather than the cost of reproduction or its income-producing ability.
- 6.2.4** The heterogeneous nature of many *assets* means that it is often not possible to find market evidence of transactions involving identical or similar *assets*. Even in circumstances where the *market approach* is not used, the use of market-based inputs *should* be maximised in the application of other approaches (e.g. market-based valuation metrics such as effective yields and rates of return).
- 6.2.5** When comparable market information does not relate to the exact or substantially the same *asset*, the *valuer must* perform a comparative analysis of qualitative and quantitative similarities and differences between the comparable *assets* and the subject *asset*. It will often be necessary to make adjustments based on this comparative analysis. Those adjustments *must* be reasonable and *valuers must* document the reasons for the adjustments and how they were quantified.
- 6.2.6** The *market approach* often uses market multiples derived from a set of comparables, each with different multiples. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors.
- 6.3.0 Market Approach Methods**
Comparable Transactions Method
- 6.3.1** The comparable transactions method, also known as the guideline transactions method, utilises information on transactions involving *assets* that are the same or similar to the subject *asset* to arrive at an indication of value.
- 6.3.2** When the comparable transactions considered involve the subject *asset*, this method is sometimes referred to as the prior transactions method.
- 6.3.3** If few recent transactions have occurred, the *valuer may* consider the prices of identical or similar *assets* that are listed or offered for sale, provided the relevance of this information is clearly established, critically analysed and documented. This is sometimes referred to as the comparable listings method and *should* not be used as the sole indication of value but can be appropriate for consideration together with other methods. When considering listings or offers to buy or sell, the *weight* afforded to the listings/offer price *should* consider the level of commitment inherent in the price and how long the listing/offer has been on the market. For example, an offer that represents a binding commitment to purchase or sell an *asset* at a given price *may* be given more *weight* than a quoted price without such a binding commitment.
- 6.3.4** The comparable transaction method can use a variety of different comparable evidence, also known as units of comparison, which form the basis of the comparison. For example, a few of the many common units of comparison used for real property include price per square foot (or per square metre), rent per square foot (or per square metre) and capitalisation rates. A few of the many common units of comparison used in business valuation include EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) multiples, earnings

multiples, revenue multiples and book value multiples. A few of the many common units of comparison used in financial instrument valuation include metrics such as yields and interest rate spreads. The units of comparison used by participants can differ between *asset* classes and across industries and geographies.

6.3.5 A subset of the comparable transactions method is matrix pricing, which is principally used to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities' relationship to other benchmark quoted securities and their attributes (i.e. yield).

6.3.6 The key steps in the comparable transactions method are:

- a) identify the units of comparison that are used by participants in the relevant market,
- b) identify the relevant comparable transactions and calculate the key valuation metrics for those transactions,
- c) perform a consistent comparative analysis of qualitative and quantitative similarities and differences between the comparable *assets* and the subject *asset*,
- d) make necessary adjustments, if any, to the valuation metrics to reflect differences between the subject *asset* and the comparable *assets* (see para 6.3.12(d)),
- e) apply the adjusted valuation metrics to the subject *asset*, and
- f) if multiple valuation metrics were used, reconcile the indications of value.

6.3.7 A *valuer* should choose comparable transactions within the following context:

- a) evidence of several transactions is generally preferable to a single transaction or event,
- b) evidence from transactions of very similar *assets* (ideally identical) provides a better indication of value than *assets* where the transaction prices require *significant* adjustments,
- c) transactions that happen closer to the *valuation date* are more representative of the market at that date than older/dated transactions, particularly in volatile markets,
- d) for most *bases of value*, the transactions

should be "arm's length" between unrelated parties,

- e) sufficient information on the transaction should be available to allow the *valuer* to develop a reasonable understanding of the comparable *asset* and assess the valuation metrics/comparable evidence,
- f) information on the comparable transactions should be from a reliable and trusted source, and
- g) actual transactions provide better valuation evidence than intended transactions.

6.3.8 A *valuer* should analyse and make adjustments for any *material* differences between the comparable transactions and the subject *asset*. Examples of common differences that could warrant adjustments may include, but are not limited to:

- a) *material* characteristics (age, size, specifications, etc.),
- b) relevant restrictions on either the subject *asset* or the comparable *assets*,
- c) geographical location (location of the *asset* and/or location of where the *asset* is likely to be transacted/used) and the related economic and regulatory environments,
- d) profitability or profit-making capability of the *assets*,
- e) historical and expected growth,
- f) yields/coupon rates,
- g) types of collateral,
- h) unusual terms in the comparable transactions,
- i) differences related to marketability and control characteristics of the comparable and the subject *asset*, and
- j) ownership characteristics (e.g. legal form of ownership, amount/percentage held).

6.3.9 **Guideline publicly-traded comparable method**

The guideline publicly-traded method utilises information on publicly-traded comparables that are the same or similar to the subject *asset* to arrive at an indication of value.

6.3.10 This method is similar to the comparable transactions method. However, there are several differences due to the comparables being publicly traded, as follows:

- a) the valuation metrics/comparable evidence are available as of the *valuation date*,

- b) detailed information on the comparables are readily available in public filings, and
- c) the information contained in public filings is prepared under well-understood accounting standards.

6.3.11 The method *should* be used only when the subject *asset* is sufficiently similar to the publicly-traded comparables to allow for meaningful comparison.

6.3.12 The key steps in the guideline publicly-traded comparable method are to:

- a) identify the valuation metrics/comparable evidence that are used by participants in the relevant market,
- b) identify the relevant guideline publicly-traded comparables and calculate the key valuation metrics for those transactions,
- c) perform a consistent comparative analysis of qualitative and quantitative similarities and differences between the publicly-traded comparables and the subject *asset*,
- d) make necessary adjustments, if any, to the valuation metrics to reflect differences between the subject *asset* and the publicly-traded comparables,
- e) apply the adjusted valuation metrics to the subject *asset*, and
- f) if multiple valuation metrics were used, weight the indications of value.

6.3.13 A *valuer* *should* choose publicly-traded comparables within the following context:

- a) consideration of multiple publicly-traded comparables is preferred to the use of a single comparable,
- b) evidence from similar publicly-traded comparables (for example, with similar market segment, geographic area, size in revenue and/or *assets*, growth rates, profit margins, leverage, liquidity and diversification) provides a better indication of value than comparables that require *significant* adjustments, and
- c) securities that are actively traded provide more meaningful evidence than thinly-traded securities.

6.3.14 A *valuer* *should* analyse and make adjustments for any *material* differences between the guideline publicly-traded comparables and the subject *asset*. Examples of common differences that could warrant adjustments may include, but are not limited to:

- a) *material* characteristics (age, size, specifications, etc.),

- b) relevant discounts and premiums (see para 6.3.17),
- c) relevant restrictions on either the subject *asset* or the comparable *assets*,
- d) geographical location of the underlying company and the related economic and regulatory environments,
- e) profitability or profit-making capability of the *assets*,
- f) historical and expected growth,
- g) differences related to marketability and control characteristics of the comparable and the subject *asset*, and
- h) type of ownership.

6.3.15 Other Market Approach Considerations

The following paragraphs address a non-exhaustive list of certain special considerations that *may* form part of a *market approach valuation*.

6.3.16 Anecdotal or “rule-of-thumb” valuation benchmarks are sometimes considered to be a *market approach*. However, value indications derived from the use of such rules *should* not be given substantial *weight* unless it can be shown that buyers and sellers place *significant* reliance on them.

6.3.17 In the *market approach*, the fundamental basis for making adjustments is to adjust for differences between the subject *asset* and the guideline transactions or publicly-traded securities. Some of the most common adjustments made in the *market approach* are known as discounts and premiums.

- a) Discounts for Lack of Marketability (DLOM) *should* be applied when the comparables are deemed to have superior marketability to the subject *asset*. A DLOM reflects the concept that when comparing otherwise identical *assets*, a readily marketable *asset* would have a higher value than an *asset* with a long marketing period or restrictions on the ability to sell the *asset*. For example, publicly-traded securities can be bought and sold nearly instantaneously while shares in a private company may require a *significant* amount of time to identify potential buyers and complete a transaction. Many *bases of value* allow the consideration of restrictions on marketability that are inherent in the subject *asset* but prohibit consideration of marketability restrictions that are specific to a particular owner. DLOMs

may be quantified using any reasonable method, but are typically calculated using option pricing models, studies that compare the value of publicly-traded shares and restricted shares in the same company, or studies that compare the value of shares in a company before and after an initial public offering.

- b) Control Premiums (sometimes referred to as Market Participant Acquisition Premiums or MPAPs) and Discounts for Lack of Control (DLOC) are applied to reflect differences between the comparables and the subject *asset* with regard to the ability to make decisions and the changes that can be made as a result of exercising control. All else being equal, participants would generally prefer to have control over a subject *asset* than not. However, participants' willingness to pay a Control Premium or DLOC will generally be a factor of whether the ability to exercise control enhances the economic benefits available to the owner of the subject *asset*. Control Premiums and DLOCs may be quantified using any reasonable method, but are typically calculated based on either an analysis of the specific cash flow enhancements or reductions in risk associated with control or by comparing observed prices paid for controlling interests in publicly-traded securities to the publicly-traded price before such a transaction is announced. Examples of circumstances where Control Premiums and DLOC should be considered include where:
- 1) shares of public companies generally do not have the ability to make decisions related to the operations of the company (they lack control). As such, when applying the guideline public comparable method to value a subject *asset* that reflects a controlling interest, a control premium may be appropriate, or
 - 2) the guideline transactions in the guideline transaction method often reflect transactions of controlling interests. When using that method to value a subject *asset* that reflects a minority interest, a DLOC may be appropriate.
 - c) Blockage discounts are sometimes applied when the subject *asset* represents a large block of shares in a publicly-traded security such that an owner would not be able to quickly sell the block in the public

market without negatively influencing the publicly-traded price. Blockage discounts may be quantified using any reasonable method but typically a model is used that considers the length of time over which a participant could sell the subject shares without negatively impacting the publicly-traded price (i.e. selling a relatively small portion of the security's typical daily trading volume each day). Under certain *bases of value*, particularly *fair value* for financial reporting purposes, blockage discounts are prohibited.

6.4.0 Income Approach

6.4.1 The *income approach* provides an indication of value by converting future cash flow to a single current value. Under the *income approach*, the value of an *asset* is determined by reference to the value of income, cash flow or cost savings generated by the *asset*.

6.4.2 The *income approach* should be applied and afforded *significant weight* under the following circumstances:

- a) the income-producing ability of the *asset* is the critical element affecting value from a participant perspective, and/or
- b) reasonable projections of the amount and timing of future income are available for the subject *asset*, but there are few, if any, relevant market comparables.

6.4.3 Although the above circumstances would indicate that the *income approach* should be applied and afforded *significant weight*, the following are additional circumstances where the *income approach* may be applied and afforded *significant weight*. When using the *income approach* under the following circumstances, a *valuer* should consider whether any other approaches can be applied and weighted to corroborate the value indication from the *income approach*:

- a) the income-producing ability of the subject *asset* is only one of several factors affecting value from a participant perspective,
- b) there is *significant* uncertainty regarding the amount and timing of future income-related to the subject *asset*,
- c) there is a lack of access to information related to the subject *asset* (for example,

- a minority owner may have access to historical *financial statements* but not forecasts/budgets), and/or
- d) the subject *asset* has not yet begun generating income, but is projected to do so.

6.4.4 A fundamental basis for the *income approach* is that investors expect to receive a return on their investments and that such a return *should* reflect the perceived level of risk in the investment.

6.4.5 Generally, investors can only expect to be compensated for systemic risk (also known as “market risk” or “undiversifiable risk”).

6.5.0 Income Approach Methods

6.5.1 Although there are many ways to implement the *income approach*, methods under the *income approach* are effectively based on discounting future amounts of cash flow to present value. They are variations of the Discounted Cash Flow (DCF) method and the concepts below apply in part or in full to all *income approach* methods.

Discounted Cash Flow (DCF) Method

6.5.2 Under the DCF method the forecasted cash flow is discounted back to the *valuation date*, resulting in a present value of the *asset*.

6.5.3 In some circumstances for long-lived or indefinite-lived *assets*, DCF *may* include a terminal value which represents the value of the *asset* at the end of the explicit projection period. In other circumstances, the value of an *asset may* be calculated solely using a terminal value with no explicit projection period. This is sometimes referred to as an income capitalisation method.

6.5.4 The key steps in the DCF method are:

- a) choose the most appropriate type of cash flow for the nature of the subject *asset* and the assignment (i.e. pre-tax or post-tax, total cash flows or cash flows to equity, real or nominal, etc.),
- b) determine the most appropriate explicit period, if any, over which the cash flow will be forecast,
- c) prepare cash flow forecasts for that period,

- d) determine whether a terminal value is appropriate for the subject *asset* at the end of the explicit forecast period (if any) and then determine the appropriate terminal value for the nature of the *asset*,
- e) determine the appropriate discount rate, and
- f) apply the discount rate to the forecasted future cash flow, including the terminal value, if any.

Type of Cash Flow

6.5.5 When selecting the appropriate type of cash flow for the nature of *asset* or assignment, *valuers must* consider the factors below. In addition, the discount rate and other inputs *must* be consistent with the type of cash flow chosen.

- a) Cash flow to whole *asset* or partial interest: Typically cash flow to the whole *asset* is used. However, occasionally other levels of income *may* be used as well, such as cash flow to equity (after payment of interest and principle on debt) or dividends (only the cash flow distributed to equity owners). Cash flow to the whole *asset* is most commonly used because an *asset should* theoretically have a single value that is independent of how it is financed or whether income is paid as dividends or reinvested.
- b) The cash flow can be pre-tax or post-tax: If a post-tax basis is used, the tax rate applied *should* be consistent with the *basis of value* and in many instances would be a participant tax rate rather than an owner-specific one.
- c) Nominal versus real: Real cash flow does not consider inflation whereas nominal cash flows include expectations regarding inflation. If expected cash flow incorporates an expected inflation rate, the discount rate has to include the same inflation rate.
- d) Currency: The choice of currency used *may* have an impact on *assumptions* related to inflation and risk. This is particularly true in emerging markets or in currencies with high inflation rates.

6.5.6 The type of cash flow chosen *should* be in accordance with participant's viewpoints. For example, cash flows and discount rates for real property are customarily developed on a pre-tax basis, while cash flows and

discount rates for businesses are normally developed on a post-tax basis. Adjusting between pre-tax and post-tax rates can be complex and prone to error and *should* be approached with caution.

6.5.7 When a *valuation* is being developed in a currency (“the valuation currency”) that differs from the currency used in the cash flow projections (“the functional currency”), a *valuer should* use one of the following two currency translation methods:

- a) Discount the cash flows in the functional currency using a discount rate appropriate for that functional currency. Convert the present value of the cash flows to the valuation currency at the spot rate on the *valuation date*.
- b) Use a currency exchange forward curve to translate the functional currency projections into valuation currency projections and discount the projections using a discount rate appropriate for the valuation currency. When a reliable currency exchange forward curve is not available (for example, due to lack of liquidity in the relevant currency exchange markets), it *may* not be possible to use this method and only the method described in para 6.5.7(a) can be applied.

Explicit Forecast Period

6.5.8 The selection criteria will depend upon the purpose of the *valuation*, the nature of the *asset*, the information available and the required *bases of value*. For an *asset* with a short life, it is more likely to be both possible and relevant to project cash flow over its entire life.

6.5.9 *Valuers should* consider the following factors when selecting the explicit forecast period:

- a) the life of the *asset*,
- b) a reasonable period for which reliable data is available on which to base the projections,
- c) the minimum explicit forecast period which *should* be sufficient for an *asset* to achieve a stabilised level of growth and profits, after which a terminal value can be used,
- d) in the *valuation* of cyclical *assets*, the explicit forecast period *should* generally

include an entire cycle, when possible, and

- e) for finite-lived *assets* such as most financial instruments, the cash flows will typically be forecast over the full life of the *asset*.

6.5.10 In some instances, particularly when the *asset* is operating at a stabilised level of growth and profits at the *valuation date*, it *may* not be necessary to consider an explicit forecast period and a terminal value *may* form the only basis for value (sometimes referred to as an income capitalisation method).

6.5.11 The intended holding period for one investor *should* not be the only consideration in selecting an explicit forecast period and *should* not impact the value of an *asset*. However, the period over which an *asset* is intended to be held *may* be considered in determining the explicit forecast period if the objective of the *valuation* is to determine its *investment value*.

Cash flow Forecasts

6.5.12 Cash flow for the explicit forecast period is constructed using prospective financial information (PFI) (projected income/inflows and expenditure/outflows).

6.5.13 As required by para 6.5.12, regardless of the source of the PFI (e.g. management forecast), a *valuer must* perform analysis to evaluate the PFI, the *assumptions* underlying the PFI and their appropriateness for the valuation purpose. The suitability of the PFI and the underlying *assumptions* will depend upon the purpose of the valuation and the required *bases of value*. For example, cash flow used to determine *market value should* reflect PFI that would be anticipated by participants; in contrast, *investment value* can be measured using cash flow that is based on the reasonable forecasts from the perspective of a particular investor.

6.5.14 The cash flow is divided into suitable periodic intervals (e.g. weekly, monthly, quarterly or annually) with the choice of interval depending upon the nature of the *asset*, the pattern of the cash flow, the data available, and the length of the forecast period.

6.5.15 The projected cash flow *should* capture the amount and timing of all future cash inflows and outflows associated with the subject *asset* from the perspective appropriate to the *basis of value*.

6.5.16 Typically, the projected cash flow will reflect one of the following:

- a) contractual or promised cash flow,
- b) the single most likely set of cash flow,
- c) the probability-weighted expected cash flow, or
- d) multiple scenarios of possible future cash flow.

6.5.17 Different types of cash flow often reflect different levels of risk and may require different discount rates. For example, probability-weighted expected cash flows incorporate expectations regarding all possible outcomes and are not dependent on any particular conditions or events. (note that when a probability-weighted expected cash flow is used, it is not always necessary for *valuers* to take into account distributions of all possible cash flows using complex models and techniques. Rather, *valuers* may develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows). A single most likely set of cash flows may be conditional on certain future events and therefore could reflect different risks and warrant a different discount rate.

6.5.18 While *valuers* often receive PFI that reflects accounting income and expenses, it is generally preferable to use cash flow that would be anticipated by participants as the basis for *valuations*. For example, accounting non-cash expenses, such as depreciation and amortisation, *should* be added back, and expected cash outflows relating to capital expenditures or to changes in working capital *should* be deducted in calculating cash flow.

6.5.19 *Valuers* must ensure that seasonality and cyclicity in the subject has been appropriately considered in the cash flow forecasts.

Terminal Value

6.5.20 Where the *asset* is expected to continue beyond the explicit forecast period, *valuers*

must estimate the value of the *asset* at the end of that period. The terminal value is then discounted back to the *valuation date*, normally using the same discount rate as applied to the forecast cash flow.

6.5.21 The terminal value *should* consider:

- a) whether the *asset* is deteriorating/finite-lived in nature or indefinite-lived as this will influence the method used to calculate a terminal value,
- b) whether there is future growth potential for the *asset* beyond the explicit forecast period,
- c) whether there is a predetermined fixed capital amount expected to be received at the end of the explicit forecast period,
- d) the expected risk level of the *asset* at the time the terminal value is calculated,
- e) for cyclical *assets*, the terminal value *should* consider the cyclical nature of the *asset* and *should* not be performed in a way that assumes “peak” or “trough” levels of cash flows in perpetuity and
- f) the tax attributes inherent in the *asset* at the end of the explicit forecast period (if any) and whether those tax attributes would be expected to continue into perpetuity.

6.5.22 *Valuers* may apply any reasonable method for calculating a terminal value. While there are many different approaches to calculating a terminal value, the three most commonly used methods for calculating a terminal value are:

- a) Gordon growth model/constant growth model (appropriate only for indefinite-lived *assets*),
- b) *market approach*/exit value (appropriate for both deteriorating/finite-lived *assets* and indefinite-lived *assets*), and
- c) salvage value/disposal cost (appropriate only for deteriorating/finite-lived *assets*).

Gordon Growth Model/Constant Growth Model

6.5.23 The constant growth model assumes that the *asset* grows (or declines) at a constant rate into perpetuity.

Market Approach/Exit Value

6.5.24 The *market approach*/exit value method can

be performed in a number of ways, but the ultimate goal is to calculate the value of the *asset* at the end of the explicit cash flow forecast.

6.5.25 Common ways to calculate the terminal value under this method include application of a market-evidence based capitalisation factor or a market multiple.

6.5.26 When a *market approach*/exit value is used, *valuers should* comply with the requirements in the market approach and market approach methods section of this standard (sections 6.2.0 and 6.3.0). However, *valuers should* also consider the expected market conditions at the end of the explicit forecast period and make adjustments accordingly.

Salvage Value/ Disposal Cost

6.5.27 The terminal value of some *assets* may have little or no relationship to the preceding cash flow. Examples of such *assets* include wasting *assets* such as a mine or an oil well.

6.5.28 In such cases, the terminal value is typically calculated as the salvage value of the *asset*, less costs to dispose of the *asset*. In circumstances where the costs exceed the salvage value, the terminal value is negative and referred to as a disposal cost or an *asset* retirement obligation.

Discount Rate

6.5.29 The rate at which the forecast cash flow is discounted *should* reflect not only the time value of money, but also the risks associated with the type of cash flow and the future operations of the *asset*.

6.5.30 *Valuers may* use any reasonable method for developing a discount rate. While there are many methods for developing or determining the reasonableness of a discount rate a non-exhaustive list of common methods includes:

- a) the capital asset pricing model (CAPM),
- b) the weighted average cost of capital (WACC),
- c) the observed or inferred rates/yields,
- d) the internal rate of return (IRR),
- e) the weighted average return on assets (WARA), and
- f) the build-up method (generally used only in the absence of market inputs).

6.5.31 In developing a discount rate, a *valuer should* consider:

- a) the risk associated with the projections made in the cash flow used,
- b) the type of *asset* being valued. For example, discount rates used in valuing debt would be different than those used when valuing real property or a business,
- c) the rates implicit in transactions in the market,
- d) the geographic location of the *asset* and/ or the location of the markets in which it would trade,
- e) the life/term of the *asset* and the consistency of inputs. For example, the risk-free rate considered would differ for an *asset* with a three-year life versus a 30-year life,
- f) the type of cash flow being used, and
- g) the *bases of value* being applied. For most *bases of value*, the discount rate *should* be developed from the perspective of a participant.

6.6.0 Cost Approach

6.6.1 The *cost approach* provides an indication of value using the economic principle that a buyer will pay no more for an *asset* than the cost to obtain an *asset* of equal utility, whether by purchase or by construction, unless undue time, inconvenience, risk or other factors are involved. The approach provides an indication of value by calculating the current replacement or reproduction cost of an *asset* and making deductions for physical deterioration and all other relevant forms of obsolescence.

6.6.2 The *cost approach should* be applied and afforded *significant weight* under the following circumstances:

- a) participants would be able to recreate an *asset* with substantially the same utility as the subject *asset*, without regulatory or legal restrictions, and the *asset* could be recreated quickly enough that a participant would not be willing to pay a *significant* premium for the ability to use the subject *asset* immediately,
- b) the *asset* is not directly income-generating and the unique nature of the *asset* makes using an *income approach* or *market approach* unfeasible, and/or

- c) the *basis of value* being used is fundamentally based on replacement cost, such as replacement value.

6.6.3 Although the circumstances in paragraph 6.6.2 would indicate that the *cost approach* should be applied and afforded *significant weight*, the following are additional circumstances where the *cost approach* may be applied and afforded *significant weight*. When using the *cost approach* under the following circumstances, a *valuer* should consider whether any other approaches can be applied and weighted to corroborate the value indication from the *cost approach*:

- a) participants might consider recreating an *asset* of similar utility, but there are potential legal or regulatory hurdles or *significant* time involved in recreating the *asset*,
- b) when the *cost approach* is being used as a reasonableness check to other approaches (for example, using the *cost approach* to confirm whether a business valued as a going-concern might be more valuable on a liquidation basis), and/or
- c) the *asset* was recently created, such that there is a high degree of reliability in the *assumptions* used in the *cost approach*.

6.6.4 The value of a partially completed *asset* will generally reflect the costs incurred to date in the creation of the *asset* (and whether those costs contributed to value) and the expectations of participants regarding the value of the property when complete, but consider the costs and time required to complete the *asset* and appropriate adjustments for profit and risk.

6.7.0 Cost Approach Methods

6.7.1 Broadly, there are three *cost approach* methods:

- a) replacement cost method: a method that indicates value by calculating the cost of a similar *asset* offering equivalent utility,
- b) *depreciated replacement cost* ("DRC") is a method in the absence of sufficient market data to arrive at the *market value* of real property and plant and equipment by means of market-based evidence,
- c) reproduction cost method: a method under the cost that indicates value by

calculating the cost to recreating a replica of an *asset*, and

- d) summation method: a method that calculates the value of an *asset* by the addition of the separate values of its component parts.

Replacement Cost Method

6.7.2 Generally, replacement cost is the cost that is relevant to determining the price that a participant would pay as it is based on replicating the utility of the *asset*, not the exact physical properties of the *asset*.

6.7.3 Usually replacement cost is adjusted for physical deterioration and all relevant forms of obsolescence. After such adjustments, this can be referred to as *depreciated replacement cost*.

6.7.4 The key steps in the replacement cost method are:

- a) calculate all of the costs that would be incurred by a typical participant seeking to create or obtain an *asset* providing equivalent utility,
- b) determine whether there is any depreciation related to physical, functional and external obsolescence associated with the subject *asset*, and
- c) deduct total depreciation from the total costs to arrive at a value for the subject *asset*.

6.7.5 The replacement cost is generally that of a modern equivalent *asset*, which is one that provides similar function and equivalent utility to the *asset* being valued, but which is of a current design and constructed or made using current cost-effective materials and techniques.

Depreciated Replacement Cost

6.7.6 *Depreciated replacement cost* ("DRC") is an application (method) in the absence of sufficient market data to arrive at the *market value* of real property and plant and equipment by means of market-based evidence. The application of DRC method in real property *valuation* is based on an estimate of the *market value* of the land in its existing use, plus the current cost of replacement of the improvements less allowance for physical deterioration and

all relevant forms of obsolescence and optimization.

- (1) The application of the DRC method in real property *valuations* is based on an estimate of the *market value* of the land in its existing use, plus the current cost of replacement of the improvements less allowance for physical deterioration and all relevant forms of obsolescence and optimisation.
- (2) When the *client* instructs the *valuer* to estimate the *market value* of the land on alternative use basis which is different from the existing use of the land, the *valuer should* take reasonable steps to verify the rationale and soundness of the instruction. Where the alternative use is not an *assumption* but a *special assumption*, VS 2.2 applies.
- (3) When using the DRC method, the *valuer should* include a statement in the *report* to justify his use of the DRC method and the efforts he made in considering the DRC method as the most appropriate approach to value.
- (4) Should the subject real property comprise various buildings and structures of a complex or development, the *valuer* should include a statement in the *report* that the reported *market value* only applies to the whole of the complex or development as a unique interest, and no piecemeal transaction of the complex or development is assumed.
- (5) The DRC method when used in the private sector *must* always be expressed by the *valuer* as subject to adequate potential profitability of the business (or to service potential of the entity from the use of *assets* as a whole) paying due regard to the total *assets* employed.
- (6) The DRC method when used in the public sector *must* always be expressed by the *valuer* as subject to the prospect and viability of the continued operation and use instead of subject to adequate potential profitability of the business (or to service potential of the entity from the use of *assets* as a whole).

Reproduction Cost Method

6.7.7 Reproduction cost is appropriate in circumstances such as the following:

- a) the cost of a modern equivalent *asset* is greater than the cost of recreating a replica of the subject *asset*, or
- b) the utility offered by the subject *asset* could only be provided by a replica rather than a modern equivalent.

6.7.8 The key steps in the reproduction cost method are:

- a) calculate all of the costs that would be incurred by a typical participant seeking to create an exact replica of the subject *asset*,
- b) determine whether there is any depreciation related to physical, functional and external obsolescence associated with the subject *asset*, and
- c) deduct total depreciation from the total costs to arrive at a value for the subject *asset*.

Summation Method

6.7.9 The summation method, also referred to as the underlying *asset* method, is typically used for investment companies or other types of *assets* or entities for which value is primarily a factor of the values of their holdings.

6.7.10 The key steps in the summation method are:

- a) value each of the component *assets* that are part of the subject *asset* using the appropriate valuation approaches and methods, and
- b) add the value of the component *assets* together to reach the value of the subject *asset*.

Cost Considerations

6.7.11 The *cost approach should* capture all of the costs that would be incurred by a typical participant.

6.7.12 The cost elements may differ depending on the type of the *asset* and *should* include the direct and indirect costs that would be required to replace/recreate the *asset* as of the *valuation date*. Some common items to consider include:

- a) direct costs:
 1. materials and
 2. labour.

- b) indirect costs:
 1. transport costs,
 2. installation costs,
 3. professional fees (design, permit, architectural, legal, etc),
 4. other fees (commissions, etc),
 5. overheads,
 6. taxes,
 7. finance costs (e.g. interest on debt financing), and
 8. profit margin/entrepreneurial profit to the creator of the *asset* (e.g. return to investors).

6.7.13 An *asset* acquired from a third party would presumably reflect their costs associated with creating the *asset* as well as some form of profit margin to provide a return on their investment. As such, under *bases of value* that assume a hypothetical transaction, it may be appropriate to include an assumed profit margin on certain costs which can be expressed as a target profit, either a lump sum or a percentage return on cost or value. However, financing costs, if included, may already reflect participants' required return on capital deployed, so *valuers should* be cautious when including both financing costs and profit margins.

6.7.14 When costs are derived from actual, quoted or estimated prices by third party suppliers or contractors, these costs will already include a third parties' desired level of profit.

6.7.15 The actual costs incurred in creating the subject *asset* (or a comparable reference *asset*) may be available and provide a relevant indicator of the cost of the *asset*. However, adjustments *may* need to be made to reflect the following:

- a) cost fluctuations between the date on which this cost was incurred and the *valuation date*, and
- b) any atypical or exceptional costs, or savings, that are reflected in the cost data but that would not arise in creating an equivalent.

6.8.0 Depreciation/ Obsolescence

6.8.1 In the context of the *cost approach*, "depreciation" refers to adjustments made to the estimated cost of creating an *asset* of equal utility to reflect the impact on value

of any obsolescence affecting the subject *asset*. This meaning is different from the use of the word in financial reporting or tax law where it generally refers to a method for systematically expensing capital expenditure over time.

6.8.2 Depreciation adjustments are normally considered for the following types of obsolescence, which may be further divided into subcategories when making adjustments:

- a) Physical obsolescence: Any loss of utility due to the physical deterioration of the *asset* or its components resulting from its age and usage.
- b) Functional obsolescence: Any loss of utility resulting from inefficiencies in the subject *asset* compared to its replacement such as its design, specification or technology being outdated.
- c) External or economic obsolescence: Any loss of utility caused by economic or locational factors external to the *asset*. This type of obsolescence can be temporary or permanent.

6.8.3 Depreciation/obsolescence *should* consider the physical and economic lives of the *asset*:

- a) The physical life is how long the *asset* could be used before it would be worn out or beyond economic repair, assuming routine maintenance but disregarding any potential for refurbishment or reconstruction.
- b) The economic life is how long it is anticipated that the *asset* could generate financial returns or provide a non-financial benefit in its current use. It will be influenced by the degree of functional or economic obsolescence to which the *asset* is exposed.

6.8.4 Except for some types of economic or external obsolescence, most types of obsolescence are measured by making comparisons between the subject *asset* and the hypothetical *asset* on which the estimated replacement or reproduction cost is based. However, when market evidence of the effect of obsolescence on value is available, that evidence *should* be considered.

6.8.5 Physical obsolescence can be measured in two different ways:

- a) curable physical obsolescence, i.e. the cost to fix/cure the obsolescence, or
- b) incurable physical obsolescence which considers the *asset's* age, expected total and remaining life where the adjustment for physical obsolescence is equivalent to the proportion of the expected total life consumed. Total expected life *may* be expressed in any reasonable way, including expected life in years, mileage, units produced, etc.

6.8.6 There are two forms of functional obsolescence:

- a) excess capital cost, which can be caused by changes in design, materials of construction, technology or manufacturing techniques resulting in the availability of modern equivalent *assets* with lower capital costs than the subject *asset*, and
- b) excess operating cost, which can be caused by improvements in design or excess capacity resulting in the availability of modern equivalent *assets* with lower operating costs than the subject *asset*.

6.8.7 Economic obsolescence may arise when external factors affect an individual *asset* or all the *assets* employed in a business and *should* be deducted after physical deterioration and functional obsolescence. For *real estate*, examples of economic obsolescence include:

- a) adverse changes to demand for the products or services produced by the *asset*,
- b) oversupply in the market for the *asset*,
- c) a disruption or loss of a supply of labour or raw material, or
- d) the *asset* being used by a business that cannot afford to pay a *market rent* for the *assets* and still generate a market rate of return.

6.8.8 Cash or cash equivalents do not suffer obsolescence and are not adjusted. Marketable *assets* are not adjusted below their *market value* determined using the *market approach*.

VS 7

Valuation Processes and Records

The process of a *valuation*, including *inspection*, investigation, analysis and computation, etc., *must* always be carried out to the extent necessary to produce a *valuation* that is professionally adequate for its purpose. The *valuer must* take reasonable steps to verify the information relied on in the preparation of the *valuation* and, if not already agreed, clarify with the *client* any necessary *assumptions* that will be relied on.

These general principles are supplemented by the following additional requirements embodied in **VS 4** and **VS 9**:

- Any limitations or restrictions on the *inspection*, inquiry and analysis for the purpose of the valuation assignment *must* be identified and recorded in the *terms of engagement* and also in the *report*.
- If the relevant information is not available because the conditions of the assignment restrict the investigation, then if the assignment is accepted, these restrictions and any necessary *assumptions* or *special assumptions* made as a result of the restriction *must* be identified and recorded in the *terms of engagement* and in the *report*.

7.1.0 General Requirements

- 7.1.1** Sufficient evidence *must* be assembled by means, such as *inspection*, examination, inquiry, research, comparison, analysis and computation, etc., to ensure that the *valuation* is properly supported.
- 7.1.2** When settling the *terms of engagement*, the *valuer must* agree the extent to which the subject *asset* is to be inspected and any investigation is to be made – see **VS 4** paragraph 4.3.2(i).
- 7.1.3** When determining the extent of evidence necessary, professional judgment is required to ensure the information to be obtained and the analysis to be carried out are adequate for the purpose of the *valuation* and consistent with the *basis of value* adopted. In each case the *valuer must* judge the extent to which the information to be provided is likely to be reliable and be mindful to recognise

and not to exceed the limitations of their qualification and expertise when making this judgment.

- 7.1.4** When a property or other physical *asset* is inspected or examined the degree of investigation that is appropriate will vary, depending on the nature of the *asset* and the purpose of the *valuation*. Except in the circumstances described in the section 'Revaluation without re-inspection of real property previously valued' below, *valuers* are reminded that to dispense voluntarily with an *inspection* or examination of physical *assets may* introduce an unacceptable degree of risk in the valuation advice to be provided – they *must* therefore carefully assess that risk before proceeding.
- 7.1.5** Where it is agreed that *inspections* and investigations may be limited, it is likely that the *valuation* will be on the basis of restricted information and **VS 4** section 4.5.0 will apply.
- 7.1.6** The *valuer*, having considered the knowledge, experience, reliability and ability of his staff member, could designate suitably trained staff member(s) under his supervision to conduct the *inspection* in order to comply with the mandatory *inspection* requirement under *the Standards*. However, the *valuer* shall still be liable for the accuracy of the entire contents of the *valuation report* and hence is fully accountable for the input of his designated staff member(s).
- 7.1.7** Subject to **VS 2** paragraph 2.2.2 and **VS 4** paragraph 4.3.2(j), the *valuer must* take reasonable steps to verify the information relied on in the preparation of the *valuation* and, if not already agreed, clarify with the *client* any necessary *assumptions* that will be made. While a *client* may request, or consent to, an *assumption* being relied on, nevertheless if – following an *inspection* or examination – the *valuer* considers that such an *assumption* is at variance with the observed facts, then its continued adoption could, providing that it is realistic, relevant and valid for the particular circumstances of the *valuation* become a *special assumption*.
- 7.1.8** If relevant information is not available because the conditions of the instruction prevent *inspection*, or where it is agreed that *inspections* and investigations may be limited, then if the instruction is accepted,

the *valuation* will be on the basis of restricted information and **VS 4 paragraph 4.3.2 (j) and section 4.5.0** will apply. Any restriction on *inspection* or examination or lack of relevant information *should* be set out in the *terms of engagement* and *valuation report*. If the *valuer* considers that it is not possible to provide a *valuation* even on a restricted basis, the instruction *should* be declined.

7.1.9 When a valuation assignment involves reliance on information supplied by a party other than the *valuer*, the *valuer should* consider whether the information is credible and *may* be relied on without adversely affecting the credibility of the valuation opinion. In that event, the assignment *may* proceed. *Significant* inputs provided to the *valuer* (e.g. by management or owners) that materially affect the valuation outcome but about which the *valuer* considers some element of doubt arises will require assessment, investigation and/or corroboration, as the case may be. In cases where the credibility or reliability of information supplied cannot be supported, such information *should* not be used.

7.1.10 While the *valuer should* take reasonable care to verify any information provided or obtained as well as to conduct analysis to such information, any limitations on this requirement *must* be clearly stated. When preparing a *valuation for financial statements* the *valuer should* be prepared to discuss the appropriateness of any *assumptions* that were made with the *client's* auditor, other professional adviser or regulator.

7.1.11 A *valuer* meeting the criteria in **VS 2**, will be familiar with, if not expert on, many of the matters affecting either the type of *asset*, including where applicable the locality. Where an issue, or potential issue, that could affect value is within the *valuer's* knowledge or evident from an *inspection* or examination of the *asset*, including where applicable the immediate locality, or from routine enquiries, it *should* be drawn to the *client's* attention no later than when the *report* is issued, and ideally in advance of the *report* in cases where the impact is *significant*.

7.2.0 Revaluation without re-inspection of real property previously valued

7.2.1 A revaluation without a re-inspection of an interest in real property previously valued by the *valuer* or his *firm must* not be undertaken unless the *valuer* is satisfied that there have been no *material* changes to the physical attributes of the property, or the nature of its location, since the last assignment.

7.2.2 It is recognised that the *client* may need the *valuation* of its property updated at regular intervals and that *re-inspection* on every occasion may be unnecessary. Provided that the *valuer* has previously inspected the property, and the *client* has confirmed that no *material* changes to the physical attributes of the property and the area in which it is situated have occurred, a revaluation without re-inspection *may* be undertaken. The *terms of engagement must* state that this *assumption* has been made.

7.2.3 The *valuer must* obtain from the *client* information of current or anticipated changes in rental income from *investment properties* and any *material* changes to the non-physical attributes of each property, such as other lease terms, planning consents, statutory notices and so on. The *valuer must* also consider whether any *sustainability* factors that affect the *valuation* are likely to have altered.

7.2.4 Where the *client* advises that there have been *material* changes, or if the *valuer* is otherwise aware or has good reason to believe that such changes have taken place, the *valuer must* inspect the property. In all other cases, the interval between *inspections* is a matter for the professional judgment of the *valuer* who will, among other considerations, have regard to its type and location.

7.2.5 If the *valuer* believes that it is inappropriate to undertake a revaluation without re-inspection because of *material* changes, the passage of time or other reasons, the *valuer may* nevertheless accept an instruction to proceed without *inspection* providing the *client* confirms in writing, prior to the delivery of the *report*, that it is required solely for internal management purposes, that no publication or disclosure will be

made to *third parties* and that the *client* accepts responsibility for the associated risk. A statement declaring this position and that the *report* must not be published *must* be set out unequivocally in the *report*.

7.3.0 Valuation records

A proper record *must* be kept of *inspections* and *investigations*, and of other key inputs, analyses and computations, in an appropriate business format.

7.3.1 Details of the *inspection* and any investigations *must* be clearly and accurately recorded in a manner that is neither ambiguous nor misleading and does not create a false impression.

7.3.2 To maintain a proper audit trail and be in a position to respond effectively to a future enquiry, legible notes (which may include photographs or other images) of the findings and, particularly, the limits of *inspection* and the circumstances in which it was carried out *must* be made. The notes *should* also include a record of the key inputs and all calculations, investigations and analyses considered when arriving at the *valuation*.

7.3.3 All notes and records *should* be retained in an appropriate business format. The appropriate period for retention will depend on the purpose of the *valuation* and the circumstances of the case but *must* have regard to any relevant statutory, legal or regulatory requirements.

7.3.4 For all reports where the governing *jurisdiction* is Hong Kong law, such records *must* be held for at least six (6) years after completion of the engagement or two (2) years after the final disposition of any judicial proceeding in which a testimony was given.

7.3.5 The records *must* include:

- a. the name of the *client* and the identity, by name or type, of any other intended users;
- b. true copies of any written *reports*, documented on any forms of media;
- c. summaries of any oral *reports* or testimony, or a transcript of testimony, the *valuer's* signed and dated certification; and,
- d. all other data, information, and documentation, which are necessary

to support the *valuer's* opinions and conclusions and to prove compliance with *the Standards*, or reference to the location(s) of such other documentation.

7.3.6 If a *valuer* is unable to retain a copy of the *report* and its working papers, whether by reason of an employer's internal rules or by change of employers, all reasonable steps *must* be taken by the *valuer* to ensure the availability of such data upon request. In this regard, the *valuer should* obtain written commitment from his employer that such data will be made available when required by regulatory authorities, including, but not limited to, the Committee of Investigation /Disciplinary Board of the Institute. If the employer refuses to provide such written commitment, the *valuer* shall keep a record of such refusal and provide it to the *HKIS*, upon receipt of request from the *HKIS*.

VS 8

Assumptions and Special Assumptions

8.1.0 Assumptions

8.1.1 An *assumption* is made where it is reasonable for the *valuer* to accept that something is true without the need for specific investigation or verification. Any such *assumption* must be reasonable and relevant having regard to the purpose for which the *valuation* is required.

8.1.2 The full definition from the glossary is as follows:

'A supposition taken to be true. It involves facts, conditions or situations affecting the subject of, or approach to, a *valuation* that, by agreement, do not need to be verified by the *member* as part of the *valuation* process. Typically, *assumptions* are made where specific investigation by the *valuer* is not required in order to prove that something is true.'

8.1.3 In addition to stating the *basis of value*, it is often necessary to make an *assumption* or multiple *assumptions* to clarify either the state of the *asset* in the hypothetical exchange or the circumstances under which the *asset* is assumed to be exchanged. Such *assumptions* can have a *significant* impact on value.

8.1.4 These types of *assumptions* generally fall into one of two categories:

- a) assumed facts that are consistent with, or could be consistent with, those existing at the *valuation date*, and
- b) assumed facts that differ from those existing at the *valuation date*.

The *assumptions* under category a) above is taken as *General Assumptions* which is covered in the paragraphs below and those under category b) is *special assumptions* which is covered in section 8.2.0.

8.1.5 *General Assumptions* related to facts that are consistent with, or could be consistent with, those existing at the *date of valuation* may be the result of a limitation on the extent of the investigations or enquiries undertaken by the *valuer*. Examples of such *assumptions* include, without limitation:

- a) an *assumption* that a business is transferred as a complete operational entity,
- b) an *assumption* that *assets* employed in a business are transferred without the business, either individually or as a group,
- c) an *assumption* that an individually valued *asset* is transferred together with other complementary *assets*, and
- d) an *assumption* that a holding of shares is transferred either as a block or individually.

8.1.6 As a *General Assumption* is often linked to a limitation on the extent of the investigations or enquiries that could be undertaken by the *valuer*, all *General Assumptions* that are likely to be included in the *report* are at best practice to be agreed with the *client* and included in the *terms of engagement*. In any cases, the *General Assumptions* should be agreed in writing with the *client* before the *valuation report* is issued. *Client's* confirmation on the contents of the draft *reports* containing all the *General Assumptions* will be taken as one form of agreement in writing.

8.1.7 If, after *inspection* or investigation, the *valuer* considers that an *assumption* agreed in advance with the *client* is likely to be inappropriate, or should become a *special assumption*, the revised *assumptions* and approach must be discussed with the *client* prior to the conclusion of the *valuation* assignment and delivery of the *report*.

8.2.0 Special Assumptions

8.2.1 A *special assumption* is made by the *valuer* where an *assumption* either assumes facts that differ from those existing at the *valuation date* or that would not be made by a typical market participant in a transaction on that *valuation date*.

8.2.2 Where *special assumptions* are necessary in order to provide the *client* with the *valuation* required, these must be expressly agreed and confirmed in writing to the *client* and intended users before the *report* is issued.

8.2.3 *Special assumptions* may only be made if they can reasonably be regarded as realistic, relevant and valid for the particular circumstances of the *valuation*.

8.2.4 *Special assumptions* are often used to illustrate the effect of possible changes on

the value of an *asset*. They are designated as “special” so as to highlight to a *valuation* user that the *valuation* is contingent upon a change in the current circumstances or that it reflects a view that would not be taken by participants generally on the *valuation date*.

8.2.5 The *valuer* may include in the *report* some comment or assessment of the likelihood of the *special assumption* being fulfilled. For example, a *special assumption* that permission had been granted to develop land may have to reflect the impact on value of any conditions that might be imposed.

8.2.6 A typical *special assumption* might be that a property or *asset* has been altered in some defined way, for example, ‘the *market value* on the *special assumption* that the works had been completed’. In other words, it assumes facts that differ from those existing at the *valuation date*.

8.2.7 If a *client* requests a *valuation* on the basis of a *special assumption* that the *valuer* considers to be unrealistic, the instruction *should* be declined.

8.2.8 Circumstances where it *may* be appropriate to make *special assumptions* include, for example:

- a situation where a bid from a *special purchaser* has been made, or can be reasonably anticipated;
- a situation where the interest being valued cannot be offered freely and openly in the market;
- a past change in the physical aspects of the property or *asset* where the *valuer* has to assume those changes have not taken place;
- an impending change in the physical aspects of the property, such as a new building to be constructed or an existing building to be refurbished or demolished;
- an anticipated change in the mode of occupation or trade at the property;
- the treatment of alterations and improvements carried out under the terms of a lease; and
- the property may be affected by environmental factors, including natural (such as flooding), non-natural (such as contamination) or existing use issues (such as a non-conforming user).

8.2.9 Some illustrations of *special assumptions* in relation to real property are that:

- planning (zoning) consent has been, or will be, granted for development (including a change of use) at the property
- a building or other proposed development has been completed in accordance with a defined plan and specification
- the property has been changed in a defined way (for example, removal of process equipment)
- the property is vacant when, in reality, at the *valuation date* it is occupied
- the property is let on defined terms when, in reality, at the *valuation date* it is vacant or
- the exchange takes place between parties where one or more has a special interest and that additional value, or *marriage value*, is created as a result of the merger of the interests.

8.2.10 Where a *real estate* has been damaged the *special assumptions* may include:

- treating the property as having been reinstated (reflecting any insurance claims)
- valuing as a cleared site with development permission assumed for the existing use
- refurbishment or redevelopment for a different use reflecting the prospects of obtaining the necessary development permissions.

8.2.11 All the *special assumptions* must be **expressly** agreed and confirmed in writing to the *client* and the intended users before the *report* is issued. *Members* must, in writing, communicate with the *clients* and the intended users, as far as applicable, on any *special assumptions* and confirm with the *clients* and the intended users on their agreements on the *valuations* under such *special assumptions*. The confirmation *must* be made expressly, and mere confirmation on the contents of the *report* may not be taken as sufficient.

8.2.12 All the *special assumptions* must be clearly written in the prominent positions in the *report*.

8.2.13 The adoption of some of these special *assumptions* may qualify the application of *market value*. They are often particularly appropriate where the *client* is a lender and *special assumptions* are used to illustrate the potential effect of changed circumstances on the value of a property as a security.

- 8.2.14** Where *valuations* are prepared for *financial statements* or public announcements, the normal *basis of value* will exclude any additional value attributable to *special assumptions*. **However, if (exceptionally) a *special assumption* is made, this must be referred to in any published reference.**
- 8.3.0 Valuation reflecting an actual or anticipated market constraint, and forced sales**
- 8.3.1** Wherever the *valuer*, or *client*, identifies that a *valuation* may need to reflect an actual or anticipated marketing constraint, details of that constraint **must be agreed and set out in the terms of engagement.**
- 8.3.2** The *valuer* may be instructed to undertake a *valuation* reflecting an actual or anticipated market constraint, which may take one of many different forms.
- 8.3.3** If a property or *asset* cannot be freely or adequately presented to the market, the price is likely to be adversely affected. Before accepting instructions to advise on the likely effect of a constraint, the *valuer* *should* ascertain whether this arises from an inherent feature of the *asset*, or of the interest being valued, or from the particular circumstances of the *client*, or some combination of all of these.
- 8.3.4** If an inherent constraint exists at the *valuation date*, it is normally possible to assess its impact on value. The constraint *should* be identified in the *terms of engagement*, and it *should* be made clear that the *valuation* will be provided on this basis. It *may* also be appropriate to provide an alternative *valuation* on the *special assumption* that the constraint did not exist at the *valuation date* in order to demonstrate its impact.
- 8.3.5** Greater care is needed if an inherent constraint does not exist at the *valuation date*, but is a foreseeable consequence of a particular event or sequence of events. Alternatively, the *client* *may* request a *valuation* to be on the basis of a specified marketing restriction. In either case the *valuation* would be provided on the *special assumption* that the constraint had arisen at the *valuation date*. The precise nature of the constraint **must** be included in the *terms of engagement*. It *may* also be appropriate to provide a *valuation* without the *special assumption* in order to demonstrate the impact that the constraint would have if it arose.
- 8.3.6** A *special assumption* that simply refers to a time limit for disposal without stating the reasons for that limit would not be a reasonable *assumption* to make. Without a clear understanding of the reasons for the constraint, the *valuer* would be unable to determine the impact that it may have on marketability, sale negotiations and the price achievable, or to provide meaningful advice.
- 8.3.7** A marketing constraint *should* not be confused with a forced sale. A constraint may result in a forced sale, but it can also exist without compelling the owner to sell.
- 8.3.8** The term 'forced sale value' **must** not be used. A 'forced sale' is a description of the situation under which the exchange takes place, not a distinct *basis of value*. Forced sales arise where there is pressure on a particular vendor to sell at a specific time – for example, because of the need to raise money or to extinguish a liability by a given date. The fact that a sale is 'forced' means that the vendor is subject to external legal or personal commercial factors, and therefore the time constraint is not merely a preference of the vendor. The nature of these external factors and the consequences of failing to conclude a sale are just as important in determining the price that can be achieved within the length of time available.
- 8.3.9** While a *valuer* can assist a vendor in determining a price that *should* be accepted in forced sale circumstances, this is a commercial judgment. Any relationship between the price achievable by a forced sale and the *market value* is coincidental; it is not a *valuation* that can be determined in advance, but a figure that might be seen as a reflection of *worth* to that particular vendor at the particular point in time having regard to the specific context. As emphasised in paragraph 8.3.8 above, although advice *may* be given on the likely realisation in forced sale circumstances, the term is a description of the situation under which the sale takes place, and so it **must** not be described or used as a *basis of value*.

8.3.10 It is a common misconception that in a poor or falling market there are automatically few 'willing sellers' and that, as a consequence, most transactions in the market are the result of 'forced sales'. Accordingly, the *valuer* may be asked to provide forced sale advice on this basis. This argument has little merit because it suggests that the *valuer should* ignore the evidence of what is happening in the market. The definition of *market value* makes it clear that a willing seller is motivated to sell at the best terms available in the market after proper marketing, whatever that price *may* be. The *valuer should* be careful not to accept instructions on the basis of a misconception and *should* explain to *clients* that, in the absence of a defined constraint affecting either the *asset* or the vendor, the appropriate basis is *market value*. In a depressed market, a *significant* proportion of sales may be made by vendors that are obliged to sell, such as administrators, liquidators and receivers. However, such vendors are normally under a duty to obtain the best price in the current circumstances and cannot impose unreasonable marketing conditions or constraints of their own volition. These sales will normally comply with the definition of *market value*.

8.4.0 Assumptions and special assumptions related to projected values

8.4.1 Any *assumptions*, special or otherwise, relating to projected values *must* be agreed with the *client* prior to reporting an opinion of value.

8.4.2 The *valuation report must* make reference to the higher degree of uncertainty that is likely to be implicit with a projected value, where by definition, comparable evidence will not be available.

8.4.3 By their nature, projected values rely wholly on *assumptions*, which *may* include some *significant special assumptions*. For example, the *valuer may* make various *assumptions* about the state of the market in the future – yields, rental growth, interest rates, etc. which *must* be supported by credible studies or economic outlook-based forecasts.

8.4.4 Great care is required to ensure that all *assumptions* made are:

- in accordance with any applicable national or jurisdictional standard
- realistic and credible
- clearly and comprehensively set out in the *report*.

8.4.5 When making *special assumptions*, great care *must* also be exercised concerning the reliability and precision of any methods, tools or data used for forecasting or extrapolation.

8.4.6 If a *client* requests a projected values on the basis of a cash flow projection that the *valuer* considers to be unrealistic, the instruction *should* be declined.

VS 9

Reporting

The report must:

- clearly and accurately set out the conclusions of the *valuation* in a manner that is neither ambiguous nor misleading, and which does not create a false impression. If appropriate, the *valuer should* draw attention to, and comment on, any issues affecting the degree of certainty, or uncertainty, of the *valuation* under paragraph 9.2.2(o) below.
- deal with all the matters agreed between the *client* and the *valuer* in the *terms of engagement* (see VS 4 Terms of Engagement).

9.1.0 General Requirements

9.1.1 It is essential that the *valuation report* communicates the information necessary for proper understanding of the *valuation* or valuation review. A *report must* provide the intended users with a clear understanding of the *valuation* and *should* be couched in terms that can be read and understood by someone with no prior knowledge of the subject asset or liability.

9.1.2 To provide useful information, the *report must* set out a clear and accurate description of the scope of the assignment, its purpose and intended use (including any limitations on that use) and disclosure of any *assumptions*, *special assumptions* (VS8 Assumptions and Special Assumptions), *significant* uncertainty or limiting conditions that directly affect the *valuation*.

9.1.3 This standard applies to all *valuation report* on the outcome of a valuation review which may range from comprehensive narrative reports to abbreviated summary reports.

9.1.4 The format and detail of the *report* is a matter to be agreed between the *valuer* and the *client* in the *terms of engagement*. It *should* always be proportionate to the task, and – as for the *valuation* itself – professionally adequate for the purpose. Where the *report* is to be provided on a form, or in a format, specified by the *client* that omits reference to one or more of the headings below, then either the initial service agreement or the

terms of engagement – or an appropriate combination of the two – *must* clearly address these matters. Failure to do so would result in the *valuation* not being undertaken in accordance with this Standards.

9.1.5 The purpose of the *valuation*, the complexity of the *asset* being valued and the users' requirements will determine the level of detail appropriate to the *valuation report*. The format of the *report should* be agreed with all parties as part of establishing a scope of work (see VS4 Terms of Engagement).

9.1.6 Compliance with this standard does not require a particular form or format of *report* (please refer to section 9.2.0); however, the *report must* be sufficient to communicate to the intended users the scope of the valuation assignment, the work performed, and the conclusions reached.

9.1.7 The *report should* also be sufficient for an appropriately experienced valuation professional with no prior involvement with the valuation engagement to review the report and understand the items in sections 9.2.0 and 9.3.0, as applicable.

9.1.8 Where multiple *reports* are to be made to a single *client* over a period of time, with identical *terms of engagement*, it *must* be made clear to the *client* and to any others who may rely on the valuation advice provided, that the *terms of engagement* and form of *report must* always be read together.

9.1.9 A *valuer may* provide the *client* with preliminary valuation advice, or a draft *report* or draft *valuation*, in advance of the completion of the final *report*. However, it is essential that the preliminary or provisional status is made clear, pending issue of the formal and final *report*.

9.1.10 In providing a *client* with preliminary advice, or a draft *report* or *valuation* in advance of its completion, the *member must* state that:

- 1) The opinion is provisional and subject to completion of the final *report*;
- 2) The advice is provided for *client's* internal purposes only; and
- 3) Any draft is on no account to be published or disclosed.

If any matters of fundamental importance are not reflected, their omission *must* be declared.

9.1.11 Members are reminded that any valuation advice provided, in whatever format, creates a potential liability to the *client*, or under certain circumstances, to one or more third parties. Great care *should* therefore be taken to identify and understand when and how such liabilities do, or may, arise, and their likely extent. See paragraph 9.2.3 (p) below.

9.1.12 The terms 'certificate of value', 'valuation certificate', and 'statement of value' *should* not be used in connection with the provision of valuation advice. However a *valuer* may use the term 'certified', or similar words in the body of the *report* where it is known that the *valuation* is to be submitted for a purpose that requires formal certification of a valuation opinion.

9.1.13 Where necessary for the purpose of brevity, *members* may provide a separate summary of values, provided that it is part of a *valuation report* prepared for the required same purpose and complying fully with *the Standards*, and clearly cross referenced and stated as such.

9.1.14 In some instances, the *client* may request the *valuer* to prepare a *report* in a language other than English. Due care *must* be taken to ensure that the requirements set out in *the Standards* have been fully complied with and reflected in such a *report* and that the approved text of *the Standards* is correctly interpreted.

9.2.0 Valuation Reports

9.2.1 Where the *report* is the result of an assignment involving the *valuation* of an *asset*, the *report* *must* convey the following, at a minimum:

- a) Identification and status of the *valuer*
- b) Identification of the *client* and any other intended users
- c) Purpose of the *valuation*
- d) Identification of the *asset(s)* valued
- e) *Basis(es)* of value adopted
- f) *Valuation date*
- g) Extent of investigation
- h) Nature and source(s) of the information relied upon

- i) All *assumptions* and *special assumptions*
- j) Restrictions on use, distribution and publication of the *report*
- k) Confirmation that the assignment has been undertaken in accordance with the IVS and/or HKIS Valuation Standards
- l) Valuation approach and reasoning
- m) Amount of the *valuation* or *valuations*
- n) *Date of the report*
- o) Commentary on any *material* uncertainty in relation to the *valuation* where it is essential to ensure clarity on the part of the valuation user
- p) A statement on whether or not any limiting conditions have been agreed.

9.2.2 Some of the above requirements *may* be explicitly included in a *report* or incorporated into a *report* through reference to other documents (engagement letters, scope of work documents, internal policies and procedures, etc.).

9.2.3 Each *report* heading is considered in more detail below. The text in bold specifies the key principles. The accompanying text that follows specifies how the principles are to be interpreted and implemented in individual cases.

a) Identification and status of the *valuer*

The *valuer* can be an individual or a member of a *firm*. The *report* *must* include:

- the signature of the individual responsible for the valuation assignment
- a statement confirming that the *valuer* is in a position to provide an objective and unbiased *valuation* and is competent to undertake the valuation assignment.

If the *valuer* has obtained material assistance from others in relation to any aspect of the assignment, the nature of such assistance and the extent of reliance *must* be referenced in the *report*.

- i. A *valuation* is the responsibility of an individual *member*. HKIS does not allow a *valuation* to be prepared by a '*firm*' although the use of 'for and on behalf of' under the responsible *valuer's* signature is an acceptable substitution.

- ii. In all cases the signatory's professional designation (for example, MHKIS) or other relevant professional qualification, *must* be made clear.
 - iii. Where it is a specific requirement to do so, the *valuer must* state if he or she is acting as an internal or external *valuer* as defined in **VS 2**. However, for certain purposes in individual *jurisdictions* other definitions of these terms may apply, which *must* be recognised in the *terms of engagement* (assuming the *valuer* meets the criteria specified in the definition) and made explicit in the *report*. Where other criteria concerning the status of a *valuer* have been adopted they *must* again be confirmed, together with a statement that the *valuer* meets them.
 - iv. In considering the extent of any material previous involvement, whether past, current or possible future, the *valuer must* have regard to the requirements of **VS 3 Section 3.5.0**. Any disclosures or statements made in accordance with **VS 4 paragraph 4.3.2 (a) (iii)**, *must* be repeated in the *valuation report*. Where there has not been any previous material involvement, a statement to that effect *must* be made in the *valuation report*.
 - v. A statement *should* be made that the *valuer* has sufficient current local, national and international (as appropriate) knowledge of the particular market, and the skills and understanding to undertake the *valuation* competently. Where more than one *valuer* within a *firm* has contributed, confirmation that **VS 2** has been satisfied is needed, though it is not necessary to provide any details.
 - vi. Where the *valuer* incorporates into the *report* a *valuation* prepared by another *valuer* or *firm* – whether in the capacity of a subcontractor or third party expert in one or more aspects – see (j) subparagraphs iv–v below.
 - vii. In some countries or states the relevant valuation standards specific to that *jurisdiction may* require additional disclosures to be made with regard to the status of the *valuer*.
- b) **Identification of the *client* and any other intended users**

The party commissioning the valuation assignment *must* be identified together with any other parties whom it is intended may rely on the results of the assignment (see also (j) Restrictions on use, distribution or publication of the report, below).

 - i. The *report must* be addressed to the *client* or its representatives. The source of the instructions and the identity of the *client must* be stated, if different from the addressee. Other known users of the *report* are to be named.
 - ii. For some purposes *valuers may* be unable to exclude liability to third parties (see **VS 3 Ethics, Professionalism and Conflict of Interests section 3.5.0**). Any limitation on disclosure of a *valuation* based on restricted information or instruction *should* be included (see VS 4 Terms of Engagement 4.3.2(j)).
 - c) **Purpose of the *valuation***

The purpose of the valuation assignment *must* be clearly stated.

 - i. The *report must* be unambiguous. Where the purpose of the *valuation* is not disclosed by the *client*, the *valuer should* seek clarification why this is so. The *valuation report must* include an appropriate statement to clarify the circumstances.
 - d) **Identification of the *asset(s)* valued**

The asset or liability to which the valuation assignment relates *must* be clearly identified. Clarification *may* be needed to distinguish between an *asset* and an interest in or right of use of that *asset*. If the *valuation* is of an *asset* that is used in conjunction with other *assets*, it will be necessary to clarify whether those *assets* are:

 - included in the valuation assignment
 - excluded but assumed to be available
 - or
 - excluded and assumed not to be available.

If the *valuation* is of a fractional interest held in an asset or liability, the relationship of the fractional interest being valued relative to all other fractional interests and the obligations of the fractional interest ownership, if any, to other fractional interest owners, *must* be made clear.

Particular regard *must* be had to the identification of portfolios, collections and groups of properties. It is essential to consider 'lotting' or 'grouping'; the identification of different property or *asset* categories; and any *assumptions* or *special assumptions* relating to the circumstances under which the properties, assets, liabilities or collections may be brought to the market.

- i. The legal interest in each asset or liability *should* be stated. Clarification is essential to distinguish between the characteristics of the *asset* in its entirety and the particular right or interest that is being valued. Where the *asset* is a real property, the extent to which vacant possession is, or may be available (if required), *should* also be noted.
- ii. Where the *assets* are located in more than one country or state, the *report must* list the *assets* within each country or state separately and *should* normally be arranged so that all the *assets* in one country or state are grouped together. The legal interest in each asset or liability *should* be stated.
- iii. Where the *terms of engagement* have required separate identification of *assets* by their use, category or class, the *report should* be structured accordingly.
- iv. Where there is doubt about what constitutes a single property or *asset*, the *valuer should* generally 'lot', or group, the properties for *valuation* in the manner most likely to be adopted in the case of an actual sale of the interest(s) being valued. However, the *valuer should* discuss the options with the *client* and *must* confirm the approach adopted in both the *terms of engagement* and the *report*.

e) **Basis(es) of value adopted**

The *basis of value must* be appropriate for the purpose. The source of the definition of any *basis of value* used *must* be cited or the basis explained.

This requirement does not apply to a valuation review where no opinion of value is to be provided or no comment is required on the *basis of value* used.

- i. The *basis of value*, together with its definition (but not supporting conceptual framework or other explanatory material regarding that definition), *must* be stated in full in the *report*.
- ii. Unless agreed otherwise in the *terms of engagement* the *valuer* is not required to provide a *valuation* on an alternative *basis of value*. However, where the *basis of value* is not a market-based figure and the *valuation* is materially different from *market value*, an explanatory statement to that effect *may* be appropriate, where necessary to ensure that the user of the *valuation* is alerted to the possibility that, although relevant for the specified purpose, the *valuation* may not bear a relation to the price that could be obtained if the asset or liability were placed on the market for disposal.
- iii. Where, exceptionally, a *valuation* is provided relating to a future date this *must* be made explicit (see paragraph (f) below). It *should* always be separately reported with confirmation that it complies as appropriate with any applicable jurisdictional and/or national standards. A projection *may* take one of a number of forms and does not normally constitute a distinct *basis of value* in itself. But, as it rests substantially on *special assumptions*, which may or may not be borne out by actual events, it is of a different character from advice relating to a current or past date and *must* not be represented as if it were on an equal footing. In particular it *must* never be described or represented simply as '*market value*'.

f) **Valuation date**

The *valuation date may* be different from the date on which the *valuation report* is issued or the date on which investigations are to be undertaken or completed. Where appropriate, these

dates *must* be clearly distinguished in the report.

This requirement does not apply to a valuation review unless the reviewer is required to comment on the *valuation date* used in the valuation under review.

- i. The *valuation date* must be stated (see VS 4 Terms of Engagement 4.3.2(h)).
- ii. If there has been a *material* change in market conditions, or in the circumstances of a property, *asset* or portfolio, between the *valuation date* (where this is earlier than the *date of the report*) and the *date of report*, the *valuer* should draw attention to this. It may also be prudent in appropriate instances for the *valuer* to draw the *client's* attention to the fact that values change over time and a *valuation* given on a particular date may not be valid on an earlier or later date.
- iii. Additional care is needed when providing a projection of value, in order to ensure that the *client* understands that the actual value at the future date, on whatever basis is adopted, may diverge from that being reported and almost certainly will if the then state of the *asset* or conditions of the market differ from the *special assumptions* statements made at the time of the projection. See also paragraph (e)(iii) above.

g) Extent of investigation

The extent of the investigations undertaken, including the limitations on those investigations set out in the *terms of engagement* (scope of work), *must* be disclosed in the report.

- i. Where the *asset* is a real property interest, the *report* must record the date and extent of any *inspection*, including reference to any part of the property to which access was not possible. Equivalent steps, appropriate to the class of *asset* concerned, *should* be taken in relation to tangible personal property.
- ii. The *valuer* must make it clear if the *valuation* has been made without an opportunity to carry out an adequate

inspection (see VS 7 paragraphs 7.1.3 and 7.1.8) or equivalent check.

- iii. In the case of a revaluation, the *report* should also refer to any agreement in respect of the requirement for, or frequency of, an *inspection* of the property (See VS 7).
 - iv. Where a substantial number of properties are being valued, a generalized statement of these aspects (i.e. regarding *inspection*) is acceptable, provided that it is not misleading.
 - v. Where the *asset* is not real or tangible personal property, particular care *should* be taken in the *report* to note the extent to which investigations were possible.
 - vi. Where the *valuation* is undertaken on the basis of restricted information, or is a revaluation without an *inspection*, the *report* must include full particulars of the restriction (see also VS 4 paragraph 4.3.2(i)).
- h) Nature and source(s) of the information relied upon

The nature and source of any relevant information relied upon in the valuation process and the extent of any steps taken to verify that information *must* be disclosed.

To the extent that information provided by the commissioning party or another party has not been verified by the *valuer*, this *should* be clearly stated with reference, as appropriate, to any representation from that party.

For this purpose, 'information' is to be interpreted as including data and other such inputs.

- i. Where the *client* has provided information that is to be relied on, the *valuer* has a responsibility to state clearly that the information is covered by, or in, the *terms of engagement* and, where appropriate, to specify its source. In each case the *valuer* must judge the extent to which the information to be provided is likely to be reliable and whether any further, reasonable steps are required to verify it.

- ii. The *valuer must* make it clear if the *valuation* has been carried out without information that would normally be, or be made, available. The *valuer must* also indicate in the *report* if verification (where practicable) is needed of any information or *assumptions* on which the *valuation* is based, or if any information considered material has not been provided.
 - iii. If any such information or *assumption* requiring verification is *material* to the amount of the *valuation*, the *valuer must* make clear that the *valuation should* not be relied on without that verification (see **VS 4 paragraph 4.3.2(j)**). In the case of a revaluation, a statement of any *material* changes advised by the *client* or a stated *assumption* that there have been no *material* changes, *should* be included.
 - iv. The *client* may expect the *valuer* to express an opinion, and in turn the *valuer may* wish to express an opinion, on legal issues that affect the *valuation*. In these circumstances the *valuer must* therefore make clear in the *report* any information that must be verified by the *client's* or other interested parties' legal advisers before the *valuation* can be relied on or published.
 - v. The *report should* state any additional information that has been available to, or established by, the *valuer*, and is believed to be crucial to the *client's* ability to understand and benefit from the *valuation*, with regard to the purpose for which it has been prepared.
- i) **All assumptions and special assumptions**
- All assumptions and any special assumptions made must be clearly stated.**
- i. All *assumptions* and any *special assumptions must* be set out in the *report* in full, together with any reservations that may be required and a statement that they have been agreed with the *client*. Both the valuation conclusion and the executive summary (if provided) *should* explicitly set out all *special assumptions* that have been made to arrive at the reported figure. Where the *assumptions* vary in different countries or states the *report must* make this clear.
- j) **Restrictions on use, distribution and publication of the report**
- Where it is necessary or desirable to restrict the use of the valuation or those relying upon it, this must be stated.**
- i. The *valuer must* state the permitted use, distribution and publication of the *valuation*.
 - ii. Where the purpose of the *report* requires a published reference to it, the *valuer must* provide a draft statement for inclusion in the publication. This *may* be provided as a separate document annexed to the *report* or a part of the *report*, where the rules or regulations under different *jurisdiction* may require to do so.
 - iii. A *report* may be published in full, for instance in the annual accounts of a company, but it is more common for only a reference to be made to it. In this case it is essential that the *valuer* has a close involvement in the publication statement to ensure that all the references are accurate and that the reader is not misled, unless the *valuer* is not provided with or is barred from amendments on the reference of such publication statement. This is particularly important if the *valuer* is asked to take responsibility for any published statement or any part of a published statement.
 - iv. If the whole *report* is not to be published, it is common for the *valuer* to prepare a statement or summary as a separate document and to provide to the *client* at the same time as the *report*. The content of the statement or summary may be governed by rules issued by local regulatory bodies, *valuers must* check and ensure his *report* containing all the minimum contents as required under the prevailing rules of the regulatory bodies. In case the contents in the statement or summary are not

- specified, the statement or summary *should* contain the following minimum information:
- the name and qualification of the *valuer*, or the *valuer's firm*
 - an indication of whether the *valuer* is an internal or external *valuer*, and where required, that the specific criteria relating to this status have been met
 - the *valuation date* and *basis (or bases) of value*, together with any *special assumptions*
 - comment on the extent to which the values were determined directly by reference to market evidence or were estimated using other valuation techniques
 - confirmation that the *valuation* has been made in accordance with these standards, or the extent of and reason(s) for *departure* from them and
 - a statement indicating any parts of the *report* prepared by another *valuer* or specialist.
- v. For *valuations* in which the public has an interest or which may be relied on by parties other than the *client* commissioning the *report* or to which it is addressed, the *valuer must* make additional disclosures in the *valuation report* and any published reference to it. These are set out in **VS 3 section 3.5.0**.
- vi. 'Publication' does not include making the *report* or the valuation figure available to a mortgage (lending) applicant or borrower.
- vii. The *valuer should* check the accuracy of any other relevant material referring to the properties or to the *valuation* that is to be published.
- viii. The *valuer* is also advised to read the whole document in which the *report* or reference is to be published to ensure that there is no misstatement of any other matter or opinion of which the *valuer* may have knowledge.
- ix. The *valuer should* insist that a copy of the final proof of the document or the reference is supplied before issue, and attach that proof to the letter of consent. Any pressure by other parties or persuasion to delegate power to sign *should* be resisted.
- x. The *valuer* is permitted to exclude information of a commercially sensitive nature from a *report* that is published in full, subject to any legal requirements that may apply in a particular country or state.
- xi. An opinion *may* be expressed which, if included in a public document, might have some effect on a matter that is in dispute, under negotiation or subject to certain rights between the owner and a *third party* (for example, an opinion of the rental or capital value of a property with an imminent rent review). The *report may* also include information about a company's trading that would not usually be in the public domain. Such information is commercially sensitive and the *client* must decide, subject to the approval of the auditors and any regulatory body, whether it should be included in the publication.
- xii. In the published reference the *valuer must* refer to the omission(s) and state that this has been done on the express instructions of the *client* and with the approval of the regulatory body and/or auditors. Without this note the *valuer* may be inadvertently placed in a situation where there is unjustifiable criticism.
- xiii. Where the full *report* is not published, the publication statement *must* refer to any *special assumption* made and any additional *valuation* provided. Similarly, sufficient reference to any *departures should* be made in any published document.
- xiv. In each case the onus is on the *valuer* to determine what constitutes a 'sufficient reference'. A reference would not be regarded as 'sufficient' if it failed to alert the reader to matters of fundamental importance as to the basis or amount of the *valuation*, or if there was any risk that the reader might be misled.
- xv. It is expected that a *valuer* would not normally consent to the publication of a projected value. Where, in exceptional cases, consent is given, great care *should* be taken to ensure that any associated provisos or disclaimers are accurately reproduced.

- k) Confirmation that the assignment has been undertaken in accordance with the IVS and /or HKIS Valuation Standards

The valuer should provide:

confirmation that the *valuation* has been undertaken in accordance with the International Valuation Standards (IVS) and that all *significant* inputs have been assessed by the valuer and found to be appropriate for the *valuation* provided

or (depending on *clients'* particular requirements)

confirmation that the *valuation* has been undertaken in accordance with the HKIS Valuation Standards, which incorporate the IVS, and (where applicable) the relevant *HKIS* or jurisdictional supplement.

In both cases an accompanying note and explanation of any *departures* from the IVS or the HKIS Valuation Standards *must* be included. A *departure* would not be justified if it resulted in a *valuation* that is misleading.

- i. There is no *material* difference in outcome between the respective forms of endorsement above, which *may* be used according to the particular requirements of the valuation assignment. Some *clients* will expressly wish to have confirmation that the *valuation* has been undertaken in accordance with the IVS, and it is naturally in order for this to be given. In all other cases confirmation that the *valuation* has been undertaken in accordance with the HKIS Valuation Standards carries with it the dual assurance of compliance with the IVS technical standards and with the HKIS Valuation Standards overall.
- ii. References to the HKIS Valuation Standards without reference to the year of issue will be taken to mean the version of the HKIS standards operative at the *valuation date*, provided that it is on or before the date of signature of the *report*.
- iii. The statement of compliance *should*

draw attention to any *departures* (see **VS 1 section 1.5.0**). Where a *departure* is made that is not mandatory, it will not be possible to confirm compliance with the IVS.

- iv. Where valuation standards specific to a particular *jurisdiction* have been followed, a formal statement regarding compliance with those jurisdictional standards *may* be added.
- v. Where the valuer incorporates into the *report* a *valuation* prepared by another valuer or *firm* – whether as a subcontractor or as a third party expert – it *must* be confirmed that such *valuations* have been prepared in accordance with *the Standards*, or other standards that may apply in the particular circumstances.
- vi. The valuer may be requested to incorporate a *valuation* commissioned directly by the *client*. In such cases the valuer *must* be satisfied that any such *report* has been prepared in accordance with *the Standards*.

l) Valuation approach and reasoning

To understand the valuation figure in context, the *report must* make reference to the approach or approaches adopted, the key inputs used and the principal reasons for the conclusions reached.

Where the *report* is of the results of a valuation review it *must* state the reviewer's conclusions about the work under review, including supporting reasons.

This requirement does not apply if it has been specifically agreed and recorded in the *terms of engagement* (scope of work) that a *report* shall be provided without reasons or other supporting information.

- i. Where different valuation approaches and *assumptions* are required for different *assets* it is important that they are separately identified and reported.
- m) Amount of the *valuation* or *valuations*

This *must* be expressed in the applicable currency.

This requirement does not apply to a valuation review if the valuer is not required to provide his or her own valuation opinion.

- i. In the main body of the *report* the opinion of value is required in words, as well as in figures.
- ii. Where the valuation instruction includes a number of *assets* falling into different use categories or geographic location, whether the *valuation* is reported asset by asset or otherwise will depend on the purpose for which the *valuation* is required, the circumstances and *client* preferences. Where a portfolio includes *assets* of differing tenures, the value of the tenure groups *may* be subtotaled, together with a statement of the overall value.
- iii. An entity will usually require asset or liability values to be expressed in the currency of the country in which it is based. For financial statement purposes, this is known as the 'reporting currency'. Irrespective of the location of the *client*, *valuations must* be made in the currency of the country in which the asset or liability is located.
- iv. Where the *client* requires the *valuation* to be translated into a different currency (for example, into the reporting currency), unless agreed otherwise the exchange rate to be adopted is the closing rate (also known as the 'spot rate') on the *valuation date*.
- v. Where the valuation instruction requires the opinion of value to be reported in more than one currency (such as with cross-border portfolio *valuations*), the opinion of value *must* indicate the currencies adopted and the amount *should* be shown in words and figures in the main body of the *report*. In addition the exchange rate adopted *should* be as at the *valuation date* and this *must* be stated in the *valuation report*.
- vi. If the identification of individual *assets* and their values is consigned to a schedule(s) appended to the *report*, a summary of values *must* be included within the body of the *report*.
- vii. If there has been a *material* change

in market conditions, or in the circumstances of an *asset* or portfolio, between the *valuation date* (where this is earlier than the *date of the report*) and the *date of the report*, the *valuer should* draw attention to this. It *may* also be prudent in appropriate instances for the *valuer* to draw the *client's* attention to the fact that values change over time and a *valuation* given on a particular date may not be valid on an earlier or later date.

viii. 'Negative values' and liabilities may arise and *must* always be stated separately. They *should* not be offset. **It is not correct in such cases to report a 'nil' figure of value.**

n) **Date of the report**

The date on which the *report* is issued *must* be included. This may be different from the *valuation date* (see (f) above).

o) **Commentary on any *material* uncertainty in relation to the *valuation* where it is essential to ensure clarity on the part of the valuation user**

i. This requirement is mandatory only where the uncertainty is material. For this purpose, 'material' means where the degree of uncertainty in a *valuation* falls outside any parameters that might normally be expected and accepted.

ii. All *valuations* are professional opinions on a stated *basis of value*, coupled with any appropriate *assumptions* or *special assumptions*, which *must* also be stated (see **VS 8**) – a *valuation* is not a fact. Like all opinions, the degree of subjectivity involved will inevitably vary from case to case, as will the degree of 'certainty' – for example, the probability that the *valuer's* opinion of *market value* would exactly coincide with the price achieved were there an actual sale at the *valuation date*, even if all the circumstances envisaged by the *market value* definition and the *valuation assumptions* were identical to the circumstances of an actual sale. Most *valuations* will be subject to a degree of variation (that is, a difference in professional opinion), a principle well-recognised by the

- courts in a variety of *jurisdictions*.
- iii. Ensuring user understanding and confidence in *valuations* requires clarity and transparency, hence the general requirement under subsection (l) above for the *report* to make reference to the approach or approaches adopted, the key inputs used and the principal reasons for the conclusions reached, thereby enabling the user to understand the valuation figure in context. How much explanation and detail is necessary concerning the supporting evidence, the valuation approach and the particular market context is a matter of judgment in individual cases.
 - iv. Normally, *valuations* will not require additional explanation or clarification beyond the general requirement referred to in paragraph iii. above. However, in some cases there may be a greater degree of uncertainty concerning the valuation figure reported than usual, and where that uncertainty is *material* further proportionate commentary *must* be added in order to ensure that the *report* does not create a false impression. *Valuers should* not treat such a statement expressing less confidence in a *valuation* than usual as an admission of weakness – it is not a reflection on their professional skill or judgment, but a matter entirely proper for disclosure. Indeed, if a failure to draw attention to *material* uncertainty gave a *client* the impression that greater *weight* could be attached to the opinion than was warranted, the *report* would be misleading.
- p) **A statement on whether or not any limiting conditions have been agreed.**

The statement on whether or not any limiting conditions, such as limitations on liability, etc., *must* be included.

9.3.0 Valuation Review Reports

9.3.1 Where the *report* is the result of a valuation review, the *report must* convey the following, at a minimum:

- a. the scope of the review performed, including the elements noted in **VS4 Terms of Engagement** to the extent each is applicable to the assignment,
- b. the *valuation report* being reviewed and the inputs and *assumptions* upon which that *valuation* was based,
- c. the reviewer's conclusions about the work under review, including supporting reasons, and
- d. the *date of the report* (which may differ from the *valuation date*).

9.3.2 Some of the above requirements may be explicitly included in a *report* or incorporated into a *report* through reference to other documents (e.g. engagement letters, scope of work documents, internal policies and procedures, etc.).

VS 10**Real property****10.1.0 Overview**

10.1.1 This standard contains additional requirements for *valuations* of real property.

10.2.0 Introduction

10.2.1 Property interests are normally defined by state or the law of individual *jurisdictions* and are often regulated by national or local legislation. Before undertaking a *valuation* of a real property, a *valuer must* understand the relevant legal framework that affects the interest being valued.

10.2.2 A real property is a right of ownership, control, use or occupation of land and buildings. There are three main types of interest:

- (a) the superior interest in any defined area of land. The owner of this interest has an absolute right of possession and control of the land and any buildings upon it in perpetuity, subject only to any subordinate interests and any statutory or other legally enforceable constraints,
- (b) a subordinate interest that normally gives the holder rights of exclusive possession and control of a defined area of land or buildings for a defined period, e.g. under the terms of a lease contract, and/or
- (c) a right to use land or buildings but without a right of exclusive possession or control, e.g. a right to pass over land or to use it only for a specified activity.

10.2.3 Intangible assets fall outside the classification of real property assets. However, an intangible asset may be associated with, and have a *material* impact on, the value of real property assets. It is therefore essential to be clear in the scope of work precisely what the valuation assignment is to include or exclude. For example, the *valuation* of a hotel can be inextricably linked to the hotel brand. In such cases, the valuation

process will involve consideration of the inclusion of intangible assets and their impact on the *valuation* of the real property and plant and equipment assets. When there is an intangible asset component, *valuer should* also follow VGN 2 Intangible Assets.

10.2.4 Although different words and terms are used to describe these types of real property in different *jurisdictions*, the concepts of an unlimited absolute right of ownership, an exclusive interest for a limited period or a non-exclusive right for a specified purpose are common to most. The immovability of land and buildings means that it is the right that a party holds that is transferred in an exchange, not the physical land and buildings. The value, therefore, attaches to the legal interest rather than to the physical land and buildings.

10.2.5 To comply with the requirement to identify the *asset* to be valued in **VS 4** the following matters *must* be included:

- (a) a description of the real property to be valued, and
- (b) identification of any superior or subordinate interests that affect the interest to be valued.

10.2.6 To comply with the requirements to state the extent of the investigation and the nature and source of the information to be relied upon in **VS4**, the following matters *must* be considered:

- (a) the evidence required to verify the real property and any relevant related interests,
- (b) the extent of any *inspection*,
- (c) responsibility for information on the site area and any building floor areas,
- (d) responsibility for confirming the specification and condition of any building,
- (e) the extent of investigation into the nature, specification and adequacy of services,
- (f) the existence of any information on ground and foundation conditions,
- (g) responsibility for the identification of actual or potential environmental risks,
- (h) legal permissions or restrictions

on the use of the property and any buildings, as well as any expected or potential changes to legal permissions and restrictions.

10.2.7 Typical examples of *special assumptions* that *may* need to be agreed and confirmed in order to comply with **VS4** include:

- (a) that a defined physical change had occurred, e.g. a proposed building is valued as if complete at the *valuation date*,
- (b) that there had been a change in the status of the property, e.g. a vacant building had been leased or a leased building had become vacant at the *valuation date*,
- (c) that the interest is being valued without taking into account other existing interests, and
- (d) that the property is free from contamination or other environmental risks.

10.2.8 *Valuations* of real property are often required for different purposes including secured lending, sales, taxation, litigation, compensation, insolvency proceedings and financial reporting.

10.3.0 *Bases of Value*

10.3.1 In accordance with **VS 5**, a *valuer must* select the appropriate *basis(es) of value* when valuing real property.

10.3.2 Under most *bases of value*, a *valuer must* consider the highest and best use of the real property, which may differ from its current use (see **VS5 paragraph 5.3.6**). This assessment is particularly important to real property which can be changed from one use to another or that have development potential.

10.3.3 There are certain types of *real properties* that have been designed to be sold in an open market as fully operational business units for a strictly limited use and at prices based upon trading potential. Examples of these are hotels, bars, restaurants, movie theatres or cinemas, gasoline or petrol stations. The prices of these real properties will include trade fixtures, fittings, furniture, furnishings and

equipment. A *valuer* will need to collect additional information apart from *market value*, clarifying whether the *valuation* assumes that the real property is to be sold as a fully-equipped real property, part of a going concern trading entity, or on some other *assumptions*.

10.4.0 *Valuation Approaches and Methods*

10.4.1 The three valuation approaches described in the **VS6 - Valuation Approaches and Methods** can all be applicable for the *valuation* of a real property.

10.4.2 When selecting an approach and method, in addition to the requirements of this standard, a *valuer must* follow the requirements of **VS6 - Valuation Approaches and Methods**.

10.5.0 *Market Approach*

10.5.1 Property interests are generally heterogeneous (i.e. with different characteristics). Even if the land and buildings have identical physical characteristics to others being exchanged in the market, the location will be different. Notwithstanding these dissimilarities, the *market approach* is commonly applied for the *valuation* of real property.

10.5.2 In order to compare the subject of the *valuation* with the price of other real property, *valuers should* adopt generally accepted and appropriate units of comparison that are considered by participants, dependent upon the type of *asset* being valued. Units of comparison that are commonly used include:

- (a) price per square metre (or per square foot) of a building or per hectare for land,
- (b) price per room, and
- (c) price per unit of output, e.g. crop yields.

10.5.3 A unit of comparison is only useful when it is consistently selected and applied to the subject property and the comparable properties in each analysis. To the extent possible, any unit of comparison

used *should* be one commonly used by participants in the relevant market.

10.5.4 The reliance that can be applied to any comparable price data in the valuation process is determined by comparing various characteristics of the property and transaction from which the data was derived with the property being valued. Differences between the following *should* be considered in accordance with **VS6 – Valuation Approaches and Methods**. Specific differences that *should* be considered in valuing real property include, but are not limited to:

- (a) the type of interest providing the price evidence and the type of interest being valued,
- (b) the respective locations,
- (c) the respective quality of the land or the age and specification of the buildings,
- (d) the permitted use or zoning at each property,
- (e) the circumstances under which the price was determined and the *basis of value* required,
- (f) the effective date of the price evidence and the *valuation date*, and
- (g) market conditions at the time of the relevant transactions and how they differ from conditions at the *valuation date*.

10.6.0 Income Approach

10.6.1 Various methods are used to indicate value under the general heading of the *income approach*, all of which share the common characteristic that the value is based upon an actual or estimated income that either is, or could be, generated by an owner of the interest. In the case of an *investment property*, that income could be in the form of rent (see paras 10.9.1 – 10.9.3); in an owner-occupied building, it could be an assumed rent (or rent saved) based on what it would cost the owner to lease equivalent space.

10.6.2 For some real property, the income-generating ability of the property is closely tied to a particular use or business/trading activity (for example, hotels, golf courses, etc.). Where a building is suitable for only

a particular type of trading activity, the income is often related to the actual or potential cash flows that would accrue to the owner of that building from the trading activity. The use of a property's trading potential to indicate its value is often referred to as the "profits method".

10.6.3 When the income used in the *income approach* represents cash flow from a business/trading activity (rather than cash flow related to rent, maintenance and other real property-specific costs), the *valuer may* also comply as appropriate with the requirements of VGN 1 – Business Interests and Businesses Enterprises and, where applicable, VGN 2 – Intangible Assets.

10.6.4 For real property, various forms of discounted cash flow models *may* be used. These vary in detail but share the basic characteristic that the cash flow for a defined future period is adjusted to a present value using a discount rate. The sum of the present day values for the individual periods represents an estimate of the capital value. The discount rate in a discounted cash flow model will be based on the time cost of money and the risks and rewards of the income stream in question.

10.6.5 Further information on the derivation of discount rates is included in **VS 6**. The development of a yield or discount rate will be influenced by the objective of the *valuation*. For example:

if the objective of the *valuation* is to establish the value to a particular owner or potential owner based on their own investment criteria, the rate used may reflect their required rate of return or their weighted average cost of capital, and if the objective of the *valuation* is to establish the *market value*, the discount rate *may* be derived from observation of the returns implicit in the price paid for real property traded in the market between participants or from hypothetical participants' required rates or return. When a discount rate is based on an analysis of market transactions, *valuers should* also follow the guidance contained in **VS 6**.

10.6.6 An appropriate discount rate *may* also be built up from a typical "risk free" return

adjusted for the additional risks and opportunities specific to the particular real property.

economic utility of the subject property compared to the modern equivalent.

10.7.0 Cost Approach

10.8.0 Special Considerations for Real property

10.7.1 In applying the *cost approach*, valuers must follow the guidance contained in **VS 6**.

10.8.1 The following sections address a non-exhaustive list of topics relevant to the *valuation* of real property.

10.7.2 This approach is generally applied to the *valuation* of real property through the depreciated replacement cost method.

- (a) Hierarchy of Interests (section 10.9.0).
- (b) Rent (section 10.10.0).

10.7.3 It *may* be used as the primary approach when there is either no evidence of transaction prices for similar property or no identifiable actual or notional income stream that would accrue to the owner of the relevant interest.

10.9.0 Hierarchy of Interests

10.7.4 In some cases, even when evidence of market transaction prices or an identifiable income stream is available, the *cost approach* *may* be used as a secondary or corroborating approach.

10.9.1 The different types of real property are not mutually exclusive. For example, a superior interest may be subject to one or more subordinate interests. The owner of the absolute interest may grant a lease interest in respect of part or all of his interest. Lease interests granted directly by the owner of the absolute interest are “head lease” interests. Unless prohibited by the terms of the lease contract, the holder of a head lease interest can grant a lease of part or all of that interest to a third party, which is known as a sub-lease interest. A sub-lease interest will always be shorter than, or coterminous with, the head lease out of which it is created.

10.7.5 The first step requires a replacement cost to be calculated. This is normally the cost of replacing the property with a modern equivalent at the relevant *valuation date*. An exception is where an equivalent property would need to be a replica of the subject property in order to provide a participant with the same utility, in which case the replacement cost would be that of reproducing or replicating the subject building rather than replacing it with a modern equivalent. The replacement cost *must* reflect all incidental costs, as appropriate, such as the value of the land, infrastructure, design fees, finance costs and developer profit that would be incurred by a participant in creating an equivalent *asset*.

10.9.2 These property interests will have their own characteristics, as illustrated in the following examples:

10.7.6 The cost of the modern equivalent *must* then, as appropriate, be subject to adjustment for physical, functional, technological and economic obsolescence (see **VS 6**). The objective of an adjustment for obsolescence is to estimate how much less valuable the subject property might, or would be to a potential buyer than the modern equivalent. Obsolescence considers the physical condition, functionality and

(a) Although an absolute interest provides outright ownership in perpetuity, it may be subject to the effect of subordinate interests. These subordinate interests could include leases, restrictions imposed by a previous owner or restrictions imposed by statute.

(b) A lease interest will be for a defined period, at the end of which the property reverts to the holder of the superior interest out of which it was created. The lease contract will normally impose obligations on the lessee, e.g. the payment of rent and other expenses. It may also impose conditions or restrictions, such as in the way the property may be used or on any transfer of the interest to a

third party.

- (c) A right of use may be held in perpetuity or may be for a defined period. The right may be dependent on the holder making payments or complying with certain other conditions.

10.9.3 When valuing a real property it is therefore necessary to identify the nature of the rights accruing to the holder of that interest and reflect any constraints or encumbrances imposed by the existence of other interests in the same property. The sum of the individual values of various different interests in the same property will frequently differ from the value of the unencumbered superior interest.

10.10.0 Rent

10.10.1 Market rent is addressed as a *basis of value* in VS 5.

10.10.2 When valuing either a superior interest that is subject to a lease or an interest created by a lease, *valuers must* consider the contract rent and, in cases where it is different, the *market rent*.

10.10.3 The contract rent is the rent payable under the terms of an actual lease. It may be fixed for the duration of the lease or variable. The frequency and basis of calculating variations in the rent will be set out in the lease and *must* be identified and understood in order to establish the total benefits accruing to the lessor and the liability of the lessee.

10.11.0 Inspection

10.11.1 *Valuers must* carry out *inspections* and investigations into the real property to the extent necessary to produce a *valuation report* which is professionally adequate for its purpose.

10.11.2 *Inspection* is mandatory save for a *valuation* for secured lending instructed by the lenders otherwise. The *valuer should* state the extent and date of the *inspection* in his *report*.

10.11.3 Many matters may or will have an impact on the market's perception of the value of the relevant interest, aspects of which may only become fully apparent during an *inspection* of the property. These can include:

- a) characteristics of the locality and surrounding area, and the availability of communications, services and facilities that affect value
- b) characteristics of the property and its use
 - (i) dimensions, areas and use(s) of constituent elements
 - (ii) age, construction and nature of buildings or structures
 - (iii) accessibility both for occupiers and for visitors
 - (iv) installations, amenities and services
 - (v) fixtures, fittings and improvements
 - (vi) plant and equipment that would normally form an integral part of the building
 - (vii) apparent state of repair and condition
 - (viii) hazardous materials kept on the property, such as (but not limited to) regulated items including chemicals, radioactive substances, explosive materials, asbestos, ozone depleting substances, oils, etc. or regulated activities being conducted such as waste management activity.
- c) characteristics of the site
 - (i) natural hazards such as ground instability, mining or mineral extraction, risk of flooding from all mechanisms, including pluvial and fluvial sources
 - (ii) non-natural hazards such as ground contamination where there are substances in, on or under the ground resulting from historic or current uses (see also (b) above)
- d) potential for development or redevelopment, including any physical restrictions on further development, if appropriate.

10.11.4 Other matters on which relevant information may be acquired during, or further enquiries made prompted by, an *inspection*, may include:

- (a) improvements to leasehold properties: when valuing leases and reversions,

where the property included in the original letting may subsequently have been altered or improved, care needs to be taken to ascertain what is to be valued as it may not exactly equate with what is seen and (as appropriate) measured on the ground. If the *valuer* is unable to inspect the lease, or due to the absence of documented licences the extent of alterations or improvements cannot be confirmed, the *valuer should* proceed on the basis of stated *assumptions*

- (b) planning (zoning) controls: controls and the need for licences or permissions for increased or altered use, including development, will vary between countries or states and the extent of the particular enquiries that are appropriate and need to be made in individual cases will be informed by the *valuer's* knowledge of the relevant market, by the nature and extent of the property, and by the purpose of the *valuation*
- (c) where relevant, information on any substantial outgoings and running costs, and the level of recovery from the occupier – energy efficiency may be one of a number of factors relevant when considering *sustainability* issues.

10.11.5 In a *valuation* for secured lending and where the lender has instructed the *valuer* not to carry out any *inspection* (internal or external or both), the *valuer must* consider the risk before proceeding. In case any *valuation* without *inspection* is taken, the *valuer should* state such instruction in the *report* and a caveat or *assumption* is required to reflect the absence of *inspection*.

10.11.6 If any *valuation* without adequate *inspection* may undermine the reliability of such *valuation*, such instruction *must* not be taken.

10.11.7 The primary reason for *inspection* of a *real estate* is to enable the *valuer* to have a better understanding of the real property and its characteristics that are relevant to its value. The *valuer should* agree with the *client* on the extent and depth of the *inspection* and investigation and identify the minimum level of *inspection* and investigation procedures to be conducted

prior to commencing the engagement, and document such agreed scope of *inspection* and investigation in his *report*.

10.11.8 For the avoidance of doubt, the *inspection* required in the *Standards* is not the equivalent of an *inspection* to be conducted by a professional (for instance, Building Surveyor, Structural Engineer or Electrical Engineer) other than a General Practice Surveyor to the subject property. In other words, the *inspection* required under this Standard is not a building survey or the like.

10.11.9 The *inspection* of comparables is also expected under normal circumstances where and when possible.

10.11.10 The *valuer*, having considered the knowledge, experience, reliability and ability of his staff member, could designate suitably trained staff member(s) under his supervision to conduct the *inspection* in order to comply with the mandatory *inspection* requirement under the *Standards*. However, the *valuer* signing off the *valuation report* shall still be liable for the accuracy of the entire content of the *valuation report* and hence is fully accountable for the input of his designated staff member.

10.11.11 Where the *valuer* does not inspect the real property directly, the *valuation report must* disclose the fact that the *inspection* was undertaken by the designated staff member under the supervision of the *valuer*. The identity and qualifications of the staff member assigned to undertake the *inspection must* be disclosed in the *report*.

10.11.10 Where measurement needs to be undertaken or checked, *members must* have regard to the Code of Measuring Practice wherever applicable.

10.11.12 Should the *valuer*, at the time of his *inspection*, suspect that there may have a possible alterations or additions or improvements made in the *real estate* being inspected and such alterations or additions or improvements do not appear on any approved building plan, he has a duty to disclose the same in his *report* and to advise the *client* to consult a

professional, such as building surveyor or a *firm* of professional building surveyors in Hong Kong or other professional in other *jurisdictions*, in respect of these potential unauthorized building works. And that, the *valuer should* make a highlight in his *report* on the extent of such unauthorized building works may affect his reported value.

10.12.0 Investigation and assumptions

10.12.1 The following aspects are common to many *valuations* involving *real estate*, and often raise issues about the extent of investigation that is appropriate or about the nature of the *assumptions* that might validly be made. The guidance below cannot cover all circumstances – a *valuer's* knowledge, experience and judgment will always need to be brought to bear on individual assignments, and in some cases appropriate limitations will have been specified by, or discussed and agreed with, the *client* as part of the *terms of engagement*. Similarly, the relevance and appropriateness of *assumptions* can only be judged on a 'case by case' basis – what follows is not in any way prescriptive.

10.12.2 Title

The *valuer must* have information on the essential details of the interest being valued. This *may* take one of a number of forms, such as a synopsis obtained from the *client* or a *third party*; copies of the relevant documents; or a current detailed *report* on title by the *client's* lawyers – this list is not exhaustive. The *valuer must* state what information has been relied on and – where appropriate – what *assumptions* have been made. For example, if a lease document were not available the *valuer* might need to make an *assumption* that the terms advised and stated were those in the actual lease. However, if an assurance of good title had been provided, the *valuer* might reasonably rely on the correctness of this information – but this would ultimately be a matter for lawyers, and where appropriate the *valuer* might specifically note that the position must be checked by the *client's* legal advisers. A *valuer*

would not expect to take responsibility or liability for the true interpretation of the *client's* legal title in the property or *asset*.

10.12.3 Condition of buildings

Even if competent to do so, a *valuer* would not normally undertake a building survey to establish the details of any building defects or disrepair. However, it would also be wrong for the *valuer* to ignore obvious defects that would have an impact on the value, unless a *special assumption* to that effect has been agreed. The *valuer should* therefore clearly state that the *inspection* will not amount to a full building survey. In addition the limits that will apply to the *valuer's* responsibility to investigate and comment on the structure or any defects *must* be defined. It *should* also be stated – wherever appropriate – that an *assumption* will be made that the building(s) is(are) in good repair, except for any (minor) defects specifically noted.

10.12.4 Services

The presence and efficiency of building services and any associated plant and equipment will often have a *significant* impact on value: however, detailed investigation will normally be outside the scope of the *valuation*. The *valuer* will need to establish what sources of information are available, and the extent to which these can be relied on, in undertaking the *valuation*. It is usual to agree on an *assumption* that the services and any associated controls or software are in working order or free from defect.

10.12.5 Planning (zoning)

Where there is an element of doubt, the *valuer may* need to establish whether the property has the necessary statutory consents for the current buildings and use, or advise that verification should be sought, and whether there are any policies or proposals by statutory authorities that could impact the value positively or adversely. This information will often be readily available, but delays or expenses may be incurred in obtaining definitive information. The *valuer should*, among other things, state what investigations are proposed, or what *assumptions*

will be made, where verification of the information is impractical within the context of the *valuation*.

10.12.6 Environmental matters

Potential or actual constraints on the enjoyment and use of property caused by environmental factors may result from natural causes (such as flooding), from non-natural causes (such as contamination) or sometimes from a combination of the two (such as subsidence resulting from historic minerals extraction). Despite the considerable diversity of circumstances, the key question is always the extent to which the factors identified affect value. Particular care *should* be taken when assessing or commenting on environmental factors, as *valuers may* not have the specialist knowledge and experience that is often required. In appropriate cases the *valuer may* recommend the making of further enquiries and/or the obtaining of further specialist or expert advice in respect of environmental matters. The following paragraphs consider the matter in more detail.

a) Natural environmental constraints

- (i) Some property will be affected by environmental factors that are an inherent feature either of the property itself or of the surrounding area, and which have an impact on the value of the property interest. Examples include ground instability issues (such as swelling and shrinking clay, subsidence consequent on historic or current mineral extraction, etc.) and the risk of flooding from any mechanism.
- (ii) Although detailed commentary on both the risks and the effects may be outside the realm of the *valuer's* direct knowledge and expertise, the presence, or potential presence, of these factors is something that can often be established in the course of a valuation *inspection* through normal enquiries or by local knowledge. It is not just the risk of a particular event occurring that needs to be considered, but also the various

consequences. For example, if the property has suffered a recent event such as flooding this may affect the availability of insurance cover, which, if *material, should* be reflected in the *valuation*.

- (iii) The *valuer should* be careful to state the limits that will apply to the extent of the investigations and the *assumptions* that will be made in relation to environmental matters, and *should* state any sources of information relied upon.

b) Non-natural constraints (contamination and hazardous substances)

- (i) A *valuer* will not normally be competent to advise on the nature or risks of contamination or hazardous substances, or on any costs involved with their removal, except in the more straightforward cases. However a *valuer* who has prior knowledge of the locality and experience of the type of property being valued, can reasonably be expected to comment on the potential that may exist for contamination and the impact that this could have on value and marketability.
- (ii) The nature and risks may of course be directly attributable to the use of the property itself. For example, a number of businesses depend on activities that involve the use of hazardous substances or operate waste management activities that *may* be regarded as a nuisance by third parties. Although detailed commentary on such effects will normally be outside the realm of the *valuer's* expertise, their presence, or potential presence, is something that can often be established in the course of a valuation *inspection* through normal enquiries or by local knowledge.
- (iii) The *valuer should* state the limits on the investigations that will be undertaken and state any sources of information or *assumptions* that will be relied on.

c) **Sustainability** – assessing the implications for value

(i) While not a term that yet has a universally recognised definition, in a valuation context *sustainability* encompasses a wide range of physical, social, environmental and economic factors that can affect value and of which *valuers should* be aware.

(ii) The range of issues includes, but is not limited to, key environmental risks, such as flooding, energy efficiency and climate, as well as matters of design, configuration, accessibility, legislation, management and fiscal considerations. As commercial markets in particular become more sensitised to *sustainability* matters, so they may begin to complement traditional value drivers, both in terms of occupier preferences and in terms of purchaser behaviour.

(iii) The pace at which *sustainability* is feeding directly or indirectly into value is showing some wide jurisdictional variations. In order to respond appropriately as markets change, *valuers should* continuously seek to enhance their knowledge. The role of *valuers* is to assess value in the light of evidence normally obtained through analysis of comparable transactions. While *valuers should* reflect markets, not lead them, they *should* be aware of *sustainability* features and the implications these could have on property values in the short, medium and longer term. The issues *may* extend to:

- environmental matters (see above) including, where applicable, climate change
- configuration and design including use of materials and concepts increasingly associated with ‘wellness’
- accessibility and adaptability, including access and use by those with disabilities
- energy efficiency, building ‘intelligence’ and other ‘costs in use’
- fiscal considerations.

(iv) Notwithstanding its current bearing on value, within the context of their instructions *valuers* are actively

encouraged to identify and collect *sustainability* related data, as and when it becomes available, for future comparability.

(v) Only where market evidence would support this, *should sustainability* characteristics be built into a *report* on value.

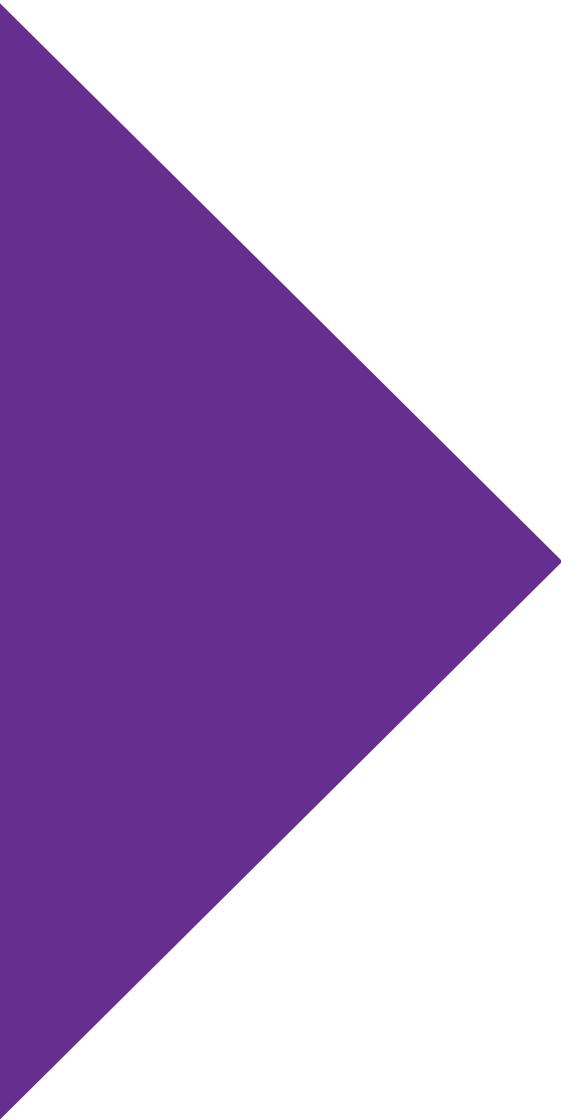
(vi) *Valuers* are often asked to provide additional comment and strategic advice. In these cases it *may* be appropriate to consult with the *client* as to the use and applicability of *sustainability* metrics and benchmarks that are applicable in each case. For example, when preparing *valuations* on the basis of *Investment value* or *worth*, *sustainability* factors that could influence investment decision-making *may* properly be incorporated, even though they are not directly evidenced through transactions.

(vii) Where appropriate, in order to comply with best practice in reporting, *valuers* are recommended to:

- assess the extent to which the subject property currently meets *sustainability* criteria typically expected within the context of its market standing and arrive at an informed view on the likelihood of these impacting on value, i.e. how a well-informed purchaser would take account of them in making a decision as to offer price
- provide a description of the *sustainability*-related property characteristics and attributes that have been collected, which *may*, where appropriate, include items not directly reflected in the final advice as to value
- provide a statement of their opinion on the relationship between *sustainability* factors and the resultant *valuation*, including a comment on the current benefits/risks that are associated with these *sustainability* characteristics, or the lack of risks and
- provide an opinion on the potential impact of these benefits and/or risks to relative property values over time.

FOR RATIFICATION PURPOSE

(HKIS AGM 2017)



PART D:
GUIDANCE NOTE

VGN 1

Business Interests and Business Enterprises

1.0 This guidance note contains additional requirements that apply to *valuations* of businesses and business interests.

2.0 Introduction

2.1 The definition of what constitutes a business may differ depending on the purpose of a *valuation*. However, generally a business conducts a commercial, industrial, service or investment activity. Businesses can take many forms, such as corporations, partnerships, joint ventures and sole proprietorships. The value of a business may differ from the sum of the values of the individual *assets* that make up that business. When a business value is greater than the sum of the recorded and unrecorded net tangible and identifiable intangible *assets* of the business, the excess value is often referred to as going concern value or goodwill.

2.2 When valuing individual *assets* owned by a business, *valuers should* follow the applicable standard for that type of asset or liability (VGN2 Intangible Assets, VS10 Real property, etc.).

2.3 *Valuers must* establish whether the *valuation* is of the entire entity, shares or a shareholding in the entity (whether a controlling or non-controlling interest), or a specific business activity of the entity. The type of value being provided *must* be appropriate to the purpose of the *valuation* and communicated as part of the scope of the engagement. It is especially critical to clearly define the business or business interest being valued as, even when a *valuation* is performed on an entire entity, there *may* be different levels at which that value could be expressed. For example:

(a) Enterprise value: Often described as the total value of the equity in a business plus the value of its debt or debt-related liabilities, minus any cash or cash equivalents available to meet those liabilities.

(b) Total invested capital value: The total amount of money currently invested in a business, regardless of the source, often reflected as the value of total assets less current liabilities and cash.

(c) Operating Value: The total value of the operations of the business, excluding the value of any non-operating assets and liabilities.

(d) Equity value: The value of a business to all of its equity shareholders.

2.4 *Valuations* of businesses are required for different purposes including acquisitions, mergers and sales of businesses, taxation, litigation, insolvency proceedings and financial reporting. Business valuations may also be needed as an input or step in other *valuations* such as the *valuation* of stock options, particular class(es) of stock, or debt.

3.0 Bases of Value

3.1 In accordance with **VS 5**, a *valuer must* select the appropriate *basis(es) of value* when valuing a business or business interest.

3.2 Often, business valuations are performed using *bases of value* defined by entities/organisations other than the *HKIS* (some examples of which are mentioned in **VS 5**) and it is the *valuer's* responsibility to understand and follow the regulation, case law and/or other interpretive guidance related to those *bases of value* as of the *valuation date*.

4.0 Valuation Approaches and Methods

4.1 The three principal valuation approaches described in **VS 6** *may* be applied to the *valuation* of businesses and business interests.

4.2 When selecting an approach and method, in addition to the requirements of this guidance note, a *valuer must* follow the requirements of **VS 6**, including paragraph 6.1.3.

5.0 Market Approach

5.1 The *market approach* is frequently applied in the *valuation* of businesses and business interests as these *assets* often meet the criteria in **VS 6** **paragraph 6.2.2 or 6.2.3**. When valuing businesses and business interests under the *market approach*, *valuers should* follow the requirements of **VS 6**.

5.2 The three most common sources of data used to value businesses and business

interests using the *market approach* are:

- (a) public stock markets in which ownership interests of similar businesses are traded,
- (b) the acquisition market in which entire businesses or controlling interests in businesses are bought and sold, and
- (c) prior transactions in shares or offers for the ownership of the subject business.

5.3 There *must* be a reasonable basis for comparison with, and reliance upon, similar businesses in the *market approach*. These similar businesses should be in the same industry as the subject business or in an industry that responds to the same economic variables. Factors that *should* be considered in assessing whether a reasonable basis for comparison exists include:

- (a) similarity to the subject business in terms of qualitative and quantitative business characteristics,
- (b) amount and verifiability of data on the similar business, and
- (c) whether the price of the similar business represents an arm's length and orderly transaction.

5.4 When applying a market multiple, adjustments such as those in paragraph 6.8 below *may* be appropriate to both the subject company and the comparable companies.

5.5 When selecting and adjusting comparable transactions, a *valuer should* choose comparable transactions within the following context:

- (a) evidence of several transactions is generally preferable to a single transaction or event,
- (b) evidence from transactions of very similar *assets* (ideally identical) provides a better indication of value than *assets* where the transaction prices require *significant* adjustments,
- (c) transactions that happen closer to the *valuation date* are more representative of the market at that date than older/dated transactions, particularly in volatile markets,
- (d) for most *bases of value*, the transactions should be "arm's length" between unrelated parties,
- (e) sufficient information on the transaction should be available to allow the *valuer* to develop a reasonable understanding of the comparable *asset* and assess the valuation metrics/comparable evidence,

- (f) information on the comparable transactions should be from a reliable and trusted source, and

- (g) actual transactions provide better valuation evidence than intended transactions.

5.6 A *valuer should* analyse and make adjustments for any *material* differences between the comparable transactions and the subject *asset*. Examples of common differences that could warrant adjustments may include, but are not limited to:

- (a) material characteristics (age, size, specifications, etc.),
- (b) relevant restrictions on either the subject *asset* or the comparable *assets*,
- (c) geographical location (location of the *asset* and/or location of where the *asset* is likely to be transacted/used) and the related economic and regulatory environments,
- (d) profitability or profit-making capability of the *assets*,
- (e) historical and expected growth,
- (f) yields/coupon rates,
- (g) types of collateral,
- (h) unusual terms in the comparable transactions,
- (i) differences related to marketability and control characteristics of the comparable and the subject *asset*, and
- (j) ownership characteristics (eg, legal form of ownership, amount percentage held).

5.7 When selecting and adjusting comparable public company information, a *valuer should* choose comparable transactions within the following context:

- (a) consideration of multiple publicly-traded comparables is preferred to the use of a single comparable,
- (b) evidence from similar publicly-traded comparables (for example, with similar market segment, geographic area, size in revenue and/or *assets*, growth rates, profit margins, leverage, liquidity and diversification) provides a better indication of value than comparables that require *significant* adjustments, and
- (c) securities that are actively traded provide more meaningful evidence than thinly-traded securities.

5.8 A *valuer should* analyse and make adjustments for any *material* differences between the guideline publicly-traded comparables and

the subject *asset*. Examples of common differences that could warrant adjustments may include, but are not limited to:

- (a) *material* characteristics (age, size, specifications, etc.),
- (b) relevant discounts and premiums (see **VS 6 paragraph 6.3.17**),
- (c) relevant restrictions on either the subject *asset* or the comparable *assets*,
- (d) geographical location of the underlying company and the related economic and regulatory environments,
- (e) profitability or profit-making capability of the *assets*,
- (f) historical and expected growth,
- (g) differences related to marketability and control characteristics of the comparable and the subject *asset*, and
- (h) type of ownership.

6.0 Income Approach

6.1 The *income approach* is frequently applied in the *valuation* of businesses and business interests as these *assets* often meet the criteria in **VS 6 paragraph 6.4.2 or 6.4.3**.

6.2 When the *income approach* is applied, *valuers should* follow the requirements of **VS 6 sections 6.4.0 and 6.5.0**.

6.3 Income and cash flow related to a business or business interest can be measured in a variety of ways and may be on a pre-tax or post-tax basis. The capitalisation or discount rate applied *must* be consistent with the type of income or cash flow used.

6.4 The type of income or cash flow used *should* be consistent with the type of interest being valued. For example:

- (a) enterprise value is typically derived using cash flows before debt servicing costs and an appropriate discount rate applicable to enterprise level cash flows, such as a weighted-average cost of capital, and
- (b) equity value *may* be derived using cash flows to equity, that is, after debt servicing costs and an appropriate discount rate applicable to equity level cash flows, such as a cost of equity.

6.5 The *income approach* requires the estimation of a capitalisation rate when capitalising income or cash flow and a discount rate when discounting cash flow. In estimating

the appropriate rate, factors such as the level of interest rates, rates of return expected by participants for similar investments and the risk inherent in the anticipated benefit stream are considered (see **VS 6 paragraphs 6.5.29-6.5.31**).

6.6 In methods that employ discounting, expected growth *may* be explicitly considered in the forecasted income or cash flow. In capitalisation methods, expected growth is normally reflected in the capitalisation rate. If a forecasted cash flow is expressed in nominal terms, a discount rate that takes into account the expectation of future price changes due to inflation or deflation *should* be used. If a forecasted cash flow is expressed in real terms, a discount rate that takes no account of expected price changes due to inflation or deflation *should* be used.

6.7 Under the *income approach*, the historical *financial statements* of a business entity are often used as guide to estimate the future income or cash flow of the business. Determining the historical trends over time through ratio analysis may help provide the necessary information to assess the risks inherent in the business operations in the context of the industry and the prospects for future performance.

6.8 Adjustments *may* be appropriate to reflect differences between the actual historic cash flows and those that would be experienced by a buyer of the business interest on the *valuation date*. Examples include:

- (a) adjusting revenues and expenses to levels that are reasonably representative of expected continuing operations,
- (b) presenting financial data of the subject business and comparison businesses on a consistent basis,
- (c) adjusting non-arm's length transactions (such as contracts with customers or suppliers) to market rates,
- (d) adjusting the cost of labour or of items leased or otherwise contracted from related parties to reflect market prices or rates,
- (e) reflecting the impact of non-recurring events from historic revenue and expense items. Examples of non-recurring events include losses caused by strikes, new plant start-up and weather phenomena. However, the forecast cash flows *should* reflect any non-recurring revenues

or expenses that can be reasonably anticipated and past occurrences *may* be indicative of similar events in the future, and

- (f) adjusting the inventory accounting to compare with similar businesses, whose accounts *may* be kept on a different basis from the subject business, or to more accurately reflect economic reality.

6.9 When using an *income approach* it *may* also be necessary to make adjustments to the *valuation* to reflect matters that are not captured in either the cash flow forecasts or the discount rate adopted. Examples may include adjustments for the marketability of the interest being valued or whether the interest being valued is a controlling or non-controlling interest in the business. However, *valuers should* ensure that adjustments to the *valuation* do not reflect factors that were already reflected in the cash flows or discount rate. For example, whether the interest being valued is a controlling or non-controlling interest is often already reflected in the forecasted cash flows.

6.10 While many businesses *may* be valued using a single cash flow scenario, *valuers may* also apply multi-scenario or simulation models, particularly when there is *significant* uncertainty as to the amount and/or timing of future cash flows.

7.0 Cost Approach

7.1 The *cost approach* cannot normally be applied in the *valuation* of businesses and business interests as these *assets* seldom meet the criteria in **VS 6 paragraphs 6.6.2 or 6.6.3**. However, the *cost approach* is sometimes applied in the *valuation* of businesses, particularly when:

- (a) the business is an early stage or start-up business where profits and/ or cash flow cannot be reliably determined and comparisons with other businesses under the *market approach* is impractical or unreliable,
- (b) the business is an investment or holding business, in which case the summation method is as described in **VS 6 paragraphs 6.7.9 and 6.7.10**, and/or
- (c) the business does not represent a going concern and/or the value of its *assets* in a liquidation may exceed the business' value as a going concern.

7.2 In the circumstances where a business or business interest is valued using a *cost approach*, *valuers should* follow the requirements of **VS 6 sections 6.7.0 and 6.8.0**.

8.0 Special Considerations for Businesses and Business Interests

8.1 The following sections address a non-exhaustive list of topics relevant to the *valuation* of businesses and business interests:

- (a) Ownership Rights.
- (b) Business Information.
- (c) Economic and Industry Considerations.
- (d) Operating and Non-Operating Assets.
- (e) Capital Structure Considerations.

9.0 Ownership Rights

9.1 The rights, privileges or conditions that attach to the ownership interest, whether held in proprietorship, corporate or partnership form, require consideration in the valuation process. Ownership rights are usually defined within a *jurisdiction* by legal documents such as articles of association, clauses in the memorandum of the business, articles of incorporation, bylaws, partnership agreements and shareholder agreements (collectively "corporate documents"). In some situations, it *may* also be necessary to distinguish between legal and beneficial ownership.

9.2 Corporate documents may contain restrictions on the transfer of the interest or other provisions relevant to value. For example, corporate documents may stipulate that the interest *should* be valued as a pro rata fraction of the entire issued share capital regardless of whether it is a controlling or non-controlling interest. In each case, the rights of the interest being valued and the rights attaching to any other class of interest need to be considered at the outset.

9.3 Care *should* be taken to distinguish between rights and obligations inherent to the interest and those that may be applicable only to a particular shareholder (i.e., those contained in an agreement between current

shareholders which may not apply to a potential buyer of the ownership interest). Depending on the basis(es) of value used, the *valuer* may be required to consider only the rights and obligations inherent to the subject interest or both those rights and considerations inherent to the subject interest and those that apply to a particular owner.

- 9.4** All the rights and preferences associated with a subject business or business interest *should* be considered in a *valuation*, including:
- (a) if there are multiple classes of stock, the *valuation* *should* consider the rights of each different class, including, but not limited to:
 1. liquidation preferences,
 2. voting rights,
 3. redemption, conversion and participation provisions, and
 4. put and/or call rights.
 - (b) When a controlling interest in a business may have a higher value than a non-controlling interest. Control premiums or discounts for lack of control *may* be appropriate depending on the *valuation method(s)* applied (see **VS 6 paragraph 6.3.17 (b)**). In respect of actual premiums paid in completed transactions, the *valuer* *should* consider whether the synergies and other factors that caused the acquirer to pay those premiums are applicable to the subject *asset* to a comparable degree.

10.0 Business Information

- 10.1** The *valuation* of a business entity or interest frequently requires reliance upon information received from management, representatives of the management or other experts. As required by **VS 6**, *valuers* *should* maximise the use of relevant observable market information in all three approaches. Regardless of the source of the inputs and *assumptions* used in a *valuation*, a *valuer* *must* perform appropriate analysis to evaluate those inputs and *assumptions* and their appropriateness for the valuation purpose.

A *valuer* *must* assess the reasonableness of information received from management, representatives of management or other experts and evaluate whether it is appropriate to rely on that information

for the valuation purpose. For example, prospective financial information provided by management may reflect owner-specific synergies that *may* not be appropriate when using a *basis of value* that requires a participant perspective.

- 10.2** Although the value on a given date reflects the anticipated benefits of future ownership, the history of a business is useful in that it may give guidance as to the expectations for the future. *Valuers* *should* therefore consider the business' historical *financial statements* as part of a valuation engagement. To the extent the future performance of the business is expected to deviate significantly from historical experience, a *valuer* *must* understand why historical performance is not representative of the future expectations of the business.

11.0 Economic and Industry Considerations

- 11.1** Awareness of relevant economic developments and specific industry trends is essential for all *valuations*. Matters such as political outlook, government policy, exchange rates, inflation, interest rates and market activity may affect *assets* in different locations and/or sectors of the economy quite differently. These factors can be particularly important in the *valuation* of businesses and business interests, as businesses may have complex structures involving multiple locations and types of operations. For example, a business may be impacted by economic and industry factors specific related to:
- (a) the registered location of the business headquarters and legal form of the business,
 - (b) the nature of the business operations and where each aspect of the business is conducted (i.e., manufacturing may be done in a different location to where research and development is conducted),
 - (c) where the business sells its goods and/or services,
 - (d) the currency(ies) the business uses,
 - (e) where the suppliers of the business are located, and
 - (f) what tax and legal *jurisdictions* the business is subject to.

12.0 Operating and Non-Operating Assets

12.1 The *valuation* of an ownership interest in a business is only relevant in the context of the financial position of the business at a point in time. It is important to understand the nature of assets and liabilities of the business and to determine which items are required for use in the income-producing operations of the business and which ones are redundant or “excess” to the business at the *valuation date*.

12.2 Most *valuation methods* do not capture the value of *assets* that are not required for the operation of the business. For example, a business valued using a multiple of EBITDA would only capture the value the *assets* utilized in generating that level of EBITDA. If the business had non-operating assets or liabilities such as an idle manufacturing plant, the value of that non-operating plant would not be captured in the value. Depending on the level of value appropriate for the valuation engagement (see paragraph 2.3 above), the value of non-operating *assets* *may* need to be separately determined and added to the operating value of the business.

12.3 Businesses may have unrecorded *assets* that are not reflected on the balance sheet. Such *assets* could include intangible assets, machinery and equipment that is fully depreciated and legal liabilities/lawsuits.

12.4 When separately considering non-operating *assets*, a *valuer* *should* ensure that the income and expenses associated with non-operating *assets* are excluded from the cash flow measurements and projections used in the *valuation*. For example, if a business has a *significant* liability associated with an underfunded pension and that liability is valued separately, the cash flows used in the *valuation* of the business *should* exclude any “catch-up” payments related to that liability.

12.5 If the *valuation* considers information from publicly-traded businesses, the publicly-traded stock prices implicitly include the value of non-operating *assets*, if any. As such, *valuers* *must* consider adjusting information from publicly-traded businesses to exclude the value, income and expenses associated with non-operating *assets*.

13.0 Capital Structure Considerations

13.1 Businesses are often financed through a combination of debt and equity. However, in many cases, *valuers* *may* be asked to value only equity or a particular class of equity in a business. While equity or a particular class of equity can occasionally be valued directly, more often the enterprise value of the business is determined and then that value is allocated between debt and any types of equity.

13.2 When the value of debt is equal to its carrying value/book value, allocations of value *may* be straightforward. For example, in such cases it *may* be appropriate to deduct the book value of debt from enterprise value to calculate equity value (sometimes referred to as a “waterfall” method of value allocation). However, *valuers* *should* not necessarily assume that the value of debt and its book value are equal.

13.3 In circumstances where the value of debt may differ from its book value, *valuers* *should* either value the debt directly or use a method that appropriately allocates value to debt and any equity securities such as a probability-weighted expected return method or an option-pricing model.

VGN 2

Intangible Assets

1.0 This guidance note contains additional requirements that apply to *valuations* of intangible assets.

2.0 Introduction

2.1 An intangible asset is a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and/or economic benefits to its owner.

2.2 Specific intangible assets are defined and described by characteristics such as their ownership, function, market position and image. These characteristics differentiate intangible assets from one another.

2.3 There are many types of intangible assets, but they are often considered to fall into one or more of the following categories (or goodwill):

- (a) Marketing-related: Marketing-related intangible assets are used primarily in the marketing or promotion of products or services. Examples include trademarks, trade names, unique trade design and internet domain names.
- (b) Customer-related: Customer-related intangible assets include customer lists, backlog, customer contracts, and contractual and non-contractual customer relationships.
- (c) Artistic-related: Artistic-related intangible assets arise from the right to benefits from artistic works such as plays, books, films and music, and from non-contractual copyright protection.
- (d) Contract-related: Contract-related intangible assets represent the value of rights that arise from contractual agreements. Examples include licensing and royalty agreements, service or supply contracts, lease agreements, permits, broadcast rights, servicing contracts, employment contracts and non-competition agreements and natural resource rights.
- (e) Technology-based: Technology-related intangible assets arise from contractual or non-contractual rights to use patented technology, unpatented technology,

databases, formulae, designs, software, processes or recipes.

2.4 Although similar intangible assets within the same class will share some characteristics with one another, they will also have differentiating characteristics that will vary according to the type of intangible asset. In addition, certain intangible assets, such as brands, may represent a combination of categories in paragraph 2.3.

2.5 Particularly in valuing an intangible asset, *valuers must* understand specifically what needs to be valued and the purpose of the *valuation*. For example, customer data (names, addresses, etc) typically has a very different value from customer contracts (those contracts in place on the *valuation date*) and customer relationships (the value of the ongoing customer relationship including existing and future contracts). What intangible assets need to be valued and how those intangible assets are defined may differ depending on the purpose of the *valuation*, and the differences in how intangible assets are defined can lead to *significant* differences in value.

2.6 Generally, goodwill is any future economic benefit arising from a business, an interest in a business or from the use of a group of *assets* which has not been separately recognised in another *asset*. The value of goodwill is typically measured as the residual amount remaining after the values of all identifiable tangible, intangible and monetary *assets*, adjusted for actual or potential liabilities, have been deducted from the value of a business. It is often represented as the excess of the price paid in a real or hypothetical acquisition of a company over the value of the company's other identified assets and liabilities. For some purposes, goodwill *may* need to be further divided into transferable goodwill (that which can be transferred to third parties) and non-transferable or "personal" goodwill.

2.7 As the amount of goodwill is dependent on which other tangible and intangible *assets* are recognised, its value can be different when calculated for different purposes. For example, in a business combination accounted for under IFRS or US GAAP, an intangible asset is only recognised to the extent that it:

- (a) is separable, i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so, or
- (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

2.8 While the aspects of goodwill can vary depending on the purpose of the *valuation*, goodwill frequently includes elements such as:

- (a) company-specific synergies arising from a combination of two or more businesses (eg, reductions in operating costs, economies of scale or product mix dynamics),
- (b) opportunities to expand the business into new and different markets,
- (c) the benefit of an assembled workforce (but generally not any intellectual property developed by members of that workforce),
- (d) the benefit to be derived from future *assets*, such as new customers and future technologies, and
- (e) assemblage and going concern value.

2.9 *Valuers* may perform direct *valuations* of intangible *assets* where the value of the intangible *assets* is the purpose of the analysis or one part of the analysis. However, when valuing businesses, business interests, real property, and machinery and equipment, *valuers should* consider whether there are intangible assets associated with those *assets* and whether those directly or indirectly impact the *asset* being valued. For example, when valuing a hotel based on an *income approach*, the contribution to value of the hotel's brand may already be reflected in the profit generated by the hotel.

2.10 Intangible asset *valuations* are performed for a variety of purposes. It is the *valuer's* responsibility to understand the purpose of a *valuation* and whether intangible assets *should* be valued, whether separately or grouped with other *assets*. A non-exhaustive list of examples of circumstances that

commonly include an intangible asset *valuation* component is provided below:

- (a) For financial reporting purposes, *valuations* of intangible *assets* are often required in connection with accounting for business combinations, *asset* acquisitions and sales, and impairment analysis.
- (b) For tax reporting purposes, intangible asset *valuations* are frequently needed for transfer pricing analyses, estate and gift tax planning and reporting, and ad valorem taxation analyses.
- (c) Intangible assets may be the subject of litigation, requiring valuation analysis in circumstances such as shareholder disputes, damage calculations and marital dissolutions (divorce).
- (d) Other statutory or legal events may require the *valuation* of intangible assets such as compulsory purchases/eminent domain proceedings.
- (e) *Valuers* are often asked to value intangible assets as part of general consulting, collateral lending and transactional support engagements.

3.0 *Bases of Value*

3.1 In accordance with **VS 5**, a *valuer must* select the appropriate *basis(es) of value* when valuing intangible assets.

3.2 Often, intangible asset *valuations* are performed using *bases of value* defined by entities/organisations other than the HKIS (some examples of which are mentioned in **VS 5**) and the *valuer must* understand and follow the regulation, case law, and other interpretive guidance related to those *bases of value* as of the *valuation date*.

4.0 *Valuation Approaches and Methods*

4.1 The three valuation approaches described in **VS 6** can all be applied to the *valuation* of intangible *assets*.

4.2 When selecting an approach and method, in addition to the requirements of this guidance note, a *valuer must* follow the requirements of **VS 6**, including paragraph 6.1.3.

5.0 Market Approach

5.1 Under the *market approach*, the value of an intangible asset is determined by reference to market activity (for example, transactions involving identical or similar *assets*).

5.2 Transactions involving intangible assets frequently also include other *assets*, such as a business combination that includes intangible assets.

5.3 *Valuers must comply with VS 6 paragraphs 6.2.2 and 6.2.3* when determining whether to apply the *market approach* to the valuation of intangible assets. In addition, *valuers should only apply the market approach* to value intangible assets if both of the following criteria are met:

- (a) information is available on arm's length transactions involving identical or similar intangible assets on or near the *valuation date*, and
- (b) sufficient information is available to allow the *valuer* to adjust for all *significant* differences between the subject intangible asset and those involved in the transactions.

5.4 The heterogeneous nature of intangible assets and the fact that intangible assets seldom transact separately from other *assets* means that it is rarely possible to find market evidence of transactions involving identical assets. If there is market evidence at all, it is usually in respect of assets that are similar, but not identical.

5.5 Where evidence of either prices or valuation multiples is available, *valuers should* make adjustments to these to reflect differences between the subject asset and those involved in the transactions. These adjustments are necessary to reflect the differentiating characteristics of the subject intangible asset and the assets involved in the transactions. Such adjustments *may* only be determinable at a qualitative, rather than quantitative, level. However, the need for *significant* qualitative adjustments may indicate that another approach would be more appropriate for the *valuation*.

5.6 Consistent with the above, examples of intangible assets for which the *market approach* is sometimes used include:

- (a) broadcast spectrum,
- (b) internet domain names, and
- (c) taxi medallions.

5.7 The guideline transactions method is generally the only market approach method that can be applied to intangible assets.

5.8 In rare circumstances, a security sufficiently similar to a subject intangible asset may be publicly traded, allowing the use of the guideline public company method. One example of such securities is contingent value rights (CVRs) that are tied to the performance of a particular product or technology.

6.0 Income Approach

6.1 Under the *income approach*, the value of an intangible asset is determined by reference to the present value of income, cash flows or cost savings attributable to the intangible asset over its economic life.

6.2 *Valuers must comply with VS 6 paragraphs 6.4.2 and 6.4.3* when determining whether to apply the *income approach* to the valuation of intangible assets.

6.3 Income related to intangible assets is frequently included in the price paid for goods or a service. It may be challenging to separate the income related to the intangible asset from income related to other tangible and intangible assets. Many of the *income approach* methods are designed to separate the economic benefits associated with a subject intangible asset.

6.4 The *income approach* is the most common method applied to the *valuation* of intangible assets and is frequently used to value intangible assets including the following:

- (a) technology,
- (b) customer-related intangibles (eg, backlog, contracts, relationships),
- (c) tradenames/trademarks/brands,
- (d) operating licenses (eg, franchise agreements, gaming licenses, broadcast spectrum), and
- (e) non-competition agreements.

- 6.5 There are many *income approach* methods. The following methods are discussed in this standard in more detail:
- (a) excess earnings method,
 - (b) relief-from-royalty method,
 - (c) premium profit method or with-and-without method,
 - (d) greenfield method, and
 - (e) distributor method.

Excess Earnings Method

- 6.6 The excess earnings method estimates the value of an intangible asset as the present value of the cash flows attributable to the subject intangible asset after excluding the proportion of the cash flows that are attributable to other *assets* required to generate the cash flows (“contributory assets”). It is often used for *valuations* where there is a requirement for the acquirer to allocate the overall price paid for a business between tangible assets, identifiable intangible assets and goodwill.

- 6.7 Contributory assets are *assets* that are used in conjunction with the subject intangible asset in the realisation of prospective cash flows associated with the subject intangible asset. *Assets* that do not contribute to the prospective cash flows associated with the subject intangible asset are not contributory assets.

- 6.8 The excess earnings method can be applied using several periods of forecasted cash flows (“multi-period excess earnings method” or “MPEEM”), a single period of forecasted cash flows (“single-period excess earnings method”) or by capitalising a single period of forecasted cash flows (“capitalised excess earnings method” or the “formula method”).

- 6.9 The capitalised excess earnings method or formula method is generally only appropriate if the intangible asset is operating in a steady state with stable growth/decay rates, constant profit margins and consistent contributory asset levels/charges.

- 6.10 As most intangible assets have economic lives exceeding one period, frequently follow non-linear growth/decay patterns and may require different levels of contributory assets over time, the MPEEM is the most commonly used excess earnings method

as it offers the most flexibility and allows *valuers* to explicitly forecast changes in such inputs.

- 6.11 Whether applied in a single-period, multi-period or capitalised manner, the key steps in applying an excess earnings method are to:

- (a) forecast the amount and timing of future revenues driven by the subject intangible asset and related contributory assets,
- (b) forecast the amount and timing of expenses that are required to generate the revenue from the subject intangible asset and related contributory assets,
- (c) adjust the expenses to exclude those related to creation of new intangible assets that are not required to generate the forecasted revenue and expenses. Profit margins in the excess earnings method may be higher than profit margins for the overall business because the excess earnings method excludes investment in certain new intangible assets. For example:

1. research and development expenditures related to development of new technology would not be required when valuing only existing technology, and
2. marketing expenses related to obtaining new customers would not be required when valuing existing customer-related intangible assets.

- (d) identify the contributory assets that are needed to achieve the forecasted revenue and expenses. Contributory assets often include working capital, fixed assets, assembled workforce and identified intangible assets other than the subject intangible asset,
- (e) determine the appropriate rate of return on each contributory asset based on an assessment of the risk associated with that asset. For example, low-risk assets like working capital will typically have a relatively lower required return. Contributory intangible assets and highly specialised machinery and equipment often require relatively higher rates of return,
- (f) in each forecast period, deduct the required returns on contributory assets from the forecast profit to arrive at the excess earnings attributable to only the subject intangible asset,
- (g) determine the appropriate discount

- rate for the subject intangible asset and present value or capitalise the excess earnings, and
- (h) if appropriate for the purpose of the valuation (see paragraphs 11.1-11.4 below), calculate and add the tax amortisation benefit (TAB) for the subject intangible asset.
- 6.12** Contributory asset charges (CACs) *should* be made for all the current and future tangible, intangible and financial assets that contribute to the generation of the cash flow, and if an asset for which a CAC is required is involved in more than one line of business, its CAC *should* be allocated to the different lines of business involved.
- 6.13** The determination of whether a CAC for elements of goodwill is appropriate *should* be based on an assessment of the relevant facts and circumstances of the situation, and the valuer *should* not mechanically apply CACs or alternative adjustments for elements of goodwill if the circumstances do not warrant such a charge. Assembled workforce, as it is quantifiable, is typically the only element of goodwill for which a CAC *should* be taken. Accordingly, valuers *must* ensure they have a strong basis for applying CACs for any elements of goodwill other than assembled workforce.
- 6.14** CACs are generally computed on an after-tax basis as a fair return on the value of the contributory asset, and in some cases a return of the contributory asset is also deducted. The appropriate return on a contributory asset is the investment return a typical participant would require on the asset. The return of a contributory asset is a recovery of the initial investment in the asset. There *should* be no difference in value regardless of whether CACs are computed on a pre-tax or after-tax basis.
- 6.15** If the contributory asset is not wasting in nature, like working capital, only a fair return on the asset is required.
- 6.16** For contributory intangible assets that were valued under a relief-from-royalty method, the CAC *should* be equal to the royalty (generally adjusted to an after-tax royalty rate).
- 6.17** The excess earnings method *should* be applied only to a single intangible asset for any given stream of revenue and income (generally the primary or most important intangible asset). For example, in valuing the intangible assets of a company utilising both technology and a tradename in delivering a product or service (i.e., the revenue associated with the technology and the tradename is the same), the excess earnings method *should* only be used to value one of the intangible assets and an alternative method *should* be used for the other asset. However, if the company had multiple product lines, each using a different technology and each generating distinct revenue and profit, the excess earnings method *may* be applied in the valuation of the multiple different technologies.
- Relief-from-Royalty Method**
- 6.18** Under the relief-from-royalty method, the value of an intangible asset is determined by reference to the value of the hypothetical royalty payments that would be saved through owning the asset, as compared with licensing the intangible asset from a *third party*. Conceptually, the method *may* also be viewed as a discounted cash flow method applied to the cash flow that the owner of the intangible asset could receive through licensing the intangible asset to third parties.
- 6.19** The key steps in applying a relief-from-royalty method are to:
- (a) develop projections associated with the intangible asset being valued for the life of the subject intangible asset. The most common metric projected is revenue, as most royalties are paid as a percentage of revenue. However, other metrics such as a per-unit royalty *may* be appropriate in certain valuations,
 - (b) develop a royalty rate for the subject intangible asset. Two methods can be used to derive a hypothetical royalty rate. The first is based on market royalty rates for comparable or similar transactions. A prerequisite for this method is the existence of comparable intangible assets that are licensed at arm's length on a regular basis. The second method is based on a split of profits that would hypothetically be paid in an arm's length transaction by a willing licensee to a willing licensor for the rights to use the subject intangible asset,

- (c) apply the selected royalty rate to the projections to calculate the royalty payments avoided by owning the intangible asset,
- (d) estimate any additional expenses for which a licensee of the subject asset would be responsible. This can include upfront payments required by some licensors. A royalty rate *should* be analysed to determine whether it assumes expenses (such as maintenance, marketing and advertising) are the responsibility of the licensor or the licensee. A royalty rate that is “gross” would consider all responsibilities and expenses associated with ownership of a licensed asset to reside with the licensor, while a royalty that is “net” would consider some or all responsibilities and expenses associated with the licensed asset to reside with the licensee. Depending on whether the royalty is “gross” or “net”, the *valuation should* exclude or include, respectively, a deduction for expenses such as maintenance, marketing or advertising expenses related to the hypothetically licensed asset.
- (e) if the hypothetical costs and royalty payments would be tax deductible, it *may* be appropriate to apply the appropriate tax rate to determine the after-tax savings associated with ownership of the intangible asset. However, for certain purposes (such as transfer pricing), the effects of taxes are generally not considered in the *valuation* and this step *should* be skipped,
- (f) determine the appropriate discount rate for the subject intangible asset and present value or capitalise the savings associated with ownership of the intangible asset, and
- (g) if appropriate for the purpose of the *valuation* (see paragraphs 11.1-11.4), calculate and add the TAB for the subject intangible asset.

6.20 Whether a royalty rate is based on market transactions or a profit split method (or both), its selection *should* consider the characteristics of the subject intangible asset and the environment in which it is utilised. The consideration of those characteristics form the basis for selection of a royalty rate within a range of observed transactions and/or the range of profit available to the subject intangible asset in a profit split. Factors that

should be considered include the following:

- (a) Competitive environment: The size of the market for the intangible asset, the availability of realistic alternatives, the number of competitors, barriers to entry and presence (or absence) of switching costs.
- (b) Importance of the subject intangible to the owner: Whether the subject asset is a key factor of differentiation from competitors, the importance it plays in the owner’s marketing strategy, its relative importance compared with other tangible and intangible assets, and the amount the owner spends on creation, upkeep and improvement of the subject asset.
- (c) Life cycle of the subject intangible: The expected economic life of the subject asset and any risks of the subject intangible becoming obsolete.

6.21 When selecting a royalty rate, a *valuer should* also consider the following:

- (a) When entering a licence arrangement, the royalty rate participants would be willing to pay depends on their profit levels and the relative contribution of the licensed intangible asset to that profit. For example, a manufacturer of consumer products would not license a tradename at a royalty rate that leads to the manufacturer realising a lower profit selling branded products compared with selling generic products.
- (b) When considering observed royalty transactions, a *valuer should* understand the specific rights transferred to the licensee and any limitations. For example, royalty agreements *may* include *significant* restrictions on the use of a licensed intangible asset such as a restriction to a particular geographic area or for a product. In addition, the *valuer should* understand how the payments under the licensing agreement are structured, including whether there are upfront payments, milestone payments, puts/calls to acquire the licensed property outright, etc.

With-and-Without Method

6.22 The with-and-without method indicates the value of an intangible asset by comparing two scenarios: one in which the business uses the subject intangible asset and one in

which the business does not use the subject intangible asset (but all other factors are kept constant).

6.23 The comparison of the two scenarios can be done in two ways:

- (a) calculating the value of the business under each scenario with the difference in the business values being the value of the subject intangible asset, and
- (b) calculating, for each future period, the difference between the profits in the two scenarios. The present value of those amounts is then used to reach the value of the subject intangible asset.

6.24 In theory, either method *should* reach a similar value for the intangible asset provided the *valuer* considers not only the impact on the entity's profit, but additional factors such as differences between the two scenarios in working capital needs and capital expenditures.

6.25 The with-and-without method is frequently used in the *valuation* of non-competition agreements but *may* be appropriate in the *valuation* of other intangible assets in certain circumstances.

6.26 The key steps in applying the with-and-without method are to:

- (a) prepare projections of revenue, expenses, capital expenditures and working capital needs for the business assuming the use of all of the *assets* of the business including the subject intangible asset. These are the cash flows in the "with" scenario,
- (b) use an appropriate discount rate to present value the future cash flows in the "with" scenario, and/or calculate the value of the business in the "with" scenario,
- (c) prepare projections of revenue, expenses, capital expenditures and working capital needs for the business assuming the use of all of the *assets* of the business except the subject intangible asset. These are the cash flows in the "without" scenario,
- (d) use an appropriate discount rate for the business, present value the future cash flows in the "with" scenario and/or calculate the value of the business in the "with" scenario,
- (e) deduct the present value of cash flows or the value of the business in the "without"

scenario from the present value of cash flows or value of the business in the "with" scenario, and

- (f) if appropriate for the purpose of the *valuation* (see paragraphs 11.1-11.4), calculate and add the TAB for the subject intangible asset.

6.27 As an additional step, the difference between the two scenarios *may* need to be probability-weighted. For example, when valuing a non-competition agreement, the individual or business subject to the agreement may choose not to compete, even if the agreement were not in place.

6.28 The differences in value between the two scenarios *should* be reflected solely in the cash flow projections rather than by using different discount rates in the two scenarios.

Greenfield Method

6.29 Under the greenfield method, the value of the subject intangible is determined using cash flow projections that assume the only *asset* of the business at the *valuation date* is the subject intangible. All other tangible and intangible assets must be bought, built or rented.

6.30 The greenfield method is conceptually similar to the excess earnings method. However, instead of subtracting contributory asset charges from the cash flow to reflect the contribution of contributory assets, the greenfield method assumes that the owner of the subject asset would have to build, buy or rent the contributory assets. When building or buying the contributory assets, the cost of a replacement asset of equivalent utility is used rather than a reproduction cost.

6.31 The greenfield method is often used to estimate the value of "enabling" intangible assets such as franchise agreements and broadcast spectrum.

6.32 The key steps in applying the greenfield method are to:

- (a) prepare projections of revenue, expenses, capital expenditures and working capital needs for the business assuming the subject intangible asset is the only asset owned by the subject business at the *valuation date*, including the time period

- needed to “ramp up” to stabilised levels,
- (b) estimate the timing and amount of expenditures related to the acquisition, creation or rental of all other *assets* needed to operate the subject business,
- (c) using an appropriate discount rate for the business, present value the future cash flows to determine the value of the subject business with only the subject intangible in place, and
- (d) if appropriate for the purpose of the *valuation* (see paragraphs 11.1-11.4 below), calculate and add the TAB for the subject intangible asset.

Distributor Method

- 6.33** The distributor method, sometimes referred to as the disaggregated method, is a variation of the multi-period excess earnings method sometimes used to value customer-related intangible assets. The underlying theory of the distributor method is that businesses that are comprised of various functions are expected to generate profits associated with each function. As distributors generally only perform functions related to distribution of products to customers rather than development of intellectual property or manufacturing, information on profit margins earned by distributors is used to estimate the excess earnings attributable to customer-related intangible assets.
- 6.34** The distributor method is appropriate to value customer-related intangible assets when another intangible asset (for example, technology or a brand) is deemed to be the primary or most *significant* intangible asset and is valued under a multi-period excess earnings method.
- 6.35** The key steps in applying the distributor method are to:
- (a) prepare projections of revenue associated with existing customer relationships. This *should* reflect expected growth in revenue from existing customers as well as the effects of customer attrition,
 - (b) identify comparable distributors that have customer relationships similar to the subject business and calculate the profit margins achieved by those distributors,
 - (c) apply the distributor profit margin to the projected revenue,
 - (d) identify the contributory assets related to performing a distribution function

- that are needed to achieve the forecast revenue and expenses. Generally distributor contributory assets include working capital, fixed assets and workforce. However, distributors seldom require other *assets* such as trademarks or technology. The level of required contributory assets *should* also be consistent with participants performing only a distribution function,
- (e) determine the appropriate rate of return on each contributory asset based on an assessment of the risk associated with that asset,
 - (f) in each forecast period, deduct the required returns on contributory assets from the forecast distributor profit to arrive at the excess earnings attributable to only the subject intangible asset,
 - (g) determine the appropriate discount rate for the subject intangible asset and present value the excess earnings, and
 - (h) if appropriate for the purpose of the *valuation* (see paragraphs 11.1-11.4 below), calculate and add the TAB for the subject intangible asset.

7.0 Cost Approach

- 7.1** Under the *cost approach*, the value of an intangible asset is determined based on the replacement cost of a similar asset or an asset providing similar service potential or utility.
- 7.2** *Valuers must* comply with **VS 6 paragraphs 6.6.2 and 6.6.3** when determining whether to apply the *cost approach* to the *valuation* of intangible assets.
- 7.3** Consistent with these criteria, the *cost approach* is commonly used for intangible assets such as the following:
- (a) acquired third-party software,
 - (b) internally-developed and internally-used, non-marketable software, and
 - (c) assembled workforce.
- 7.4** The *cost approach may* be used when no other approach is able to be applied; however, a *valuer should* attempt to identify an alternative method before applying the *cost approach* in situations where the subject asset does not meet the criteria in **VS 6 paragraphs 6.6.2 and 6.6.3**.

- 7.5 There are broadly two main methods that fall under the *cost approach*: replacement cost and reproduction cost. However, many intangible assets do not have physical form that can be reproduced and assets such as software, which can be reproduced, generally derive value from their function/utility rather than their exact lines of code. As such, the replacement cost is most commonly applied to the *valuation* of intangible assets.
- 7.6 The replacement cost method assumes that a participant would pay no more for the asset than the cost that would be incurred to replace the asset with a substitute of comparable utility or functionality.
- 7.7 *Valuers should* consider the following when applying the replacement cost method:
- the direct and indirect costs of replacing the utility of the asset, including labour, materials and overhead,
 - whether the subject intangible asset is subject to obsolescence. While intangible assets do not become functionally or physically obsolete, they can be subject to economic obsolescence,
 - whether it is appropriate to include a profit mark-up on the included costs. An asset acquired from a third party would presumably reflect their costs associated with creating the asset as well as some form of profit to provide a return on investment. As such, under *bases of value* (see **VS 5**) that assume a hypothetical transaction, it *may* be appropriate to include an assumed profit mark-up on costs. As noted in **VS 6**, costs developed based on estimates from third parties would be presumed to already reflect a profit mark-up, and
 - opportunity costs *may* also be included, which reflect costs associated with not having the subject intangible asset in place for some period of time during its creation.
- 8.0 **Special Considerations for Intangible Assets**
- 8.1 The following sections address a non-exhaustive list of topics relevant to the *valuation* of intangible assets.
- Discount Rates/Rates of Return for Intangible Assets (section 1.9.0).
 - Intangible Asset Economic Lives (section 1.10.0).
 - Tax Amortisation Benefit (section 1.11.0).
- 9.0 **Discount Rates/Rates of Return for Intangible Assets**
- 9.1 Selecting discount rates for intangible assets can be challenging as observable market evidence of discount rates for intangible assets is rare. The selection of a discount rate for an intangible asset generally requires *significant* professional judgment.
- 9.2 In selecting a discount rate for an intangible asset, *valuers should* perform an assessment of the risks associated with the subject intangible asset and consider observable discount rate benchmarks.
- 9.3 When assessing the risks associated with an intangible asset, a *valuer should* consider factors including the following:
- intangible assets often have higher risk than tangible assets,
 - if an intangible asset is highly specialised to its current use, it may have higher risk than assets with multiple potential uses,
 - single intangible assets may have more risk than groups of assets (or businesses),
 - intangible assets used in risky (sometimes referred to as non-routine) functions may have higher risk than intangible assets used in more low risk or routine activities. For example, intangible assets used in research and development activities may be higher risk than those used in delivering existing products or services,
 - the life of the asset. Similar to other investments, intangible assets with longer lives are often considered to have higher risk, all else being equal,
 - intangible assets with more readily estimable cash flow streams, such as backlog, may have lower risk than similar intangible assets with less estimable cash flows, such as customer relationships.
- 9.4 Discount rate benchmarks are rates that are observable based on market evidence or observed transactions. The following are some of the benchmark rates that a *valuer should* consider:
- risk-free rates with similar maturities to the life of the subject intangible asset,
 - cost of debt or borrowing rates with maturities similar to the life of the subject intangible asset,
 - cost of equity or equity rates or return for participants for the subject intangible asset,

- (d) weighted average cost of capital (WACC) of participants for the subject intangible asset or of the company owning/using the subject intangible asset,
- (e) in contexts involving a recent business acquisition including the subject intangible asset, the Internal Rate of Return (IRR) for the transaction *should* be considered, and
- (f) in contexts involving a *valuation* of all assets of a business, the *valuer should* perform a weighted average return on assets (WARA) analysis to confirm reasonableness of selected discount rates.

10.0 Intangible Asset Economic Lives

10.1 An important consideration in the *valuation* of an intangible asset, particularly under the *income approach*, is the economic life of the asset. This *may* be a finite period limited by legal, technological, functional or economic factors; other assets may have an indefinite life. The economic life of an intangible asset is a different concept than the remaining useful life for accounting or tax purposes.

10.2 Legal, technological, functional and economic factors *must* be considered individually and together in making an assessment of the economic life. For example, a pharmaceutical technology protected by a patent may have a remaining legal life of five years before expiry of the patent, but a competitor drug with improved efficacy may be expected to reach the market in three years. This might cause the economic life of the patent to be assessed as only three years. In contrast, the expected economic life of the technology could extend beyond the life of the patent if the knowhow associated with the technology would have value in production of a generic drug beyond the expiration of the patent.

10.3 In estimating the economic life of an intangible asset, a *valuer should* also consider the pattern of use or replacement. Certain intangible assets may be abruptly replaced when a new, better or cheaper alternative becomes available, while others may be replaced slowly over time, such as when a software developer releases a new version of software every year but only replaces a portion of the existing code with each new release.

10.4 For customer-related intangibles, attrition is a key factor in estimating an economic life as well as the cash flows used to value the customer related intangibles. Attrition applied in the *valuation* of intangible assets is a quantification of expectations regarding future losses of customers. While it is a forward-looking estimate, attrition is often based on historical observations of attrition.

10.5 There are a number of ways to measure and apply historical attrition:

- (a) a constant rate of loss (as a percentage of prior year balance) over the life of the customer relationships *may* be assumed if customer loss does not appear to be dependent on age of the customer relationship,
- (b) a variable rate of loss *may* be used over the life of the customer relationships if customer loss is dependent on age of the customer relationship. In such circumstances, generally younger/new customers are lost at a higher rate than older, more established customer relationships,
- (c) attrition *may* be measured based on either revenue or number of customers/customer count as appropriate, based on the characteristics of the customer group,
- (d) customers may need to be segregated into different groups. For example, a company that sells products to distributors and retailers may experience different attrition rates for each group. Customers may also be segregated based on other factors such as geography, size of customer and type of product or service purchased, and
- (e) the period used to measure attrition *may* vary depending on circumstances. For example, for a business with monthly subscribers, one month without revenue from a particular customer would indicate a loss of that customer. In contrast, for larger industrial products, a customer might not be considered "lost" unless there have been no sales to that customer for a year or more.

10.6 The application of any attrition factor *should* be consistent with the way attrition was measured. Correct application of attrition factor in first projection year (and therefore all subsequent years) *must* be consistent with form of measurement.

- (a) If attrition is measured based on the number of customers at the beginning-of-period versus end-of-period (typically a year), the attrition factor *should* be applied using a “mid-period” convention for the first projection year (as it is usually assumed that customers were lost throughout the year). For example, if attrition is measured by looking at the number of customers at the beginning of the year (100) versus the number remaining at the end of the year (90), on average the company had 95 customers during that year, assuming they were lost evenly throughout the year. Although the attrition rate could be described as 10%, only half of that *should* be applied in the first year.
- (b) If attrition is measured by analysing year-over-year revenue or customer count, the resulting attrition factor *should* generally be applied without a mid-period adjustment. For example, if attrition is measured by looking at the number of customers that generated revenue in Year 1 (100) versus the number of those same customers that had revenue in Year 2 (90), application would be different even though the attrition rate could again be described as 10%.
- 10.7** Revenue-based attrition *may* include growth in revenue from existing customers unless adjustments are made. It is generally a best practice to make adjustments to separate growth and attrition in measurement and application.
- 10.8** It is a best practice for *valuers* to input historical revenue into the model being used and check how closely it predicts actual revenue from existing customers in subsequent years. If attrition has been measured and applied appropriately, the model *should* be reasonably accurate. For example, if estimates of future attrition were developed based on historical attrition observed from 20X0 through 20X5, a *valuer* *should* input the 20X0 customer revenue into the model and check whether it accurately predicts the revenue achieved from existing customers in 20X1, 20X2, etc.
- 11.0 Tax Amortisation Benefit (TAB)**
- 11.1** In many tax *jurisdictions*, intangible assets can be amortised for tax purposes, reducing a taxpayer’s tax burden and effectively increasing cash flows. Depending on the purpose of a *valuation* and the *valuation method* used, it *may* be appropriate to include the value of TAB in the value of the intangible.
- 11.2** If the market or *cost approach* is used to value an intangible asset, the price paid to create or purchase the asset would already reflect the ability to amortise the asset. However, in the *income approach*, a TAB needs to be explicitly calculated and included, if appropriate.
- 11.3** For some valuation purposes, such as financial reporting, the appropriate *basis of value* assumes a hypothetical sale of the subject intangible asset. Generally, for those purposes, a TAB *should* be included when the *income approach* is used because a typical participant would be able to amortise an intangible *asset* acquired in such a hypothetical transaction. For other valuation purposes, the assumed transaction might be of a business or group of assets. For those *bases of value*, it *may* be appropriate to include a TAB only if the transaction would result in a step-up in basis for the intangible assets.
- 11.4** There is some diversity in practice related to the appropriate discount rate to be used in calculating a TAB. *Valuers* *may* use either of the following:
- (a) a discount rate appropriate for a business utilising the subject asset, such as a weighted average cost of capital. Proponents of this view believe that, since amortisation can be used to offset the taxes on any income produced by the business, a discount rate appropriate for the business as a whole *should* be used, or
- (b) a discount rate appropriate for the subject asset (i.e., the one used in the *valuation* of the *asset*). Proponents of this view believe that the *valuation* *should* not assume the owner of the subject asset has operations and income separate from the subject asset and that the discount rate used in the TAB calculation *should* be the same as that used in the *valuation* of the subject asset.

VGN 3

Valuation for Financial Statements and Accounts Reporting Purposes

1. General Requirements

- 1.1 This VGN provides additional guidance on the *valuation* of property, assets and liabilities for inclusion in *financial statements*.
- 1.2 *Valuations* for inclusion in *financial statements* require particular care as they *must* comply strictly with the applicable financial reporting standards adopted by the entity. *Valuers* are strongly advised to clarify at the outset which standards their *clients* have adopted.
- 1.3 Although the International Financial Reporting Standards (IFRS) are nowadays widely adopted, other financial reporting standards may still apply in individual *jurisdictions*. *Valuer* should agree with the *client* and the auditor on the use of appropriate *basis of value* in the *terms of engagement* and disclose the same in his *report*.
- 1.4 In all cases, *valuers* are reminded that both IFRS and non-IFRS financial reporting standards continue to evolve – they *should* always refer to the standards current at the date to which the *financial statements* relate.
- 1.5 The definition of *fair value* is denoted in **VS 5 Section 5.9.0**.
- 1.6 The objective of a *fair value* measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. It is thus sometimes described as a ‘mark to market’ approach. Indeed the references in IFRS 13 to market participants and a sale make it clear that for most practical purposes the concept of *fair value* is consistent with that of *market value*, and so there would ordinarily be no difference between them in terms of the valuation figure reported.
- 1.7 Legislative, regulatory, accounting or jurisdictional requirements may require the modification of this application in some countries/states or under certain conditions.

1.8 While different professions have different interpretations for the term “Plant and Equipment”, the *Institute* has adopted the interpretation set out in the IVS, that is, “Items of plant and equipment are tangible *assets* that are held by an entity for use in the production or supply of goods and services, for rental by others or for administrative purpose and that are expected to be used over a period of time”.

1.9 It is a general practice to have the *valuation date* being set as of the ending *date of the reporting period* of the *financial statements* (or referred to as the ‘cut-off date’). There are cases that the *valuation date* may be set at a date earlier than the ending *ding period* of the *financial statements*, such as the transaction date. *Valuers* are required to discuss with the *clients* and the auditors of the *clients* to confirm the *valuation date* prior to taking up the engagement.

2. Valuations under International Financial Reporting Standards (IFRS)

2.1 Where the entity has adopted IFRS the *basis of value* will be *fair value* (see also VPS 4 section 7) and IFRS 13 Fair Value Measurement will apply. It is essential that the *valuer* is familiar with IFRS 13 requirements, especially the disclosure requirements.

3. Valuations under Hong Kong Financial Reporting Standards (HKFRS)

- 3.1 The *Institute* notices that in some instances *valuers* need to follow a set of procedures as required by the HKFRS or to arrive at a value other than a *market value* for aiding the accountant in the establishment or restatement of *financial statements*, such as ‘fair value less costs to sell’, ‘value in use’ or ‘purchase price allocation in a business combination’. In this context, *members* need to disclose the set of procedures in the *report* and to follow *the Standards* whenever and wherever possible in preparing the *report*.
- 3.2 *Members* are encouraged to obtain copies of relevant HKFRS from the HKICPA in order to have a better understanding before performing *valuation* engagements for *financial statements* and accounts reporting purposes

4. Notional Apportionment of Land and Building Elements

4.1 In the circumstances that a *valuer*, at the instruction from the *client*, is required under any financial reporting standards to notionally break down the value conclusion of a real property into land and building elements. The apportionment *may* be done by using one of following methods:

(a) By deducting from the *valuation* of the whole real property, the value of the land for its existing use as of the *valuation date*. In many instances there will be ample evidence of land values upon which a notional apportionment can be made. However, where there is little or no evidence of the land values, greater reliance will have to be placed on method (b) below.

(b) By making an assessment of the net replacement cost of the improvements as of the *valuation date* and deducting this from the *valuation* of the whole real property. The figure for the improvements will be derived from gross replacement cost which will then be reduced to the written-down value or net replacement cost as set out below, in order to reflect the current value of the real property to the business.

The *valuer should* consult the *clients* and/or auditors acting for the *clients* as to the basis of calculating the depreciable amount of the improvements, in order to maintain consistency of practice in the future.

4.2 *Valuer should* make a qualification in the *report* that the apportioned values *should* not be used other than financial reporting purpose.

5. Events after the reporting period

5.1 The *valuer should* refer to *material events* after the reporting period in the *financial statements* of which he becomes aware and which would likely affect his *valuation* in the *report*, and, at the advice sought from the *client* and its auditors to distinguish those events between adjusting or non-adjusting events in the *report*.

5.2 In referring to those *material* events in the *report*, the *Valuer* is required to discuss and obtain consent from the *directors* of the *client* to disclose such events in the *report*. The *valuer* is also required, at the advice from the *directors* of the *client* to distinguish between commercially confidential events or non-commercially confidential events, in particular when the *material* events are price sensitive to a public company.

5.3 HKAS 10 “Events after the Reporting Period” refers to events which occur between the end of the reporting period and the date on which the *financial statements* are approved by the *directors* of the *clients* and imposes upon the *directors* certain obligations regarding the disclosure of the events. Such events *may* be classified as “adjusting events” or “non-adjusting events”. *Valuers* are advised to refer to the HKAS 10 for the examples of different events.

6. Connected Leasing Arrangement

Any real property occupied by a company under an inter-company leasing arrangement within a group account *should* be valued as owner-occupied real property.

7. Relationship with Auditor

7.1 According to various standards on auditing, the auditor has a responsibility, when using the work performed by an auditor’s expert (individual or organisation), to obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit. The *Institute* noted that the term “Expert” is defined by the Hong Kong Standard on Auditing 620 “Using the Work of an Auditor’s Expert” as “an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence”. An auditor’s expert may be either an auditor’s internal expert or an auditor’s external expert. The *HKIS* considers that a *member* who is a qualified *valuer* as defined in the *Standards* in performing *valuations* for *financial statements* and accounts reporting are an auditor’s expert.

- 7.2 The auditor in performing his evaluation on whether the work of an auditor's expert is appropriate for the auditor's purposes, will consider the relevance and reasonableness of:
- the source data used;
 - the *assumptions* and methods used; and
 - the result of the auditor's expert work in the light of the results of other audit evidence.
- 7.3 In the course of the auditor's due diligence to the work with the auditor's expert, the auditor will follow the relevant standard on auditing by making inquiries regarding any procedures undertaken by the auditor's expert and reviewing or testing the data used by the auditor's expert. In some circumstances, even working papers are required to be submitted to the auditor for his review or testing.
- 7.4 The *valuer* is reminded that prior to submitting his working papers or data to the auditor, careful thought is required on the following:
- the scope of work as agreed in the *terms of engagement* with the *client*;
 - the nature of the working papers and data, such as intellectual property rights; and,
 - any consent, either expressly or implicitly, from the *client* for release of such works.

Under normal circumstances, the *report should* provide reasoning to all intended users on how the value conclusion is arrived. *Valuers* are presumed to have the responsibilities to assist all the intended users to understand the *valuation* and communications with the auditors on the key inputs are part of this responsibilities, provided that the requests from the auditor are not unreasonable.

- 7.5 The *valuer* is reminded to reach an agreement with the *client* in the *terms of engagement* on the working relationship with the *client's* auditor. This could include the way and the extent of releasing working papers and data to the *client's* auditor, to avoid unnecessary disputes with the *client* and the *client's* auditor thereafter and any potential litigation in the future.

VGN 4

Valuations of Real Properties for Secured Lending

The objective of this guidance notes on Valuations of Real Properties for Secured Lending is to provide guidance to *valuers* upon preparation of *valuation reports* of real properties on behalf of banks or lending institutions or lenders for secured lending.

1. THE QUALIFIED VALUER'S ROLES

1.1 The roles of the qualified *valuer* are:

1.1.1 to advise the bank or lending institution or lender (hereinafter collectively referred to as "the Lender") as to the *market value* of the real property(ies) at the *valuation date*; and

1.1.2 to advise the Lender as to the nature of the real property (see Section 5 below) and any factors likely to materially affect its *market value*.

1.2 It would be usual for the *valuer* to be asked to express an opinion as to the suitability of the real property as security for a loan. It is, however, a matter for the Lender to assess the risk involved and express their assessment in fixing the terms of the loan, such as the percentage of value to be advanced, and provision for repayment of the capital and the interest rate. The *valuer should* refer in his *report* where one is to be provided, to all matters which are within his knowledge and which may assist the Lender in his assessment of the risk. The *valuer should* not make a recommendation as to the amount or percentage of mortgage advance or as to the length of the loan term. Nor is it the *valuer's* responsibility to give advice as to the suitability of the real property 'for second mortgage purposes'.

1.3 When a real property is valued as security for a loan, by way of mortgage, debenture or otherwise, the *valuation* shall normally be on the basis of *market value*.

1.4 It is not normally appropriate to value a real property to be used as security for a loan on a basis other than *market value*. Where the Lender requires the *valuer* to advise on the values of certain real properties, either in addition to or in place of *market value*, e.g. *valuation* of flats subject to the restrictions

upon assignment under Home Ownership Scheme or Sandwich Class Housing Scheme, 'surrender value' of industrial properties located in Industrial Estates in Hong Kong subject to restrictions on assignment and underletting, Hong Kong residence for Hong Kong People, etc., the *valuer should* state clearly the *basis of value* adopted in the *report*.

2. TAKING INSTRUCTION

2.1 It is recognized as a common practice that the Lender may have a master service agreement with the *firm* of the *valuers* on the overall valuation services for secured lending, while the formal engagement will be contained in further correspondences in any appropriate business form. A *valuer should* ensure that the formal engagement instruction and the master service agreement together contains all the minimum contents as stipulated in **VS 4** of the *Standards*.

2.2 In case the *valuation* is not covered in any master service agreement, the *valuer must* make sure the *terms of engagement* in compliance with *the Standards*.

2.3 In some circumstances, a *valuation* may be commissioned by a party that is not the intended Lender, for example, a prospective borrower or an agent. If the party does not know, or is unwilling to disclose, the identity of the intended Lender, it *must* be stated in the *terms of engagement* that the *valuation* may not be acceptable to a Lender. This may be because some Lenders do not accept that a *valuation* procured by a borrower or an agent is sufficiently independent, or because that particular Lender has specific reporting requirements.

2.4 It is common practice for the *valuer* to provide a preliminary indication of value to the Lender before formal instruction. For the guidance on providing preliminary indication of value, see Appendix to this guidance note.

3. THE VALUATION PROCESS

3.1 Inspection Arrangement

Inspections must always be carried out to the extent necessary to produce a *valuation* that is professionally adequate for its purpose,

unless expressly agreed with the Lender. A visual and physical *inspection* shall be undertaken to the exterior and interior of the *real estate* as long as the same is accessible to the *valuer* (or designated qualified staff) without undue difficulty. With regard to the scope of *inspection* to be performed by the *valuer*, it is a best practice for the *valuer* to agree with the Lender prior to commencement of his *valuation* and to document such agreement in the *terms of engagement*. While the scope of the *inspection* is to be agreed between the *valuer* and the Lender, the *valuer* is required to observe the **VS 7** of the *Standards* and in no way should it give rise to a result that would mislead the Lender who reads the *report*. To avoid doubt, *inspection* required under the *Standards* is not in any form of a building survey to the subject *real estate*.

3.2 Valuation without Inspection

Where the Lender has instructed the *valuer* not to carry out any *inspection* (internal or external or both), the *valuer* must consider the risk before proceeding. If any *valuation* without *inspection* may undermine the reliability of such *valuation*, such instruction must not be taken. In case any *valuation* without *inspection* is taken, the *valuer* should state such instruction in the *report* and a caveat or *assumption* is required to reflect the absence of *inspection*.

3.3 Cases not Appropriate without Inspection

The *valuer* should alert the Lender and advise an internal *inspection* to be carried out when the characteristics of *real estate* are not typical in the market. Examples include, but not limited to, tenement buildings, properties subject to Building Order(s) being registered by the government, domestic buildings or non-typical developments over 30 years in age, properties with flat roof, roof and/or appurtenant open space, villas, village-type houses, all non-domestic properties, etc. If the Lender is not able to arrange an internal *inspection*, an external *inspection* should still be carried out.

3.4 Revaluation without re-inspection of real property previously valued

A revaluation without a *re-inspection* of real property previously valued by the *valuer* or his *firm* must not be undertaken unless the *valuer* is satisfied that there have been no *material* changes to the physical attributes of the *real estate*, or the nature of its location, since the last assignment.

3.5 The *valuer* should ensure the entire *valuation*

process in compliance with **VS 7** of the *Standards*.

4. THE REPORT

4.1 Subject to the matters referred to in Sections 1 and 3 above, the *report* should be confined strictly to answering questions raised by the Lender.

4.2 If it is suspected that there exists hidden defects that could have *material* effect on the value of the real property, the *valuer* should so advise and recommend to the Lender that a more extensive investigation should be carried out. It may be appropriate in exceptional circumstances to defer making a *valuation* until the results of such further investigations are made known to the *valuer*.

4.3 If it is not possible to carry out *inspection* on any substantial part of the *real estate*, this should be stated in the *report*.

4.4 If there is obvious evidence of any serious disrepair, potential hazard or any other matters which may materially affect the value of the real property, this should be stated in the *report*.

4.5 Where the *valuer* relies on information provided by others, this should be indicated in the *report*, so should the source of that information. With regard to the verification work to be conducted by the *valuer*, it is a good practice for the *valuer* to agree with the Lender prior to commencement of his *valuation* and to document such agreement in the *terms of engagement*. While the scope of the verification work is to be agreed between the *valuer* and the Lender, the *valuer* is required to observe the **VS 7** of the *Standards* and in no way should it give rise to a result that would mislead the Lender who reads the *report*.

4.6 The Lender should be informed of the existence of any apparent and *significant* additions, alterations and extensions so as to alert the Lender's legal adviser for any enquiries to be made. In particular, the Lender's attention should be drawn to any unauthorised structure or addition or alteration made in the subject *real estate* or any other apparent unauthorised structures which are or could be subject to action

under Section 24 of the Buildings Ordinance (Chapter 123 – Laws of Hong Kong) or under applicable regulations in other *jurisdictions*.

4.7 The *valuer* should consider the subject real property in accordance with its original approved state and disregard any premium attached to the unauthorised additions and/or alterations. Unless otherwise agreed between the *valuer* and the Lender and with assistance from a registered contractor in the government, the *valuer* would not consider any costs required to restore the real property to its original approved state if requested by the government authorities. The *valuer* should state such *assumptions* in the *report*. If as instructed by the Lender to make any *assumptions* which are different from the above, the *valuer* must state such *assumptions* in the *report*.

4.8 If there are any additional requirements from a Lender in conducting *valuations*, subject to the agreement made between the Lender and *valuer* beforehand, extra information or findings can be included in the *report*.

4.9 The format and extent of the detail of the *report* are a matter of the *valuer's* discretion except where the *report* is to be provided on a form supplied by the *client*. The presentation of the *valuation report* should take into account the need for any special format and should contain the following minimum required information:

- (a) the status of the *valuer* and where appropriate and applicable, the disclosure of any material involvement, previously or current;
- (b) the identification of the *client* and any other intended users;
- (c) the purpose of the *valuation*;
- (d) the identification of the *asset(s)* being valued;
- (e) the *basis* or *bases of value*;
- (f) the *valuation date*;
- (g) the extent of the *Valuer's inspections* and investigations;
- (h) the nature and source of information to be relied on by the *valuer*;
- (i) any *assumptions*, *special assumptions*, reservations, any special instructions or departures;
- (j) any restrictions on use, distribution and publication;
- (k) confirmation that the assignment has

been undertaken in accordance with the IVS and/or HKIS Valuation Standards;

- (l) the *valuation method* adopted and the key inputs, subject to the instructions of the Lender;
- (m) the opinions of value in figures and words;
- (n) the *date of the report*.
- (o) commentary on any material uncertainty in relation to the *valuation* where it is essential to ensure clarity on the part of the valuation user; and
- (p) any limits or exclusion of liability to parties other than the *client*

5. THE VALUATION

5.1 Unless the facts clearly shown to the contrary or subject to paragraphs 4.6 and 4.7 above, the *valuer* should state the following *assumptions* in the *report* and will be under no duty to verify these *assumptions*:

5.1.1 that all necessary statutory approvals for the subject *real estate* or the building of which the subject *real estate* forms part of the use have been obtained;

5.1.2 that no deleterious or hazardous materials or techniques have been used in the construction of the subject *real estate*;

5.1.3 that the subject real property is not subject to any unusual or especially onerous restrictions, encumbrances or outgoings and that good title can be shown;

5.1.4 that those parts of the subject *real estate* which could not be inspected would not reveal *material* defects or cause the *valuer* to alter his *valuation*;

5.1.5 that the subject *real estate* is connected to main services and sewers which are available on normal terms;

5.1.6 that in the case of a *real estate* which is under construction, the *real estate* will be satisfactorily completed to the standard in due course and details as described in the latest development schedules as contained in the sales brochure;

5.1.7 that in *valuation* of a strata-titled real property, unless instructed by the Lender or otherwise aware of to the contrary, the cost of repairs and maintenance to the building

of which the subject *real estate* forms part of the use are shared among all owners of the building, and that there are no onerous liabilities outstanding.

5.2 Suggested factors to be taken into account in the *valuation* are:

5.2.1 the tenure of the real property - If the real property is subject to tenancy(ies), details including lease period(s), rental amount(s), option to renew and other relevant conditions *should* be included;

5.2.2 the age, type, accommodation, location, amenities, fixtures and features of the *real estate* and other *significant* environmental factors within the locality;

5.2.3 the general state of repair, the construction and apparent major defects; and

5.2.4 the overall quality of management of the building of which the *real estate* forms part of.

5.3 In assessment of the *market values* of strata-titled units, unless otherwise instructed, any redevelopment potential attached to the site is to be excluded. The *valuer* would also not to include any element of value attributable to furnishings and removable fittings of any description when arriving at an opinion of value. Portable and temporary structures are also to be excluded.

5.4 'Market value' shall be adopted in accordance with *the Standards*.

5.5 The *valuation* shall be made on the *assumption* that the owner sells the subject real property on the market without the benefit or burden of cash rebate, unusual payment terms, special incentive or any similar arrangement which could affect the value of the subject real property.

5.6 Value for sale under repossession (VSR)

Value for sale under repossession (the word repossession means the action of regaining possession especially the seizure of collateral securing a loan that is in default) refers to the price that might reasonably be expected to realise within a defined period of time (the period shall be agreed upon between Lender and *valuer*) from the sale of a real property in the market under repossession by the Lender

or receiver, on an "as is" basis, taking into account the unique quality of the real property and the existence of any specific demand as well as factors which might adversely affect the marketability of the real property due to market perception of increased risk or stigma, justified or otherwise.

The underlying *basis of value* of VSR is *market value*, but subject to *special assumptions* on actual or hypothetical marketing constraints which cause the perception of increased risk of stigma. The marketing constraint *must* be agreed with the Lender prior to reporting. An example of the marketing constraint includes the anticipated time frame for completion of a transaction which strikes a balance between the Lender's liquidity need and the reasonable care to the mortgagor, but which *may* be considered as inadequate for the real property to be presented in the market.

A *special assumption* that simply refers to a time limit for disposal without stating the reasons for that limit would not be a reasonable *assumption* to make. Without a clear understanding of the reasons for the constraint, the *valuer* would be unable to determine the impact that it may have on marketability, sale negotiations and the price achievable, or to provide meaningful advice.

A marketing constraint *should* not be confused with a forced sale. A constraint may result in a forced sale, but it can also exist without compelling the owner to sell.

The term 'forced sale value' *must* not be used. A 'forced sale' is a description of the situation under which the exchange takes place, not a distinct *basis of value*. Forced sales arise where there is pressure on a particular vendor to sell at a specific time – for example, because of the need to raise money or to extinguish a liability by a given date. The fact that a sale is 'forced' means that the vendor is subject to external legal or personal commercial factors, and therefore the time constraint is not merely a preference of the vendor. The nature of these external factors and the consequences of failing to conclude a sale are just as important in determining the price that can be achieved within the length of time available. Unless in certain extreme cases the facts show otherwise, it *may* be remote and inappropriate to foresee a bank will be 'forced' to sell a real property under repossession.

While a *valuer* can assist a Lender in determining a price that *should* be accepted in marketing constraints, this is a commercial judgement of the Lender whether a discounted price to the *market value* will be accepted. A *valuer should* make a qualification in the *report* on the reliance of VSR.

To provide an estimate of the VSR, the *valuer* should:

- (1) agree with the *Lender* or receiver on the details of the actual or anticipated marketing constraints that might have impact on the *market value* whilst taking into account the unique quality of the real property and the existence of any specific demand;
- (2) ascertain whether the constraint arises from an inherent feature of the *asset*, or of the interest being valued, or from the particular circumstances of the *client*, or some combination of all of these;
- (3) estimate the *market value* of the real property;
- (4) analyse and apply adjustment(s) to the *market value* of the real property by taking into account the negative impacts and to arrive at the value for sale under repossession independently; and
- (5) make a qualification in the *report* on the reliance of the VSR.

6. BUILDING INSURANCE REPLACEMENT COST

In some cases, *valuers* are required to give the building insurance replacement cost of the subject *real estate* in the *reports* for the Lenders' reference.

The building insurance replacement cost is defined as the estimated cost of erecting the same *real estate* or a modern substitute *real estate* having the same area as the existing one at the relevant date, which includes fees, finance costs and other associated expenses directly related to the construction of the *real estate*. Coverage for loss of rent and other disturbances will not be included unless specifically requested by the Lender.

In producing the building insurance replacement cost in the *report*, should the *valuer* consider himself not a qualified professional to give an accurate building insurance replacement cost of the subject *real estate*, he *should* reach an agreement with the Lender prior to the issue of the *report* on the source of the building insurance replacement cost to be referenced and the way to use such building insurance replacement cost, and to disclose the same in the *report*. To avoid doubt, the *HKIS* considers

that the qualified professional in producing the building insurance replacement cost *should* be a professional quantity surveyor, a *firm* of professional quantity surveyors in Hong Kong or other individual / *firm* of equivalent professional qualification in other *jurisdictions* who is competent and experienced in the relevant matters. Should a *valuer* require the assistance from other professional on the building insurance replacement cost, he *should* notice the requirements under **paragraph 2.2.2 of VS 2 and section 3.4.0 of VS 3** of the *Standards*.

7. THE VALUER'S RECORD

7.1 The *valuer* *should* keep a record of the source of information quoted in the *report* and to make and retain legible notes as to his findings and, particularly, the limits of *inspection* and the circumstances under which it was carried out.

7.2 The *valuer* *should* also keep a record of the comparable transactions and/or *valuations* to which he has had regard in arriving at his *valuation*.

8. INDEPENDENCE, OBJECTIVITY AND CONFLICTS OF INTEREST

8.1 *Valuers* *must* at all times act with integrity, independence and objectivity, and avoid conflicts of interest and any actions or situations that are inconsistent with their professional obligations. *Members* *must* also declare any potential conflicts of interest – personal or professional – to all relevant parties.

8.2 The Lender may specify additional criteria for independence for a *valuation* for secured lending. In the absence of specification, the additional criteria shall be deemed to include a stipulation that the *valuer* has had no previous, current or anticipated involvement with the borrower, or prospective borrower the *asset* to be valued or any other party connected with a transaction for which the lending is required. 'Previous involvement' would normally be anything within the period of 24 months preceding the date of instruction or date of agreement of the *terms of engagement* (whichever is earlier), but a specific longer period may be prescribed or adopted in individual *jurisdictions*.

8.3 Any previous or current involvement with the borrower or the real property or *asset* to be valued *must* be disclosed to the Lender prior to the acceptance of the instruction. Disclosure *should* also extend to any anticipated future involvement. (References to 'borrower' include a prospective borrower or any other party connected with the transaction for which the lending is required). Examples of such involvement that may result in a conflict of interest include situations where the *valuer* or his *firm*:

- has a long-standing professional relationship with the borrower or the owner of the real property or *asset*
- is introducing the transaction to the Lender or the borrower, for which a fee is payable to the *valuer* or his *firm*
- has a financial interest in the *asset* or in the borrower
- is acting for the owner of the real property or *asset* in a related transaction
- is acting (or has acted) for the borrower on the purchase of the real property or *asset*
- is retained to act in the disposal or letting of a completed development on the subject real property or *asset*
- has recently acted in a market transaction involving the real property or *asset*
- has provided fee earning professional advice on the real property or *asset* to current or previous owners or their lenders and/or
- is providing development consultancy for the current or previous owners.

8.4 The *valuer* *must* consider whether any previous, current or anticipated involvement with either the real property or *asset* or related parties is sufficient to create a conflict with the *valuer's* duty to be independent and objective. Matters such as the quantum of any financial interest in a connected party, the scope for the *valuer* or his *firm* to benefit materially from a particular *valuation* outcome and the level of fees earned from any connected party as a proportion of total fee income may all be *material*.

8.5 If the *valuer* considers that any involvement creates an unavoidable conflict with his duty to the potential *client*, the instruction *should* be declined.

8.6 If the *client* considers that any disclosed involvement does create a conflict, the *valuer* *should* decline the instruction. If the *valuer* and the *client* agree that any potential conflict can be avoided by introducing arrangements for managing the instruction, those arrangements *must* be recorded in writing, included in the *terms of engagement*, if any, and referred to in the *report*.

8.7 Although a *valuer* *may* take into account the views of the prospective *client* in deciding whether a recent, current or anticipated involvement creates a conflict, it remains the *valuer's* professional responsibility to decide whether or not to accept the instruction having regard to the principles of the Codes of Conduct and **VS 3** of *the Standards*. If the instruction is accepted where *material* involvement has been disclosed, the *valuer* *may* be required to justify this decision to *HKIS*. If a satisfactory justification is not provided, *HKIS* may take disciplinary measures.

9. COMPLIANCE WITH THE GUIDANCE NOTES

All *valuations* for secured lending *should* be made in accordance with this guidance notes. In cases of any *departure* from this guidance notes, the *valuer* *must* note the disclosure requirements as denoted in **Sections 1.3.0 and 1.5.0 of VS 1** of *the Standards* and *should* notify the Lender, or be notified by the Lender, in writing. Such *departure* *should* be clearly stated in the *valuation report*, and, if possible, in the *terms of engagement*.

Valuers are reminded to observe their duty of care to the Lenders in performing their *valuations*, and the extent of liability of their *valuation reports* to the Lenders.

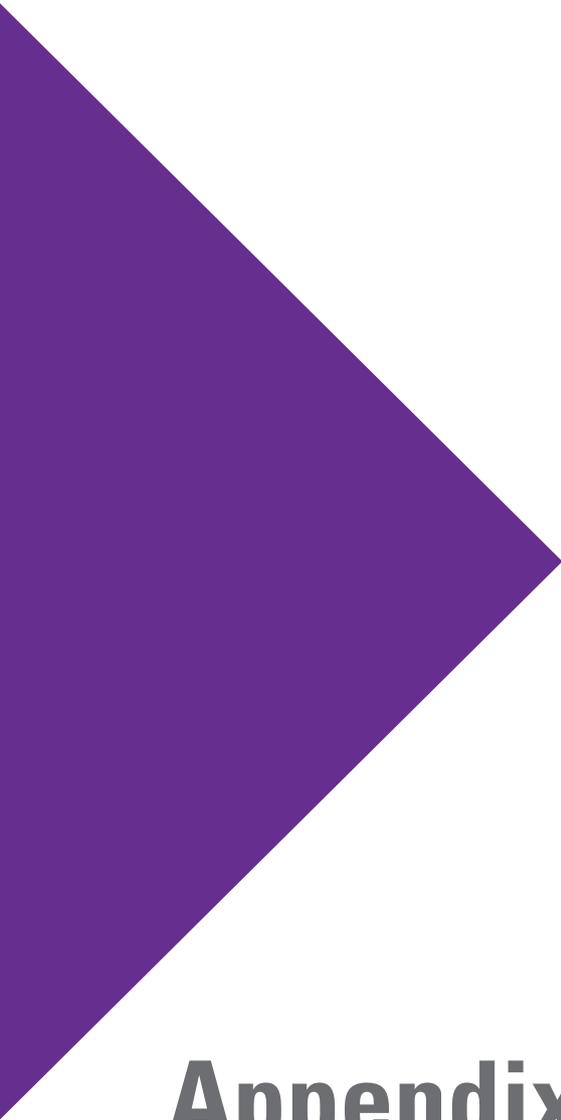
It has long been a common practice for the Lenders to request a preliminary indication of value of the intended subject of *valuation* before formal engagement. In the past, it was called “verbal valuation” which was conducted wholly orally to provide a preliminary indication on the value of an *asset*, but as time evolves, Lenders nowadays may request for a record in writing. A *member should* alert the Lender that the preliminary indication is a preliminary advice (see **paragraph 3.2.19 of VS 3**) only and *must* state that:

1. The opinion is provisional and subject to completion of the final *report*;
2. The advice is provided for the Lender’s internal purposes only; and
3. Any draft is on no account to be published or disclosed.

HKIS would recommend to use the term “Preliminary Indication of Value” or in short “Preliminary Indication” or in Chinese “初步參考值” for avoidance of doubt.

FOR RATIFICATION PURPOSE

(HKIS AGM 2017)



Appendix to VGN 4:
Guidance on Providing
Preliminary Indication of Value

It is recognized that the preliminary indication is not necessarily conducted by a qualified *valuer* and it is perfectly proper for a *valuer* to designate suitably trained staff under his supervision to provide a preliminary indication. As a best practice, a *valuer should* consider the knowledge, experience, reliability and ability of his staff in any such designation.

For avoidance of doubt, no matter whether a preliminary indication is provided orally or in writing, the principles set out in *the Standards should* still be observed to the fullest extent possible. *Members* are reminded that the mere fact that *HKIS* considers a preliminary indication as preliminary advice does not mean that the preliminary indication is therefore provided without liability – the *valuer's* responsibilities and obligations will always depend on the facts and circumstances of the individual case.

FOR RATIFICATION PURPOSE

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