

# Primer on International Valuation Standards – Part 5

In continuing with the review of *International Valuation Standards (IVS)*, this article looks at applications of both private and public sector asset valuation to financial statements or related accounts, and to decisions involving loan or mortgage security.

## IVA-1 – VALUATION FOR FINANCIAL REPORTING

The material for *International Value Application-1 (IVA-1)* is drawn from *International Financial Reporting Standards (IFRSs)* and the objective is to explain the principles that apply to valuations prepared for use in financial statements. Appraisers should have some understanding of the accounting concepts and principles underlying the relevant *International Accounting Standards (IAS)*.

In accounting terminology, there are two models for the recognition of property assets on the balance sheet: the cost model and a fair value model. It is this latter model that is the focus of this application.

The application begins with a number of definitions generally familiar to appraisers such as depreciated replacement cost, improvements, market value and specialized property. However, there are 17 additional definitions, primarily from *IFRS*, which are perhaps new to appraisers. Appraisers undertaking appraisals for financial accounting should study all of them, however, a sample of some that may have a different meaning to appraisers are as follows:

**Depreciable amount:** The cost of an asset, or other amount substituted for cost (in the financial statements), less its residual value.<sup>1</sup>

**Depreciation:** The systematic allocation of the depreciable amount of an asset over its useful life.<sup>2</sup>

**Fair value:** The amount for which an asset

could be exchanged or a liability settled between knowledgeable willing parties in an arm's length transaction.<sup>3</sup>

**Impairment loss:** The amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.<sup>4</sup>

**Investment property:** Property (land or building, or part of a building, or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation, or both, rather than for:

- a) use in the production or supply of goods or services or for administrative purposes, or
- b) sale in the ordinary course of business.<sup>5</sup>

**Net realizable value:** The estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale.<sup>6</sup> Net realizable value refers to the net amount that an entity expects to realize from the sale of inventory in the ordinary course of business. Fair value reflects the amount for which the same inventory could be exchanged between knowledgeable and willing buyers and sellers in the marketplace. The former is an entity-specific value; the latter is not. Net realizable value for inventories may not equal fair value less costs to sell.<sup>7</sup>

**Value in use:** The present value of the future cash flows expected to be derived from an asset or cash-generating unit.<sup>8</sup>

In undertaking this type of work, an appraiser must determine the classification of the asset being appraised, as such determines which accounting concept applies, i.e., *IAS* or *IFRS*. For example, if the 'fair value model' applies, regular revaluations may be required. Also, disclosure of whether the appraisal has been conducted by an external or internal appraisal is required. Keep in mind that

'fair value' is not necessarily synonymous with 'market value.' If adopting the 'fair value' concept, *IVS* notes that the fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professional, qualified valuers. If there is no market-based evidence of fair value because of the specialized nature of the item of property, plant and equipment, and the item is rarely sold, except as a part of a continuing business, an entity may need to estimate fair value using an income or depreciated replacement cost approach.<sup>9</sup>

*IVA-1* goes on to provide detail on valuations for investment properties (*IAS 40*), impaired assets (*IAS 36*), business combinations (*IFRS 3*), surplus assets (*IFRS 5*), properties held for sale in the ordinary course of business (*IAS 2*), and biological assets (*IAS 41*). If dealing with any of these concepts, an appraiser is obligated to become familiar with these terms and concepts in order to be able to claim competency in an assignment.

The disclosure requirements of this application are recognized by most appraisers. As with the 'jurisdiction exception' concept in *CUSPAP*, an appraiser undertaking financial accounting appraisals must disclose the regulatory framework and any departures required from the *IVS* to comply with local legislation, regulation (including accounting rules), or customs.<sup>10</sup>

## IVA-2 – VALUATION FOR SECURED LENDING PURPOSES

This application covers appraisals for lending or mortgage purposes – what the majority of appraisers now do – so the concepts are very familiar. As *IVS* notes, an appraisal for lending purposes is not necessarily the same as an appraisal for financial accounting purposes. Although a similar base such as 'market value' may be applicable,

the assumptions on which the valuation is based may be different. For example, valuations for financial accounting usually assume that the 'going concern' continues, an assumption that may not be required for lending purposes.

*IVS* requires comments on current market activity and trends; historic, current and anticipated future demand for the category of property in the specific location; consideration for alternative uses; marketability; and any impact of foreseeable events on the value of the property. Most importantly, *IVS* requires market-based evidence in support of the value conclusions.

The *IVA-2* application adds a paragraph that may be very helpful to appraisers dealing with mortgage brokers and the lending community. Often, there are cases when an appraiser is simply told by a mortgage broker that an appraisal is required, but the lender has yet to be identified. What can happen in this case is that a first mortgage lender uses the report to measure the risk involved in the loan. Then, a second or third mortgagee also relies on the report. However, the element of risk likely rises significantly with each succeeding mortgage. Suddenly, the appraiser is defending a report he or she believed to be a 'low risk' valuation. Had the appraiser realized that a 'high risk' valuation was in order, the decision to increase the scope of work undertaken would likely give the appraiser and the lender a higher level of comfort. *IVA-2* suggests that appraisers should have a general understanding of the requirements of the lender and possibly the structure of loan terms and agreements. Even though lenders feel that terms of the loan are confidential, it does not relieve the appraiser from the obligation to have a general understanding of the lending process, which, in turn, will dictate the scope of work involved.

Appraisers are sometimes confused when confronted with a 'specialized property.' Usually, these types of properties have limited marketability. Their value is usually derived from the business operation itself. In these cases, lenders usually require an appraisal to reflect an 'as though vacant' state of the property. An example may be a cold storage facility. The cost of such a facility is usually higher than a similar sized light industrial structure, merely due to the insulation and cooling requirements. However, if the operation ceases and the lender is forced to sell the property vacant, a potential buyer would likely put little, if any, value on the additional cost of a cold storage facility. These concepts are known to appraisers as 'value in use' and 'value in exchange.' *IVA-2* provides explanations for these concepts, along with other concepts involving 'trade related properties,' 'development properties,' and 'wasting assets' such as mines or quarries.

## IVA-3 – VALUATION OF PUBLIC SECTOR ASSETS FOR FINANCIAL REPORTING

Property in the public sector is made up of cash-generating and non cash-generating property assets, as well as specialized property assets including heritage and conservation assets, infrastructure assets, public buildings, public utility plants and recreational assets. As with private sector assets, public sector assets fall into operational and non-operational categories. Non-operational assets include investment and surplus assets.<sup>11</sup>

*IVA-3* provides definitions for these various assets and this application mirrors similar concepts involving fair value, independent valuations, re-valuations, etc. If involved in preparing appraisal of public sector assets for financial accounting purposes, an appraiser must be

familiar with *International Public Sector Accounting Standards (IPSASs)* which provide the necessary guidance, definitions and terminology for dealing with such things as value in use, government business enterprises, depreciated replacement cost approach, restoration cost approach, etc.

These past five installments of the *IVS* Primer have dealt with almost one half of the entire *IVS* document. The balance of *IVS-2007* primarily comprises Guidance Notes, which provide an excellent resource for appraisers in dealing with numerous appraisal issues from simple fundamentals of appraising to more complex subjects such as discounted cash flow analysis for market valuations and investment analysis. As such, *IVS-2007* is a must for the serious appraiser's library. 📖

## End notes

- 1 *IAS-16*, para.6
- 2 *IAS-16*, para.6; *IAS 36*, para.6
- 3 *IAS-16*, para.6
- 4 *Ibid*
- 5 *IAS-40*, para.5
- 6 *IAS-2*, para.6
- 7 *IAS-2*, para.7
- 8 *IAS-36*, para.6
- 9 *IVA-1* – 5.4 Valuations under *IAS 16*
- 10 *IVA-1* – 7.0 Disclosure requirements.
- 11 *IVA-3* – 1.5

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