International Valuation Application 1
Valuation for Financial Reporting (Revised 2005)

International Valuation Application 1
Valuation for Financial Reporting (Adopted 2005)

Material for this Application is drawn from International Financial Reporting Standards (IFRSs) published by the International Accounting Standards Board (IASB). IFRSs comprise individually numbered standards. Those originally published before 2004 are denoted IASs (International Accounting Standards) 1-41. Those published subsequently are prefixed as IFRSs. Extracts from IFRSs are reproduced in this publication of the International Valuation Standards (IVSs) with the permission of IASB.

The approved text of the IFRSs is that published by IASB in the English language, and copies may be obtained directly from IASB, 30 Cannon Street, London EC4M 6HX, United Kingdom, E-mail: *publications@iasb.org.uk*

1.0 Introduction

1.1 The objective of this Application is to explain the principles that apply to valuations prepared for use in financial statements and related accounts of business entities. Valuers undertaking work of this nature should have an understanding of the accounting concepts and principles underlying the relevant International Accounting Standards.

1.2 The Valuer's adherence to market-based definitions, objectivity, and full disclosure of relevant matters within a pertinent and user-friendly format are fundamental to the requirements of valuation for financial reporting.

2.0 Scope

2.1 This Application applies to all valuations of asset classes included in any financial statement, which fall within the skills and expertise of Valuers.

2.2 IVSs facilitate cross-border transactions and the viability of global markets through harmonisation and transparency in financial reporting. As such this Application is developed in the context of International Financial Reporting Standards (IFRSs) as at 31 March 2004.

2.3 IFRSs adopt two models for the recognition of property assets in the balance sheet: a cost model, and a fair value model. Where the fair value model is applied, a current revaluation of the asset is required, and this Application focuses on these particular circumstances where Market Values are to be reported.

2.4 Legislative, regulatory, accounting, or jurisprudence requirements may oblige modification of this Application in some countries or under certain conditions. Any departure due to such circumstances must be referred to and clearly explained in the Valuation Report.

3.0 Definitions

International Valuation Standards Definitions

3.1 *Market Value.* The estimated amount for which a property should exchange on the date of valuation between a willing buyer and willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion (IVS 1, para. 3.1).

3.2 *Depreciated Replacement Cost.* The current cost of reproduction or replacement of an asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation.

3.3 *Improvements.* Buildings, structures or modifications to land, of a permanent nature, involving expenditures of labour and capital, and intended to enhance the value or utility of the property. Improvements have differing patterns of use and economic lives.

3.4 *Specialised Property*. A property that is rarely if ever sold in the market, except by way of sale of the business or entity of which it is part, due to uniqueness arising from its specialised nature and design, its configuration, size, location, or otherwise.

3.5 *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 (IAS 16, para. 6).

3.6 *Depreciable Amount*. The cost of an asset, or other amount substituted for cost (in the financial statements), less its residual value (IAS 16, para. 6).

3.7 *Residual Value*. The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life (IAS 16, para. 6)

3.8 *Owner-Occupied Property*. Property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes (IAS 40, para. 5).

3.9 *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 (IAS 40, para. 5).

3.10 *Carrying Amount*. The amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon (IAS 36, para. 6).

3.11 *Depreciation*. The systematic allocation of the depreciable amount of an asset over its useful life (IAS 16, para. 6; IAS 36, para. 5)

3.12 *Fair Value Less Costs to Sell*. The amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal (IAS 36, para. 6).

3.13 *Net Realisable 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 (IAS 2, para. 6). Net realisable value refers to the net amount that an entity expects to realise 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 market place. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell (IAS 2, para. 7).

3.14 *Recoverable Amount*. The recoverable amount of an asset or cash-generating unitis the higher of its fair value less costs to sell and its value in use. (IAS 36, para 6)

3.15 *Revalued amount*. The fair value of an asset at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses (IAS 16, para. 31).

3.16 *Property, Plant and Equipment*. Tangible items that

a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

b) are expected to be used during more than one period. (IAS 16, para 6)

3.17 *Value in Use*. The present value of the future cash flows expected to be derived from an asset or cash-generating unit (IAS 36, para. 6).

3.18 *Useful Life.* Either

a) the period over which an asset is expected to be available for use by an entity; or
b) the number of production or similar units expected to be obtained from the asset by an entity (IAS 16, para. 6; IAS 36, para. 6; IAS 38, para. 8).

In regard to leases, useful life is defined as:

The estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity (IAS 17, para. 4).

3.19 *Economic Life*. Either

a) the period over which an asset is expected to be economically usable by one or more users; or
b) the number of production or similar units expected to be obtained from the asset by one or more users (IAS 17, para. 4).

3.20 *Impairment Loss*. The amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount (IAS 36, para. 6).

3.21 *Cash-Generating Unit.* The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets (IAS 36, para. 6)

4.0 Relationship to Accounting Standards

4.1 This Application applies the principles developed in IVS 1, IVS 2, and IVS 3 to the requirements of IASs/IFRSs.

4.2 This Application focuses on valuation requirements under IAS 16, *Property Plant and Equipment*; IAS 17, *Leases*; and IAS 40, *Investment Property*. Reference is also made to valuation requirements under IAS 36, *Impairment of Assets*; IAS 2, *Inventories*; and IFRS 5*, Non-current Assets Held for Sale and Discontinued Operations*.

4.3 IASB is currently undertaking fundamental reviews of both the measurement of assets and liabilities in financial statements and of lease accounting. Although this Application has been updated to reflect the revisions made to various standards in 2003 as part of the IASB "Improvements Project", further changes may be necessary as a result of these continuing review projects.

5.0 Application

To perform valuations that comply with this Application and Generally Accepted Valuation Principles (GAVP), it is essential that Valuers adhere to all sections of the IVS Code of Conduct pertaining to Ethics, Competence, Disclosure, and Reporting (sections 4, 5, 6, and 7)

5.1 ***Classification of Assets*****. Valuers shall obtain from the directors of the owning entity a list of assets to be valued, designating them as operational assets, i.e., assets requisite to the operations of the entity, or non-operational assets, being properties held for future development, investment, or assets surplus to the operations of the entity.**

5.2 ***Applicable Standards.*** **The classification of assets determines which IAS or IFRS applies. IAS 16 requires non current property and plant assets held for the production or supply of goods or services to be recognized initially in the balance sheet at cost and thereafter carried in accordance with either the cost model or fair value model described in 5.3. Other accounting standards that require or permit the valuation of tangible assets include:**

- **Investment Property – IAS 40**
- **Leases – IAS 17**
- **Impairment of Assets – IAS 36**
- **Inventories – IAS 2.**
- **Business Combinations – IFRS 3**
- **Non current Assets Held for Sale and Discontinued Operations – IFRS 5**

5.3 IAS 16, *Cost and Fair Value*

5.3.1 IAS 16 deals with the cost model in paragraph 30 as follows:

"After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses."

5.3.2 The fair value model, which requires regular revaluations, is explained in paragraph 31 as follows:

"After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date."

5.3.3 Fair value is not necessarily synonymous with *Market Value*. It is used throughout IFRSs in differing contexts.

5.3.4 Financial statements are produced on the assumption that the entity is a going concern unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so. (IAS 1, para 23). This assumption therefore underlies the application of fair value to property plant and equipment, except in cases where it is clear that there is either an intention to dispose of a particular asset or that option of disposal has to be considered, e.g. when undertaking an impairment review.

5.4 ***Valuations under IAS 16.***

Where an entity adopts the fair value revaluation option under IAS 16, the assets are included in the balance sheet at their fair value as follows:

a) "The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal" (IAS 16, para. 32).

b) "If there is no market-based evidence of fair value because of the specialised 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 a depreciated replacement cost approach" (IAS 16, para. 33).

5.4.1 IVSC considers that the a professional Valuer undertaking an appraisal for this purpose should report the *Market Value* of the asset.

Any assumptions or qualifications made in applying *Market Value* should be discussed with the entity and disclosed in the report.

5.4.2 The valuation conclusion shall be reported in accordance with IVS 3, Valuation Reporting. Valuers shall ensure that reports include sufficient information for the entity to meet the requirements of IAS 16, para. 77, when preparing financial statements:

a) the effective date of the revaluation;

b) whether an Independent Valuer was involved (Note, IVSC interprets this as an *External Valuer*);

c) the methods and significant assumptions applied;

d) the extent to which the values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms, or were estimated using other valuation techniques

5.5 ***Valuations under IAS 40 - Investment Property.***

Where an entity opts to account for investment property using the fair value model, IVSC considers that the requirements of this model are met by the Valuer adopting *Market Value*. Further guidance on Investment Property is provided at para. 6.6.

5.5.1 IAS 40, para. 75, requires amongst others the following disclosures, which the Valuer should include in the Report in addition to the requirements of IVS 3

a) the methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity should disclose) because of the nature of the property and lack of comparable market data; and

b) the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an Independent Valuer (IVSC interprets this as an *External Valuer*), who holds a recognised and relevant professional qualification and who has recent experience in the location and category of the investment property being valued.

5.6 ***Valuation Requirements for Leased Assets – IAS 17***

5.6.1 **Leased assets are classified under IAS 17 as either finance leases or operating leases, see para. 6.5.1 below and Addendum A, If a lease is classified as a finance lease, the fair value of the asset is required to establish the amount of the asset and liability recorded by the entity on its balance sheet, IAS 17, para 20.**

5.6.2 **For leases of land and buildings special rules apply, which are described in para. 6.5.3. For all property, other than investment property, land and buildings have to be considered separately for classification as either a finance lease or an operating lease.**

5.6.3 **IAS 40 allows Investment Property held by a lessee to be accounted for as a finance lease under IAS 17, subject to further special rules. Firstly, no allocation is made between the land and buildings. Secondly, the fair value is recognized as the value subject to the lessee's future liabilities under the lease.**

5.6.4 **IVSC considers that in each case the requirement to establish the fair value of the leased asset under IAS 17, para 20, is met by the Valuer reporting the *Market Value*. For leases of real estate, this is the *Market Value* of the lease interest held by the lessee. For leases of other assets, it is normally the *Market Value* of the asset unencumbered by the lease, as the liability is recorded separately.**

5.7 ***Valuation of Impaired Assets – IAS 36***

5.7.1 **Impairment arises where there is a permanent decrease in the value of an asset below its carrying amount. The entity is required to write down the carrying amount of an impaired assert to the higher of its *value in use* or *fair value less costs to sell*. The requirements are discussed further at para. 6.8.2.**

5.8 ***Valuations after Business Combinations* – IFRS 3**

5.8.1 **Where a business acquires or is merged with another, the acquirer has to account for the assets and liabilities of the acquiree at their fair value as of the acquisition date. For identifiable assets and liabilities, IVSC considers that the Valuer should report the Market Value as they existed at the date of acquisition.**

5.9 ***Surplus Assets – IFRS 5***

5.9.1 **Under IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*, surplus assets are to be separately identified. Such assets**

may be accounted for individually or as a "disposal group", i.e., a group of assets to be disposed of together, by sale or otherwise, and the liabilities directly associated with those assets that will also be transferred in the transaction. Surplus assets are to be initially accounted for at the lower of the carrying amount and the fair value less costs to sell, and subsequently at fair value less cost to sell. Valuers should therefore ascertain whether surplus assets are to be valued as individual items, or as a group or portfolio of assets that will be disposed of in a single transaction, and report the *Market Value* with the appropriate assumptions.

5.10 ***Properties Held for Sale in the Ordinary Course of Business – IAS* 2**

5.10.1 Valuations of properties held for sale in the ordinary course of business should comply with the requirements of IAS 2, *Inventories*. These properties are measured at the lower of cost and *net realisable value.* Net realisable value is the *Market Value* less the costs of sale.

5.11 ***Selling Costs***

5.11.1 When instructed to value impaired or surplus assets, or assets that are held for sale in the course of business, the Valuer must report their *Market Value* without deducting selling costs. If the client requests the Valuer to advise on the costs to sell the assets, such costs are to be reported separately.

5.12 Biological Assets – IAS 41

5.12.1 These include Agricultural and Forestry assets. The Valuer should value these assets in accordance with the guidance in GN 10.

5.13 ***Co-operation with Auditors*. Subject to first obtaining the consent of their client, Valuers shall discuss and explain their valuations openly with the entity's auditors.**

6.0 Discussion

6.1 *Identification of Asset Class*

Separate disclosures are required for each class of property, plant and equipment. IAS 16, para. 73, requires that financial statements shall disclose for each class the measurement basis used for determining the gross carrying amount, the depreciation method used, and the useful lives or the depreciation rates used. A class of property, plant or equipment is a grouping of assets of a similar nature and use. The following are examples of separate classes (IAS 16, para. 37):

a) land;
b) land and buildings;
c) machinery;
d) ships;
e) aircraft;
f) motor vehicles;
g) furniture and fixtures;
h) office equipment

When an item is revalued, the entire class to which it belongs should be revalued in order to avoid both selective revaluations and the reporting of a mix of costs and fair values as at different dates. An asset class for this purpose is a grouping of assets of a similar nature and use in an entity's operation

6.2 *Depreciation – IAS 16*

6.2.1 IAS 16, paras. 43–62, sets out the requirements for an entity to account for the depreciation of property, plant and machinery assets. Valuers may be requested to allocate value between different elements of an asset, to advise on the residual value or to advise on the future life of an asset.

6.2.2 *Elements of cost.* Any part of an item, which has a cost that is significant in relation to the total cost of the item, has to be depreciated separately. Where parts have a similar useful life and will depreciate at a similar rate, they may be grouped in determining the depreciation charge. Valuers may be consequently requested to allocate a valuation they have provided to the different component parts of an asset in order to enable the entity to depreciate them separately.

6.2.3 *Residual Value.* The residual value is deducted from the carrying amount of the asset to determine the amount the entity has to depreciate. If the management policy of the entity involves disposal after a specific time, the useful life of an asset may be less than its economic life. IAS 16, para. 58, recognises that land normally has an unlimited useful life and therefore should be accounted for separately. It also provides that an increase in the value of land should not affect the determination of the depreciable amount of the building.

6.2.4 *Future life*. A Valuer can advise on the remaining economic life of the asset. When reporting the economic life of buildings, improvements, plant and equipment, it should be stated that this is not necessarily the same as the useful life to the entity, which is subject to any policy of the entity on future disposal or renewal.

6.2.5 *Reporting requirements*: When providing allocations, or estimating the residual value of an element of an asset based on an apportionment of the value of the complete asset, the Valuer should state that the figures provided are hypothetical allocations of the value of the whole item prepared solely for calculating the appropriate rate of depreciation in the entity's financial statements, and that these figures should not be relied upon for any other purpose.

6.3 *Alternative Use Value*

If an owner-occupied property has potential for an alternative use, which would result in its value in isolation from the business being higher than its *value* as part of the *cash-generating unit* to which it belongs, the Valuer shall report the *Market Value* for that alternative use. A statement should also be made that the *value* for the alternative use takes no account of issues such as business closure or disruption and the associated costs that would be incurred in achieving the alternative use, and that these should be considered by the entity when deciding the appropriate amount to adopt as fair value.

6.4 *Specialised Property*

Both IVSs and IAS 16 recognize that there are categories of assets for which market-based evidence may be unavailable because of their specialized nature. It endorses the application of either an income or depreciated replacement cost approach to the valuation of these assets. The choice of approach is not dictated by the type of asset but by the presence or absence of market evidence. For further discussion and guidance on the use of these approaches see paras. 5.11 and 5.13 of GN 1 and section 5 of GN 8.

6.5 *Frequency of Revaluation*

Paragraph 31 of IAS 16 states:

> "Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date"

6.6 IAS 17 – *Leased Property, Plant and Equipment*

6.6.1 IAS 17 deals with the accounting for assets that are held under a lease. All leases require classification as either operating leases or finance leases (see para. 5.6.1 above and Addendum A). Different accounting treatments apply to each type of lease. A finance lease is recorded in a lessee's balance sheet as both an asset and a liability at amounts equal to the fair value of the asset or, if lower, the present value of the minimum lease payments, each determined as at the inception of the lease. Any initial direct costs incurred by the lessee are added to the amount recognized as an asset.

6.6.2 Valuers may be required to advise on the fair value of the asset at the inception of the lease to enable a lessee to account for the asset correctly in accordance with IAS 17.

6.6.3 Special provisions apply to leases of land and buildings. IAS 17, para. 14, states that "because a characteristic of land is that it normally has an indefinite economic life … a lease of land will be an operating lease". Where a lease is of land and buildings, these elements have to be considered separately for the purposes of lease classification (IAS 17, para. 15). Most leases of real property will grant the lessee rights to occupy both the land and buildings, following which the interest in both elements reverts to the lessor. If the lessee also has to maintain the building and hand it back to the lessor in good repair, it is probable that both elements will correctly be classified as operating leases (see Addendum A). If both elements are not considered to share the same classification, the minimum lease payments (including any initial capital payment) are allocated between the land and buildings elements in proportion to the relative fair values of the leasehold interests in the two elements at the inception of the lease. If the lease payments cannot be reliably allocated the entire lease is treated as a finance lease, unless it is clear that both elements are operating leases (IAS 17, para. 16). This allocation is not required in the case of a lessee's interest accounted for as investment property (IAS 17, para. 18).

6.6.4 For further guidance on Leasehold interests, see Addendum A.

6.7 IAS 40 -- *Investment Property*

6.7.1 IAS 40 defines an *investment property* as a property (land or a building--or part of a building--or both) held by the owner, or by a lessee under a finance lease, to earn rentals, or for capital appreciation or both. It excludes owner-occupied property used for the production or supply of goods or services, or for administrative purposes, and also property held for sale in the ordinary course of business.

6.7.1.1 If part of a property is held as an investment property and part is owner-occupied, if the parts could be sold or leased separately, the parts are accounted for separately. If the parts could not be sold separately, the property is an investment property only if an insignificant proportion is held for the production or supply of goods or services or for administrative purposes (IAS 40, para. 10).

6.7.1.2 Property leased to a subsidiary or parent under an inter-company leasing arrangement does not qualify as investment property in the consolidated financial statements of the group, but may be treated as such in the individual financial statements of the lessor entity (IAS 40, para. 15).

6.7.2 Investment property is measured initially at cost. After initial recognition an entity may choose to adopt either:

a) *The Fair Value Model*. *Investment property* should be measured at fair value and changes recognised in the profit and loss statement; or

b) *The Cost Model*. The "historic" cost model is in accordance with the model described in IAS 16. An entity that chooses the (historic) cost model should nonetheless disclose the fair value of its investment property.

6.7.2.1 The fair value model is described in detail in IAS 40, paras. 33 - 55. The *Market Value* of the entity's interest in the investment property derived in accordance with IVS 1 accords with these detailed requirements. The *Market Value* will reflect any current leases, current cash flows and any reasonable assumptions about future rental income or outgoings.

6.7.3 *Leasehold investment property.* A property held under a lease, rather than owned outright, and that otherwise meets the definition of an investment property, may be accounted for using the fair value model. If this option is taken for one such property held under a lease, all property classified as investment property shall be accounted for using the fair value model (IAS 40, para. 6).

6.7.3.1 IAS 40, para. 50(d), recognizes that the fair value of an investment property held under a lease will reflect the net income after deduction of future lease liabilities. Although the entity is required to add to the reported fair value any recognised lease liability to arrive at the carrying amount for accounting purposes, this does not affect the requirement for the Valuer to report *Market Value*.

6.7.3.2 At initial recognition an investment property held under a lease shall be accounted for as though it were a finance lease under IAS 17, para. 20, i.e., at the fair value of the property, or if lower, at the present value of the minimum lease payments. Any capital sum paid to acquire the property interest is treated as part of the minimum lease payments and is therefore included in the cost of the asset (IAS 40, para. 25).

6.7.3.3 Subsequent measurement of an investment property held under an operating lease requires the fair value model to be adopted (see para. 6.6.3.1 above).

6.7.4 *External Valuations.* Entities are encouraged, but not required, to determine the fair value of investment property on the basis of a valuation by an Independent (External) Valuer who holds a recognised and relevant professional qualification and who has recent experience in the location and category of the investment property being valued (IAS 40, para. 26).

6.8 Other Requirements under IASs

6.8.1 *Portfolios*: A collection or aggregation of properties held by a single ownership and jointly managed is referred to as a *portfolio*. The *Market Value* of such assets viewed or treated as a portfolio or as an assembled group of properties could exceed or could be less than the sum of the *Market Value* of each asset individually. Where this is the case, it should be reported separately to the directors or trustees.

6.8.2 *Impairment*: An entity is required, under IAS 36, *Impairment of Assets*, to review, at each balance sheet date, whether there is any indication that a tangible asset may be impaired. Impairment might be indicated by, for example, a reduction in the value of the asset because of market or technological changes, obsolescence of the asset, asset underperformance in comparison to the expected return, or an intention to discontinue or restructure operations. If impairment is considered to have arisen, the *carrying amount* of the asset, derived from either its historic cost or an earlier valuation should be written down to the *recoverable amount*, which is the higher of the asset's *value in use* or its *fair value less costs to sell*. *Value in use* reflects the value that the entity will obtain from the asset throughout its remaining useful life to the business and its eventual disposal. Although entity-specific, the valuation inputs for the *value in use* of an asset should be market determined wherever possible. However, if the value an entity can obtain from the continued use of an asset is less than the net proceeds that could be obtained from its immediate retirement and disposal, the *carrying amount* should reflect this latter figure. The *fair value* less *costs to sell* of an asset is its Market Value less the reasonably anticipated selling costs.

6.8.3 *Disrupted Markets*: When markets are disrupted or suspended, Valuers must be vigilant in their analyses as explained in IVS 1, paragraph 6.5. Under IAS 29, *Financial Reporting in Hyperinflationary Economies*, Valuers may be required to assess balance sheet value.

7.0 Disclosure Requirements

7.1 **The Valuer shall make all disclosures required under IVS 3, Valuation Reporting.**

7.2 **For disclosures required under IASs, see paragraphs 5.4.2, 5.5.1 and 6.1 above.**

7.3 **The Valuer shall disclose the regulatory framework and any departure required from these Standards to comply with local legislation, regulation (including accounting rules), or custom.**

8.0 Departure Provisions

8.1 **In following this Application any departures must be in accordance with directions made in IVS 3, Valuation Reporting.**

9.0 Effective Date

9.1 This International Valuation Application became effective 31 January 2005.

Addendum A

Further Guidance on Lease Accounting

Lease Classification

Under IAS 17, leases have to be classified for inclusion in financial statements as either operating leases or finance leases:

> A *finance lease* is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not be eventually transferred.
>
> An *operating lease* is a lease other than a finance lease.

The following examples are listed in IAS 17, paras 10-11, as situations that could be indicative of a finance lease, either individually or in combination. These are not absolute tests but illustrations, i.e., one or more of these circumstances may arise, but the lease would still not be classified as a finance lease if it is clear from the overall context that substantially all the risks and rewards of ownership have not been transferred from the lessor to the lessee.

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset on advantageous terms;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications;

(f) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(g) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee;

(g) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

If it is concluded that substantially all the risks and rewards of ownership are not transferred to the lessee, then the lease is an operating lease.

As classification does involve an assessment of the degree to which economic benefits are transferred by a lease, Valuers are likely to be requested to provide advice to assist classification by lessor and lessees. IVSC considers that in the majority of cases, a qualitative assessment of the lease terms will quickly indicate the correct classification without the need for detailed calculation of the value of the different lease interests. The relative values of the lessor's and lessee's interests are not a key factor in classification; the key test is whether the lessor has transferred substantially all the risks and rewards of ownership.

Land and Building Allocation

Where a lease is of land and buildings together, IAS 17, para. 15, requires that the two elements be considered separately for the purposes of classification. If it appears that the buildings element could be a finance lease, it will be necessary to make an allocation of the initial rent based on the relative fair values of the leasehold interests in each element at the inception of the lease (IAS 17, para. 16).

In most leases of real property, the interest in the land and buildings is not distinguishable, and in any event the interest in both normally reverts to the lessor at the end of the lease. There are often provisions for the rent to be reviewed periodically to reflect changes in the *Market Value* of the property and also an obligation on the lessee to hand the buildings back to the lessor in good repair. These are all clear indicators that the lessor has not transferred substantially all the risks and rewards of ownership of either the buildings or the land to the lessee.

Consequently, finance leases of real property will generally arise only where the lease is clearly designed as a way of funding the eventual purchase of the land, buildings, or both by the lessee, often by means of an option to acquire the lessor's interest for a nominal sum after the rental payments have been made. Occasionally leases that are not clearly structured as finance agreements may meet some of the criteria of a finance lease, for example, where the rental payments do not reflect the underlying value of the property. In those cases a more detailed analysis of the value of the risks and benefits transferred may be required in order to confirm or rebut their classification.

Under IAS 17, para. 17, allocation between the land and buildings elements of an investment property held under a lease is not required. Under IAS 40, even though the investor may hold the investment property under an operating lease, the whole is accounted for as though it were a finance lease.

Where a lease is of a self-contained plot of land and the building upon it, allocating the rent to each element is a task that could be undertaken reliably where there is an active market for land for similar development in the locality. In other situations, for example where the lease is of part of a multi-let building with no identifiable land attributable to any particular lease, reliable allocation may be impossible. IAS 17, para. 16, recognises that such cases can arise and makes the proviso that where a reliable allocation cannot be made, the whole lease should be treated as a finance lease, unless it is clear that both elements are operating leases. If it were clear that both elements were operating leases from the outset, the allocation exercise would not be necessary.

In practice, leases of part of a multi-let building will normally be operating leases and the whole property will be classified as investment property by the lessor. In such cases allocation will be unnecessary. In cases where the buildings element is clearly a finance lease, the land element is likely to be identifiable. It will be comparatively rare for the buildings element to meet the criteria for classification as a finance lease and for the land element not to be clearly identifiable. In such cases, the Valuer should not attempt an allocation based on unreliable criteria, but should advise that the allocation cannot be reliably made. The entity will then have to treat the whole as a finance lease.