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Market Value

1.0 Introduction

In the context of the valuation of real property assets, this book provides an analysis of the International Valuation Standards (IVS), International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) which, being dynamic, are regularly updated and/or replaced. Accordingly, readers should not rely upon this book as a current statement of an IVS, IAS or IFRS publication and should visit www.ifrs.org and/or www.ivsc.org to find the most recent version.

This chapter seeks to outline the emergence of globalisation, the role of IFRS and the evolution of valuation standards setting, the role of the International Valuation Standards Council (IVSC) and IVSs and an analysis of market value, being the central concept of IVSs, with an overview of other IVSs relevant to the valuation of businesses and business interests, intangible assets and financial instruments.

Chapter 2 will then develop a conceptual framework for valuation based on economic theory, align this framework with finance and capital market theory, examine the definition of the market and distinguish definitions of cost and price from defined concepts of value before reconciling these to the conceptual framework for valuation.

Chapter 3 will consider various aspects of valuation standard definitions within IVSs, discuss the definitions of other relevant contextual terms and identify the principal approaches to valuation within IVSs including a focus on the market approach to valuation.

International Valuation Standards: A Guide to the Valuation of Real Property Assets, First Edition. David Parker.

Chapter 4 will describe and analyse those elements of IVSs that are of relevance to the three principal stages of the real property valuation process, being the instruction of the valuer, undertaking the valuation and reporting the valuation.

Chapter 5 will consider IVSs in the context of the valuation of investment property, with particular reference to IAS 40 *Investment Property* and the income approach to valuation, including an examination of IVSC TIP 1 *Discounted Cash Flow*.

Finally, Chapter 6 will focus on IVSs in the context of the valuation of owner occupied property held by operating businesses, with particular reference to IAS 16 *Property, Plant and Equipment* and the cost approach to valuation, including an examination of IVSC TIP 2 *The Cost Approach to Tangible Assets*.

In many countries around the world, national and local valuation professional bodies adopt IVSs and supplement them with national or local valuation practice guidance which may expand upon IVSs in a national or local context for the benefit of their membership. However, only the Royal Institution of Chartered Surveyors (RICS) produces global valuation practice guidance that adopts and expands upon IVSs but is not country specific, comprising mandatory professional standards and valuation practice statements and non-mandatory practice guidance applications and practice guidance notes for use by members globally – generally referred to as the RICS Red Book Global (RICS 2013). Accordingly, this book refers to the RICS Red Book Global for the purposes of considering how a professional body interprets IVSs for application by its members worldwide but without a country-specific application.

This book is based upon International Valuation Standards 2013 (IVSC, 2013) and International Financial Reporting Standards 2013 (IFRS, 2013). Given their nature, IVSs, IAS's and IFRSs are dynamic, being regularly updated and with the most recently published versions replacing previously published versions. Accordingly, readers should not rely upon this book as a current statement of an IVS, IAS or IFRS publication and should visit www.ifrs.org and/or www.ivsc.org to find the most recent version.

1.1 Globalisation and valuation

This section seeks to outline the emergence of globalisation and the role of IFRS, with the following sections considering the evolution of valuation standards setting, the role of IVSC and IVSs and an analysis of market value, being the central concept of IVSs, with an overview of other IVSs relevant to the valuation of businesses and business interests, intangible assets and financial instruments.

1.1.1 Globalisation

Globalisation has increasingly gained pace since the end of the Second World War, with the Bretton Woods Agreement on international monetary policy, commerce and finance, the emergence of container shipping and the growth in international air travel as examples of global developments facilitating increasing international integration in trade and commerce. The late twentieth-century developments in communications, computing and the advent of the internet facilitated even greater globalisation in banking, finance and investment contributing to the current very high level of interconnectedness between the world's major economies.

The establishment of the International Monetary Fund, World Bank and Basel Committee on Banking Supervision provide examples of the impact of globalisation in the financial markets, with groups such as the G20 providing an example of governmental globalisation. The creation of the European Union led to the free movement of labour and capital across Europe and a common currency, with the fall of the Berlin Wall leading to the creation of independent eastern European states which further enhanced European movement of labour and capital.

A series of bilateral and later regional trade agreements between countries, the formation of GATT and the World Trade Organisation have each fostered the development of international trade and the growth of multinational corporations such as HSBC and Airbus, making it economically feasible for a European based company to manufacture goods in China or India and sell to world markets in the USA or Africa, either directly through the supply chain leading to the world's shopping centres or indirectly through fulfilment of internet orders.

The increasing impact of globalisation has the effect of reducing the significance of national and political borders and increasing the significance of economic integration. The interconnectedness of the world's major economies was glaringly apparent during the Global Financial Crisis towards the end of the first decade of the twenty-first century, when problems arising in the US property, banking and finance markets rapidly became problems for the property, banking and finance markets of each of the world's major economies.

In the context of property, the growth in multinational corporations has significantly increased the amount of property in other countries held by businesses for the purposes of operations. As a result of globalisation, such multinational corporations as HSBC and Airbus have become significant property owners and occupiers in a vast number of countries around the world. Similarly, property investment has rapidly globalised in the last 25 years with the emergence of sovereign wealth funds in the 1970s building diversified global property portfolios and many pension funds, superannuation funds, real estate investment trusts (REITs) and other property fund managers seeking to invest outside their country of origin, resulting in many of the major office, shopping centre, hotel and warehouse properties of large cities around the world now being owned by foreign investors.

The globalisation of property has been mirrored by the globalisation of property services groups, with the UK Richard Ellis merging with the US Coldwell Banker to become CBRE and the UK Jones Lang Wootton merging with the US LaSalle Partners in 1999 to become Jones Lang LaSalle or JLL, with 30,000 staff in 750 locations in 60 countries (Babawale, 2012a).

Consistent with trends in other parts of the economy worldwide, the emergence of both multinational corporations and international property investors has created the demand for international valuation services and the merger of major national firms into international property services groups has created the supply of international valuation services.

1.1.2 International Financial Reporting Standards

In an increasingly global marketplace, international comparability of information is essential to enable the effective allocation of scarce resources. Accordingly, global businesses require a common basis for company accounts that is understandable, comparable, reliable and relevant for internal and external users across different countries.

As globalisation evolved, it became apparent that national accounting standards would be both inadequate for and complicate international business and investment. The apparent need for international accounting standards led to the formation of the International Accounting Standards Committee (IASC) in 1973 by accounting bodies from Australia, Canada, France, Germany, Mexico, the Netherlands, the United Kingdom, Ireland and the United States. The aim of the IASC was to achieve consistency internationally in definitions, measurement and treatment of transactions in the course of business or investment to enable financial reporting that permitted cross country comparability and appreciation. (Dugeri et al., 2012) Those standards issued by the IASC between 1973 and 2001 comprise the International Accounting Standards (IAS's).

From 2001, the International Accounting Standards Board (IASB) succeeded the IASC and assumed the full standard setting role for the accountancy profession worldwide, with those standards issued by the IASB from 2001 comprising the IFRS (Dugeri et al., 2012). The objectives of the IASB are:

- to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles;

- to promote the use and rigorous application of those standards;
- to take account of the needs of a range of sizes and types of entities in diverse economic settings; and
- to promote and facilitate the adoption of IFRS through the convergence of national accounting standards and IFRS's (IFRS, 2013, para 6, page A10).

The IASB achieves its objectives primarily by developing and publishing IFRS's and promoting their use (IFRS, 2013, para 7, page A10). IFRS's set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in general purpose financial statements (IFRS, 2013, para 8, page A11), prepared by the entity (IAS 1, para 2, page A541) on the going concern assumption (IAS 1, para 25, page A547).

Those IAS's and IFRS's of principal relevance to the valuation of real property assets include:

IAS 16	*Property, Plant and Equipment*
IAS 17	*Leases*
IAS 36	*Impairment of Assets*
IAS 40	*Investment Property*
IFRS 5	*Non-Current Assets Held for Sale and Discontinued Operations*
IFRS 13	*Fair Value Measurement*

Currently, around 100 countries have adopted IFRS including the European Union, Australia, Canada, Montenegro and Nepal. However, major economies such as the USA, Japan and India are yet to require IFRS for listed companies.

The benefits of IFRS, as a common basis for accounting worldwide, includes the provision of high quality, transparent and comparable information in financial reporting to help investors, other participants in the various capital markets of the world and other users of financial information make economic decisions (IFRS, 2013). Such transparency and comparability aids the global flow of capital between countries, supports national economies and improves international competitiveness as well as reducing financial reporting costs, improving the quality of financial reporting and providing more useful information to decision makers.

Therefore, for such multinational corporations as HSBC and Airbus and for international property investors such as sovereign wealth funds, pension funds, superannuation funds, REITs and other property fund managers, who have become significant property owners and occupiers in a vast number of countries around the world, IFRS effectively provide one common basis for accounting worldwide facilitating the ultimate 'apples with apples' comparison for the purpose of decision making.

1.1.3 Valuation

While IFRS effectively provide one common basis for accounting worldwide, in order for IFRS to provide a reliable decision-making basis in the context of property, the provision of those inputs concerning property valuation also need to be undertaken on one common basis worldwide.

The global client base driving the adoption of international standards in accounting and banking also required the same for valuation, given that valuation is the basis for lending decisions, financial reporting of multinational companies, cross border property investment, securitisation of real estate and so forth (Babawale, 2012b):

> In the emerging globalised world, valuations that would be relied upon internationally can therefore be produced only by a valuation profession that conforms to international standards of professional education, competence and practice. (Babawale, 2012a)

Essentially, the principal drivers for the introduction and adoption of international valuation standards may be identified as:

- the requirement of Governments for valuations of publicly owned assets for the purpose of accountability, measurement of performance and financial transparency;
- the trend towards the privatisation of Government enterprises;
- the development of international accounting standards;
- emerging economies with no established skill or depth in real estate appraisal;
- the Basel Committee on bank lending;
- world trade agreements, designed to balance world trade practices;
- the move towards a fair value accounting model;
- the activities of the United Nations Conference on Trade and Development, which is working towards the harmonisation of accounting and other professional practices; and
- the need for performance measurement of both investment property and owner occupied property to contribute to the measurement of property, portfolio and company management performance (Edge, 2001).

While the principal benefit of converging valuation regulation internationally with accounting regulation may be contended to be the efficient and effective functioning and stability of global capital and debt markets, several further benefits of global regulatory convergence may be identified:

- improving the comparability of financial information, with consistent valuation practices supporting the transparency and credibility of

valuations in financial reporting globally, so increasing the potential mobility of capital across national borders and providing all decision makers with consistent, high quality, reliable information with which to make informed investment, resource and policy decisions;
- improving the auditability of financial statements, with adoption and application of globally consistent valuation standards providing auditors with clear benchmarks to assess whether valuations included in financial statements are reasonably founded;
- reducing the effects of systemic risk, with a reduction in the threats to the global financial systems of such behaviours as over confidence in rising markets and extreme risk aversion in falling markets which may heighten systemic risk in globally connected markets such as banking, insurance and securities;
- reducing information costs, with multinational companies and global property investors being able to measure assets consistently in different countries which reduces the cost of preparing financial statements and the need to reconcile differing valuation approaches;
- decreasing the opportunities for regulatory arbitrage by removing opportunities for pricing differentials that do not have a basis in economic fundamentals but instead arise from different valuation practices;
- providing an underpinning for a global regulatory system, through which global bodies such as the G20 can develop global solutions to address global issues with regulatory convergence facilitating intergovernmental co-operation, greater institutional linkages and international policy integration; and
- providing additional benefits for developing and emerging economies, through the adoption and implementation of existing high-quality, internationally accepted standards recognised by international bodies, governments, investors, corporations, lenders and so forth (IVSC, 2014).

The development of international valuation standards that are consistent with IFRS contributes to achieving such benefits and provides investors, regulators, and users of valuations with that which they seek, being consistency, clarity, reliability and transparency in valuation reporting worldwide (Edge, 2001), as:

> Clients need to understand that a valuation produced in Massachusetts, Manchester, Melbourne, Moscow or Matabeleland is reliable in its standards and its methodologies. (Gilbertson, 2002)

Like the journey to achieve one common basis for accounting worldwide through IFRS, the journey to achieve one common basis for valuation worldwide was an evolutionary process spanning almost half a century.

1.2 Evolution of valuation standard setting

The previous section sought to outline the emergence of globalisation and the role of IFRS, with this section seeking to consider the evolution of valuation standards setting and the role of IVSC and IVSs, with the following sections then seeking to analyse market value, being the central concept of IVSs and to provide an overview of other IVSs relevant to the valuation of businesses and business interests, intangible assets and financial instruments.

The challenge facing international valuation standard setters may be summarised as follows:

> Deals happen. There is not a perfect market. This imperfection makes a valuer's task very difficult. The valuer has to interpret where the market is going. A valuation is like a snapshot in time.
>
> Imagine a photograph containing a ball in flight. Is it actually going up or down? That's what the client wants to know. He would really like to know where that ball will be after an agreed period of time, but that is probably too difficult for all but the crystal ball gazers.
>
> Valuers have to reflect, not make, the market. A valuation could be a surrogate pricing process. Whereas, worth is what the purchaser is prepared to pay. What is value? Does value exist? Can value really be measured or is it ethereal?
>
> Does a valuer work in the property market, or measure the market in property? (Gilbertson, 2002)

with this challenge exacerbated by the booms and busts of independent and interdependent cyclical national property markets worldwide.

1.2.1 Principal phases

The journey to achieve one common basis for valuation worldwide has been an evolutionary process spanning almost half a century, which may be contended to comprise the following principal phases (Babawale 2012a, 2012b; Banfield, 2014; Dugeri et al., 2012; Edge, 2001; French, 2003; IVSC, 2015a; Mackmin, 1999; Mallinson and French, 2000):

- **initial development of valuation standards in the UK:**
  Arising from the 1970s UK recession and the 1974 UK property crash which precipitated a loss of credibility for the valuation profession, RICS established a joint working party with the Institute of Chartered Accountants in England and Wales in 1973 to report on the valuation of property assets, followed by the formation of the Asset Valuation Standards Committee in 1974 which developed guidance notes;

Following Greenwell's (1976) criticism of traditional capitalisation of income methods as incorrect, illogical and by deduction, leading to inaccurate valuations, RICS responded by establishing a research programme into valuation methods and published *Guidance Notes on the Valuation of Assets* in 1976, the original RICS Red Book, being endorsed by the Bank of England, London Stock Exchange, City Panel on Takeovers and Mergers, banking associations and others; The Red Book has been regularly updated since, including reflection of the RICS-initiated Trott Report (1980, 1986), Mallinson Report (1994) (incorporated in the 1996 RICS Red Book) and Carsberg Report (2002);

- **followed by development of regional European valuation standards:** The European Group of Valuers of Fixed Assets (TEGOVOFA) was created in 1977, now The European Group of Valuer Associations (TEGoVA), which created a set of regional European valuation standards published in 1981 as the Blue Book or Guide Bleu;
- **and development of valuation standards internationally:** The International Assets Valuation Committee (TIAVSC) was created in 1981/82 which metamorphosed into the International Valuation Standards Committee in 1996 and the International Valuation Standards Council (IVSC) in 2008, having published the first International Valuation Standards in 1985;

  Since 2000, IVSC published IVSs reviewed in accordance with IFRS, reflecting international regulatory convergence, with the process coming full circle as the 2003 edition of the RICS Red Book adopted and supported IVSs; and

  In 2014, IVSC Trustees commissioned an independent assessment 'to ensure the organisation is equipped for the next phase of its development' (IVSC, 2015a). A Review Group was created which assessed the governance, financial stability, processes and outputs of IVSC and made recommendations for improvements which are currently in the process of evaluation and implementation.

Therefore, valuation standards developed out of valuation practice rather than out of valuation theory, having evolved independently of economic theory, finance theory and capital market theory, the effect of which will be considered in greater detail in Chapter 2. Significantly, the development of valuation standards worldwide was initially undertaken by national valuation professional bodies independently or in association and then internationally for around 30 years, but in a property vacuum until 2000 when convergence with the common basis for accounting worldwide was undertaken, reflecting the demands of globalisation and leading to the evolution of one common basis for valuation worldwide.

1.2.2 Role of IVSC

The IVSC is an independent, non-profit organisation incorporated in the USA which has two principal functions:

- to develop and promulgate globally recognised financial standards, acceptable to the world's capital market organisations, regulators and market participants; and
- to act as a global focus for the valuation profession;

which came into sharp focus following the Global Financial Crisis from 2007 when G20 leaders called for standard setters to improve valuation principles and to achieve clarity and consistency worldwide (IVSC, 2009).

The objective of the IVSC is to build confidence and public trust in the valuation process by creating a framework for the delivery of credible valuation opinions by suitably trained valuation professionals acting in an ethical manner (IVSC, 2013).

In its policy paper on *Global Regulatory Convergence and the Valuation Profession*, IVSC succinctly stated:

> With many corporations and financial institutions now operating globally, convergence of the diverse systems of national regulation of the financial markets is essential for both effective regulation and to facilitate economic growth.
>
> Consistent and effective regulation is important in promoting the comparability of financial information, minimising the effects of systemic economic risks, and helping to create a level playing field for international competition.
>
> For the valuation profession, regulatory convergence includes the global adoption and implementation of high-quality internationally accepted standards for the undertaking and reporting of those valuations that are relied upon by investors and regulators of the global financial markets. (IVSC, 2014)

Acting in the public interest, IVSC contends that valuation is a key input into financial information relied upon by investors and used to support decisions in financial markets, such as financial reporting, managing the solvency of financial institutions, supporting lending or other investment decisions and pricing units in collective investment schemes, that each have a direct impact on the public interest and that each will benefit from global regulatory convergence (IVSC, 2014).

IVSC operates by consulting with valuation users to identify their concerns, working with professional valuers to identify issues and projects and then developing and promoting solutions (such as standards, valuation applications or technical information papers) following an established process of public exposure and consultation. Enforcement of compliance with IVSs is, however, not undertaken by IVSC but by those regulators and national valuation professional organisations adopting the IVSs (IVSC, 2012a).

1.2.3 Role of IVSs

The two components of the role of IVSC, being to develop and promulgate international valuation standards and to act as a global focus for the valuation profession, are effectively intertwined. IVSC is required to develop standards at a conceptual or principle level that are capable of implementation internationally and which require both enforcement of implementation by national bodies or regulators and development of complementary and consistent national standards, where necessary, by national bodies or regulators.

1.2.3.1 Structure of IVSs

IVSs, by definition, are of international application, with the role of regional and national standards considered in the following section. It is through application that IVSs gain their status as, when a statement is made that a valuation has been undertaken in accordance with IVSs, it is implicit that all relevant standards are complied with and due account is taken of any supporting guidance issued by IVSC (IVSC, 2013, page 3). Accordingly, unlike some national and regional standards issued by valuation professional organisations for their valuer members, IVSs are not mandatory on valuers unless they state that they are undertaking a valuation in accordance with the IVSs.

The objective of the IVSs is to increase the confidence and trust of users of valuation services by establishing transparent and consistent valuation procedures (IVSC, 2013, page 2). An IVS is intended to do one or more of the following:

- identify or develop globally accepted principles and definitions;
- identify and promulgate procedures for the undertaking of valuation assignments and the reporting of valuations;
- identify specific matters that require consideration and methods commonly used for valuing different types of asset or liability; and/or
- identify appropriate valuation procedures for the major purposes for which valuations are required (IVSC, 2013, page 2).

An IVS contains either:

- requirements that have to be followed in order to produce a valuation that is compliant with the standards; or

- information or guidance that does not direct or mandate any particular course of action but which is intended to assist the development of better and more consistent valuation practice or that helps users better understand a valuation on which they intend to rely (IVSC, 2013, page 2).

While IVSs may be applied to assets or liabilities, this book only considers IVSs in the context of assets, specifically real property assets. The IVSs are arranged as a Framework, General Standards, Asset Standards, Valuation Applications and Technical Information Papers.

Further, it should be noted that, rather than necessarily adopting dictionary definitions or commonly used interpretations of terms, IVSs define and construe terms in a particular manner for the purpose of consistency in application and users should be aware of such definitions and constructions in order to appropriately apply IVSs. Within this book, a reference to a term as defined by IVSs is italicised, such that, for example, *market value* refers to the term 'market value' as it is defined in IVSs.

1.2.3.1.1 IVS Framework

The IVS Framework provides, as the name suggests, a framework or scaffolding within which the General Standards, Asset Standards, Valuation Applications and Technical Information Papers sit, setting forth generally accepted valuation principles and concepts that are to be followed in the application of each but not including any procedural requirements (IVSC, 2013, page 2).

The IVS Framework is principally considered in Chapter 2 in the context of valuation concepts and valuation approaches.

1.2.3.1.2 IVS General Standards

The IVS General Standards comprise:

- IVS 101 *Scope of Work*;
- IVS 102 *Implementation*; and
- IVS 103 *Reporting*;

which are considered in detail in Chapter 4. IVS General Standards set forth the requirements for the conduct of all valuation assignments (except as modified by an Asset Standard or a Valuation Application), being designed to be capable of application to valuations of all types of assets for any valuation purpose to which the IVSs apply (IVSC, 2013, page 2).

1.2.3.1.3 IVS Asset Standards

The IVS Asset Standards include:

- IVS 220 *Plant and Equipment*;
- IVS 230 *Real Property Interests*; and
- IVS 233 *Investment Property Under Construction*;

which are considered in detail in Chapters 5 and 6 plus others not directly concerning real property assets which are considered in section 1.4, below.

IVS Asset Standards include *Requirements* and *Commentary*, with *Requirements* setting forth any additions to or modifications of the requirements in the General Standards with illustrations of application. The *Commentary* provides background information on the characteristics of each asset type that influence value and identifies the common valuation approaches and methods used (IVSC, 2013, page 2).

As referred to in section 1.0, above, IVSs are dynamic, being regularly updated and/or replaced. Currently, IVS 230 and IVS 300 may be amended, IVS 233 may be retired and a generic guidance paper on the valuation of property in the course of development may be introduced. Accordingly, as stated above, readers should not rely upon this book as a current statement of an IVS, IAS or IFRS publication and should visit www.ifrs.org and/or www.ivsc.org to find the most recent version.

1.2.3.1.4 IVS Valuation Applications

The IVS Valuation Applications include:

- IVS 300 *Valuations for Financial Reporting*; and
- IVS 310 *Valuations of Real Property Interests for Secured Lending*;

which are considered in detail in Chapters 5 and 6.

IVS Valuation Applications address common purposes for which valuations are required, each including *Requirements* and *Guidance*, with *Requirements* setting forth any additions to or modifications of the requirements in the General Standards with illustrations of application. The *Guidance* provides background information on:

- the valuation requirements of internationally applicable regulations or standards issued by other bodies, such as IFRS;
- other commonly accepted requirements for valuations for that purpose; and
- appropriate valuation procedures to meet these requirements (IVSC, 2013, page 3).

1.2.3.1.5 Technical Information Papers

The Technical Information Papers (TIP's) include:

- TIP 1 *Discounted Cash Flow* (considered in Chapter 5);
- TIP 2 *The Cost Approach to Tangible Assets* (considered in Chapter 6);
- TIP 3 *The Valuation of Intangible Assets* (considered in section 1.4.2, below); and
- TIP 4 *Valuation Uncertainty* (considered in Chapter 4).

Technical Information Papers support the application of the requirements in other standards by:

- providing information on the characteristics of different types of asset that are relevant to value; and/or
- providing information on appropriate valuation methods and their application; and/or
- providing additional detail on matters identified in another standard; and/or
- providing information to support the judgement required in reaching a valuation conclusion in different situations (IVSC, 2013, page 3).

TIP's are neither a text book nor an academic discussion and are not intended to provide training or instruction to inexperienced valuers. While TIP's provide guidance, they do not prescribe or mandate the use of a particular approach but present information to an experienced valuer to assist in the selection of the most appropriate course of action to take (IVSC, 2013, page 3).

1.2.3.2 International, Regional and National Valuation Standards

Having considered the development of IVSs, the other component of the role of IVSC is to promulgate international valuation standards and to act as a global focus for the valuation profession. This is largely operationalised by IVSC through engagement with valuation professional organisations (VPOs), regulators and other groups around the world who enforce implementation and who may also develop complementary and consistent regional and/or national standards.

IVSC further describes its role as to promote and advance the global regulatory convergence agenda through the independent development of high-quality, internationally accepted valuation standards, provision of support for their adoption and implementation and engagement with member valuation professional bodies to promote consistent competency and ethical standards (IVSC, 2014):

> We serve the public interest by promoting consistent compliance with, and implementation of, high-quality, internationally accepted standards in the preparation and presentation of valuations around the world. (IVSC, 2015b)

Through the signing of a memorandum of understanding, IVSC has formalised its relationship with 20 VPOs to foster adoption of IVSs, with IVSC having engaged with 50 VPOs spanning geographically from the Norges Takseringsforbund to the Property Institute of New Zealand and from the China Appraisal Society to the Colombian Registro Nacional de Avaluadores. (IVSC, 2015b).

Such VPOs are generally the national valuation professional body for their country who advance the adoption and implementation of IVSs in that country, act to regulate individual valuers either through self-regulation or shared regulation with government and promote the benefits of IVSs to their government and regulators (IVSC, 2014).

With IVSC producing international standards, being a limited number of high level, principle based requirements which are supported with guidance and of common applicability across countries, it is then up to member VPOs to produce regional or national standards or guidance, as may be required for that jurisdiction, consistent with the provisions of the IVSs (IVSC, 2014):

> … valuation rules are no longer national standards existing in isolation. The standards of various countries have to harmonise with each other, and to do that there must be a strong, single benchmark of common standards to which all our states can relate. This is the role that the IVSC fulfils. (Edge, 2001)

By each member VPO's standards and guidance harmonising with IVSs, they effectively harmonise with each other and so achieve the IVSC policy goal of global regulatory convergence. Such convergence may be further extended where the VPO, regulator or government of developing countries, that lack their own national standards, choose to adopt IVSs as their de facto national standards.

In a national context such as Great Britain, for example, RICS is the national VPO which engages with IVSC and adopts IVSs in the RICS Red Book (UK Version) which is binding on RICS members acting in Great Britain and who are, therefore, required to follow IVSs. The RICS Red Book includes mandatory professional standards (PS), mandatory valuation practice statements (VPS) and advisory (not mandatory) valuation practice guidance applications (VPGA), with the UK version then also including RICS UK Valuation Standards (UKVS), RICS UK Appendices and RICS UK Valuation Practice Guidance Notes (VPGN) to cover specific statutory or regulatory requirements in the jurisdiction of Great Britain while being consistent with IVSs (Banfield, 2014).

1.3 Market value

The previous sections sought to outline the emergence of globalisation, the role of IFRS, the evolution of valuation standard setting and the role of IVSC and IVSs, with this section seeking to analyse market value, being the central concept of IVSs, with the following sections then seeking to provide an overview of other IVSs relevant to the valuation of businesses and business interests, intangible assets and financial instruments.

The concept of market value evolved in an early Australian High Court decision, *Spencer v Commonwealth* (1907) 5 CLR 418, which enunciated several of the key elements found in today's definition of *market value* by the IVSC that is now adopted globally though not, necessarily, fully integrated with economic theory, finance theory and capital market theory as will be considered further in Chapter 2.

1.3.1 Spencer concept of market value

A significant early development in the evolution of the concept of market value was the decision of the Australian High Court in *Spencer v Commonwealth* (1907) 5 CLR 418 (*Spencer*). Following the cessation of colonial status with the creation of the Commonwealth of Australia upon Federation on 1 January 1901 and separation from Great Britain, the High Court of Australia was only four years old when three judges heard an appeal on a compulsory acquisition matter. The bench was particularly notable, comprising Griffith CJ who was generally claimed to be the principal author of the Constitution of Australia and the first Chief Justice of Australia, Barton J who had previously been the first Prime Minister of Australia from 1901 to 1903 and Isaacs J who became the first Australian born Governor General of Australia in 1930.

The appeal concerned the acquisition by the Commonwealth of 6 acres, 1 rood and 2 perches of land in North Fremantle for the construction of a fort, being described as follows:

> The land consists of sand-hummocks overlooking the Indian Ocean. It has no grass; and it is useless in its present condition for any purpose of production.

with Mr Spencer claiming compensation of £10,000 and the High Court awarding the sum of £3,000, being that which had previously been admitted and paid into Court.

The significance of the decision lies in the way in which the judges constructed the concept of market value:

> In my judgement, the test of value of land is to be determined, not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, ie, whether there was in fact on that day a willing buyer, but by inquiring "What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?" It is, no doubt, very difficult to answer such a question, and any answer must be to some extent conjectural. The necessary mental process is to put yourself as far as possible in the position of persons conversant with the subject at the relevant time, and from that point of view to ascertain what, according to then current opinion of land values, a purchaser would have had to offer for the land

> to induce such a willing vendor to sell it, or, in other words, to inquire at what point a desirous purchaser and a not unwilling vendor would come together. (Griffiths CJ)
>
> And I should say, in view of the many authorities cited and upon the sense of the matter, that a claimant is entitled to have for his land what it is worth to a man of ordinary prudence and foresight, not holding his land for merely speculative purposes, nor, on the other hand, anxious to sell for any compelling or private reason, but willing to sell as a business man would be to another such person, both of them alike uninfluenced by any consideration of sentiment or need. (Barton J)
>
> To arrive at the value of the land on that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever in the amount which one would otherwise be willing to fix as the value of the property. (Isaacs J)

together with:

> In order that any article may have an exchange value, there must be presupposed a person willing to give the article in exchange for money and another willing to give money in exchange for the article. (Griffiths CJ)
>
> … value implies the existence of a willing buyer as well as of a willing seller… (Griffiths CJ)
>
> Prosperity unexpected, or depression, which no man would ever have anticipated, if happening after the date named, must be alike disregarded. (Isaacs J)
>
> … the all important fact on that day is the opinion regarding the fair price of the land, which a hypothetical prudent purchaser would entertain, if he desired to purchase it for the most advantageous purpose for which it was adapted. The plaintiff is to be compensated; therefore he is to receive the money equivalent to the loss he has sustained by deprivation of his land, and that … cannot exceed what such a prudent purchaser would be prepared to give him. (Isaacs J)

Within the judges' construction of the concept of market value, the following elements may be identified:

- an estimated amount: *could actually have obtained for it, have had to pay* (Griffith CJ), *value of the land, the fair price of the land* (Isaacs J);

- an exchange: *a man desiring to buy the land have had to pay for it… to a vendor willing to sell, may have an exchange value* (Griffith CJ), *willing to trade* (Isaacs J);
- a valuation date: *on a given day, on that day* (Griffith CJ), *on that date, prosperity unexpected, or depression,… if happening after the date named* (Isaacs J);
- a willing buyer: *a man desiring to buy the land, a desirous purchaser, willing buyer* (Griffith CJ), *voluntary bargaining, willing to trade, hypothetical prudent purchaser* (Isaacs J);
- a willing seller: *a vendor willing to sell it for a fair price, a not unwilling vendor* (Griffith CJ), *voluntary bargaining, willing to trade* (Isaacs J);
- a knowledgeable and prudent buyer and seller: *to a man of ordinary prudence and foresight, willing to sell as a business man would be to another such person* (Barton J), *perfectly acquainted with the land, hypothetical prudent purchaser* (Isaacs J);
- an absence of compulsion: *but not desirous to sell* (Griffith CJ), *nor, on the other hand, anxious to sell for any compelling or private reason, uninfluenced by any consideration of sentiment or need* (Barton J), *not by means of a forced sale, overlook any ordinary business consideration* (Isaacs J); and
- an assumption of highest and best use: *the most advantageous purpose for which it was adapted* (Isaacs J).

Accordingly, at the beginning of the last century within the judgements in *Spencer*, the key elements of the concept of market value may be identified. It should, however, be noted that the judgements were in the context of a vacant block of land on the coast of Western Australia in 1907 such that, while as a concept it is still of relevance today, care is required in the interpretation of language in this century – for example, *perfectly acquainted with the land* should be interpreted relative to a vacant coastal block in 1907 rather than in the context of the application of the efficient market hypothesis to a high rise office investment property in 2015.

Significantly, as will be considered further in Chapter 2, the judgements in *Spencer* contribute to the development of valuation theory through the provision of a legal construct of supply, demand, price, market and participants for a specific statutory purpose.

1.3.2 IVS definition of market value

The definition of market value is both fundamental for and central to IVSs:

> *Market value* is 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 knowledgably, prudently and without compulsion. (IVSC, 2013, page 8; IVSC, 2013, para 29, page 18; RICS, 2013, page 9)

The definition includes most elements identified above from the concept of market value in *Spencer*, being:

- an estimated amount;
- an exchange;
- a valuation date;
- a willing buyer;
- a willing seller;
- a knowledgeable and prudent buyer and seller; and
- an absence of compulsion,

but does not explicitly include an assumption of highest and best use, though this is fundamental to the proper application of the definition and will be considered further, below.

However, the IVS definition also adds the following to the concept of market value in *Spencer*:

- an arm's length transaction; and
- a period of marketing.

Significantly, neither the IVS definition of *market value* nor the judgements in *Spencer* explicitly address an assumption concerning transaction costs, which will also be considered further below.

Reflecting the fundamental nature and centrality of the definition of *market value* to IVSs, extensive instruction concerning interpretation and application is provided by IVSC:

> The definition of *market value* shall be applied in accordance with the following conceptual framework: (IVSC, 2013, para 30, page 18)

with nine elements addressed, each of which are considered in the following subsections. Application of the definition of *market value* in this way is mandatory (*shall*), being obligatory not optional, with application otherwise not providing an assessment of *market value*. As a *conceptual framework*, the elements are proposed as a series of overarching principles or scaffolding for the valuation process, capable of interpretation and application to different types of property interests in different countries at different times, thus being an effective example of principles based standard setting for international application.

1.3.2.1 Estimated amount

The *conceptual framework* states:

> (a) "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 *special value*; (IVSC, 2013, para 30(a), page 18)

The use of the term *estimated* reinforces that a valuation is a matter of opinion rather than a matter of fact, with the *estimated amount* being an assessment of *price* or *most probable price*. Effectively, *price* or *most probable price* is the intersection between the hypothetical purchaser's assessment of worth (*most advantageous price*) and the hypothetical vendor's assessment of worth (*best price*).

The specification of *arm's length market transaction* adds the element of separation and independence of the parties to the concept expressed in *Spencer*, while the *market transaction* confirms the estimated amount to be an amount in exchange in a given market.

For both hypothetical parties, the *price* or *most probable price* is *reasonably obtainable*, requiring an assumption of reasonableness by the parties in the price-setting process. Effectively, this is consistent with the hypothetical purchaser's *most advantageous price* and the hypothetical vendor's *best price*, being that price obtainable without being unreasonable.

However, the *price* or *most probable price* is assumed to not be influenced by issues that may make the hypothetical purchaser's *most advantageous price* and the hypothetical vendor's *best price* assessments of worth which may be unlikely to converge, such as special terms, financing, leaseback or concessions. It is challenging, given the assumption of hypothetical parties and the absence of a *special purchaser*, to understand how any element of *special value* may arise. Effectively, a 'plain vanilla' or 'normal' transaction, presumably with 'typical' financing, is to be assumed with no abnormal or unusual features that may affect the pricing of the transaction, though that which may be 'plain vanilla' or 'normal' may differ between property sectors and property markets around the world.

1.3.2.2 An asset should exchange

The *conceptual framework* states:

> (b) "an asset should exchange" refers to the fact that the value of an asset 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*; (IVSC, 2013, para 30(b), page 18)

The use of the phrase *should exchange* rather than 'would' is consistent with the hypothetical nature of the transaction and the *estimated amount*, reflecting the notion of the hypothetical purchaser's *most advantageous price* and the hypothetical vendor's *best price* assessments of worth coming together at a point of agreement that satisfies (*meets*) all (not most or some) of the assumptions of *market value* on a specified date.

1.3.2.3 On the valuation date

The *conceptual framework* states:

> (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 of any other date; (IVSC, 2013, para 30(c), page 18)

The assessment of value is temporal, being reflective of market conditions at that time and only applicable on the *valuation date* thus requiring care when market conditions may be changing rapidly either upwards or downwards and even greater care when market conditions may be at an inflection point.

Consistently, if a valuation is being prepared retrospectively, care is required concerning regard to proximate changes in market conditions or the happening of a reasonably anticipated event subsequent to the *valuation date* or to evidence of transactions at the *valuation date* that emerge subsequently.

1.3.2.4 Between a willing buyer

The *conceptual framework* states:

> (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"; (IVSC, 2013, para 30(d), page 18)

The characterisation of the willing buyer as *motivated, but not compelled*, not *over eager nor determined to buy at any price* is consistent with the rational investor assumption that underlies capital market theory and finance theory, but inconsistent with the behavioural characteristics often observed in property transactions when parties become emotionally involved with buyers rarely, if ever, being unmotivated. Effectively, the definition requires the assumption of a willing buyer who is both rational and emotionally detached.

While the buyer is not explicitly stated to be hypothetical and so may be actual (such as the *present owner*), care is required to avoid infecting the assumption of *willing* with the characteristics of a specific party. While the buyer may be hypothetical, the market in which they are assumed to be transacting is real, both in terms of current conditions and expectations of that which may happen in the foreseeable future. Accordingly, it is not some form of normalised market or long-term average market, but the actual market as at the *valuation date*.

Further, the impermissibility of an *imaginary or hypothetical market* requires a focus on that market which exists with those buyers who exist. Accordingly, in a depressed market when debt financing is generally unavailable, a market of equity funded buyers could be assumed and the participation of debt funded buyers could not be assumed unless it could be *demonstrated or anticipated to exist*.

Consistent with economic theory, there will always be a price at which a market will clear. As Banfield (2014) notes:

> For there to be a sale there has to be a purchaser and in reality whatever the state of the market there is always a figure at which somebody will deal – remember the present owner is included among those who constitute the market. (Banfield, 2014, page 122)

1.3.2.5 And a willing seller

The *conceptual framework* states:

> (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; (IVSC, 2013, para 30(e), page 19)

The characteristics of the *willing seller* mirror those of the *willing buyer*, being *neither over eager nor a forced seller, nor one prepared to hold out for a price not considered reasonable.* Effectively, the definition requires the assumption of a willing seller who is also both rational and emotionally detached, consistent with a willingness to sell *for the best price attainable, whatever that price may be, after proper marketing*.

Similarly, the market is assumed to be the *current market*, consistent with the assumptions for the *willing buyer*. Further, the conditions and circumstance of the actual owner are assumed irrelevant as the hypothetical scenario requires a focus on what a hypothetical owner would do as a *willing seller*.

1.3.2.6 In an arm's length transaction

The IVS definition adds the assumption of *in an arm's length transaction* to the concept of market value in *Spencer* with the *conceptual framework* stating:

> (f) "in an arm's length transaction" is one between parties who do not have a particular or special relationship, eg parent and subsidiary companies or landlord and tenant, that may make the price level uncharacteristic of the market or inflated because of an element of *special value*. The *market value* transaction is presumed to be between unrelated parties, each acting independently; (IVSC, 2013, para 30(f), page 19)

Summarised in the last sentence, the *arm's length transaction* assumption concerns each party being assumed to be independent or not related and operating in isolation. More obvious examples of a lack of independence would be if the parties were assumed to have some form of relationship or connection that may lead to paying more or less than the price level of the market, with the extreme being if the purchaser was a *special purchaser* such that *special value* may arise.

Effectively, the parties are assumed to be standalone market participants engaging in a unique transaction which is consistent with the assumption of parties acting rationally but inconsistent with the nature of the property market where parties may be likely to transact with each other on multiple occasions over time and so not operate in isolation.

1.3.2.7 After proper marketing

The IVS definition adds the assumption of *after proper marketing* to the concept of market value in *Spencer* with the *conceptual framework* stating:

> (g) "after proper marketing" means that the asset would be 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*; (IVSC, 2013, para 30(g), page 19)

Significantly, the transaction is assumed to occur *after* marketing and such marketing is assumed to be *proper*, being marketing that is *the most appropriate manner to effect its disposal at the best price reasonably obtainable*. Accordingly, the *proper* marketing for a large office property investment for sale by tender may differ from that for a large manufacturing facility for sale by auction, but each is assumed to have occurred before the *valuation date.*

Both the marketing and the method of sale are to be *most appropriate* to achieve the *best price*, such that it may be prudent, in the case of larger or unusual properties, for the valuer to state the assumed form of marketing and method of sale in the valuation report.

The duration of the marketing period may vary depending on the nature of the property, the state of the market and the profile of market participants, being of greatest significance for large or unusual properties in declining or depressed markets or for properties for which market participants are challenging to identify. Conversely, with properties for which there are very few but easily identifiable market participants, an *adequate number* may be canvassed in a short period. As above, it may be prudent, in such cases, for the valuer to state the assumed duration of the marketing period in the valuation report.

1.3.2.8 Where the parties had each acted knowledgably, prudently

The *conceptual framework* states:

> (h) "where the parties had each acted knowledgably, 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 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; (IVSC, 2013, para 30(h), page 19)

Acting knowledgably and prudently is not explicitly defined but may be implied to be related to information. Knowledge would appear to be awareness of the information and prudence would appear to be the use of that information to seek an optimal price, which is generally consistent with the notion of prudence as carefulness and risk aversion.

The phrase *acted knowledgably, prudently* is limited to both parties being assumed to be *reasonably informed* (which is somewhat less than fully informed) about only three nominated issues, being:

- the nature and characteristics of the asset;
- its actual and potential uses; and
- the state of the market as of the valuation date

which may be contended to be a much lower level of knowledge than may be possessed by an actual major investor or major occupier prior to making a decision on a property transaction.

Significantly, the assessment of prudence is temporal, being in the context of the state of the market at the *valuation date* and disregarding anything that may have happened thereafter. Accordingly, that which may be considered prudent at the peak of a property boom just before the collapse may not be judged to have been prudent retrospectively six months after the collapse, but this should be disregarded. The assessment of prudence by the willing parties is, therefore, a snapshot rather than a video.

1.3.2.9 And without compulsion

The *conceptual framework* states:

> (i) "and without compulsion" establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it. (IVSC, 2013, para 30(i), page 19)

The use of the term *and* firmly links *without compulsion* to the definition as a requirement for both parties, being consistent with the notion of *willing* and the reference to *motivated*. While this qualification removes such scenarios as forced sales or pressure to buy/sell from third parties, the reference to undue coercion also potentially precludes reflection of some common property market behavioural characteristics such as peer pressure.

Having considered the principal elements stated in the IVS definition of *market value*, the following sections consider assumptions which are not stated in the IVS definition, being the highest and best use assumption and the transaction costs assumption.

1.3.3 Highest and best use assumption

The assumption of highest and best use is identified as an element in the concept of market value in the judgements in *Spencer* and is implicit in the IVS definition of *market value*.

In the *IVS Framework*, highest and best use is addressed as follows:

> The *market value* of an asset will reflect its highest and best use. 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. (IVSC, 2013, para 32, page 20)

and:

> 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, when its contribution to the overall value of the group must be considered. (IVSC, 2013, para 33, page 20)

The assumption of highest and best use is fundamental to the concept of *market value*, as it excludes limitation to a sub-optimal use, consistent with the rational hypothetical buyer who would seek to optimise the use of a property to the maximum of its potential and, therefore, to optimise the value of the property. Such optimal use may be the existing use or may be an alternative use, with potential alternative uses constrained to those that meet the following three criteria:

> The determination of the highest and best use involves consideration of the following:
>
> (a) to establish whether a use is possible, regard will be had to what would be considered reasonable by market participants,
> (b) to reflect the requirement to be legally permissible, any legal restrictions on the use of the asset, eg zoning designations, need to be taken into account,
> (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. (IVSC, 2013, para 34, page 20)

The interpretation of *possible* focuses on that use which *would be considered reasonable by market participants,* requiring consideration of such physical issues as being capable of real-world creation given such constraints as the location, size and topography of the land. Similarly, the interpretation of *legally permissible* focuses on planning aspects (such as use, nature of development, density, height and so forth) but may also include permissibility within the form of title held which is particularly significant for leasehold interests, licenses and other forms of title that are not freehold title. Further, the interpretation of *financially feasible* focuses on acceptability of return as a relative measure (being relative to the *existing use*) rather than as an absolute measure, consistent with the assumption of the rational hypothetical buyer.

It should be noted that all three constraints are applicable to an assessment of highest and best use, such that a proposed use which is possible and legally permissible may not be the highest and best use if it is not financially feasible. Effectively, the IVSs require the assumption of highest and best use to reflect a real-world scenario that could actually occur, rather than a hypothetical scenario that would be unlikely to or would not occur in reality.

The highest and best use assumption is linked to *aggregation* (considered further in Chapter 2) which may be a significant issue in the valuation of owner occupied property (considered further in Chapter 6). Where a property to be valued forms part of a group, such as a dilapidated warehouse in the middle of a major manufacturing facility, in terms of highest and best use its value as a renovated warehouse may vary from its value as a site for extension of the manufacturing facility, reflecting the difference in highest and best use between consideration as a standalone asset and as part of a group of assets.

Significantly, the assessment of highest and best use is through the eyes of a *market participant*, usually being the assumed rational hypothetical buyer, who reflects all aspects of the assessment of highest and best use in the price it would attribute to the property. However, such assumed rational hypothetical buyer is not necessarily a single party (which would potentially invoke aspects of *investment value* or *special value*) but is indicative or representative of a small group of assumed rational hypothetical buyers as will be considered in further detail in Chapter 2.

1.3.4 Transaction costs assumption

An assumption concerning transaction costs may not be found in either the IVS definition of *market value* or the judgements in *Spencer*, but is addressed in the *IVS Framework* as follows:

> *Market value* is the estimated exchange price of an asset without regard to the seller's costs of sale or the buyer's costs of purchase and without adjustment for any taxes payable by either party as a direct result of the transaction. (IVSC, 2013, para 35, page 20)

Accordingly, transaction costs may be interpreted to include:

- *costs of sale* and *costs of purchase* – being such costs as agency fees, marketing costs, legal fees and so forth for the seller and due diligence costs, legal fees and so forth for the buyer; and
- *any taxes payable by either party as a direct result of the transaction* – being such commonly levied taxes as stamp duty on transfer, title registration fees and so forth,

as being excluded from the estimated exchange price of an asset, though such costs and taxes may be included as inputs in some valuation methods such as discounted cash flow and the residual method.

While the exclusion of *costs of sale* and *costs of purchase* may be applied commonly and consistently to all purchaser groups, the exclusion of *taxes payable* requires greater care. Some purchaser groups (such as institutions, REITs and so forth) may be liable for taxes directly resulting from the transaction whereas other purchaser groups (such as charities, public bodies and some religious groups) may be exempt and other purchaser groups (such as private individuals) may receive concessional treatment. Accordingly, where the assumed rational hypothetical buyer is identifiable as a specific group, the exclusion of taxes may be anticipated to have a common effect on price formation. However, where the assumed rational hypothetical buyer is identifiable as potentially being one or more specific groups with differing tax status, the distinction between *market value* and *investment value* may require greater attention.

1.3.5 Market value in practice

The concept and definition of *market value* is fundamental to IVSs and may be initially challenging to grasp. The RICS Red Book Global provides a succinct description of market value as follows:

> 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. (RICS, 2013, para 1.2.2, page 53)
>
> It ignores any price distortions caused by *special value* or *synergistic value*. It represents the price that would most likely be achievable for an asset across a wide range of circumstances. (RICS, 2013, para 1.2.3, page 53)
>
> [and reflecting] the actual market state and circumstances as of the effective *valuation date*. (RICS, 2013, para 1.2.4, page 53)

with Banfield (2014) explaining:

> Market value represents the price that would most likely be achievable for a property across a wide range of circumstances. In essence the definition, if applied correctly, should produce a price that the asset or liability should be expected to sell at a specific date in an unrestricted marketplace following proper marketing appropriate for the type of asset. The definition of necessity has to include certain assumptions but these only reflect the normal workings of the marketplace and should produce the most probable price reasonably obtainable. (Banfield, 2014, page 106)

The contributory elements to *market value* will be considered further in Chapter 2, with particular reference to their difference to the contributory elements to *investment value*, *synergistic value*, *fair value* and *special value*.

1.4 Businesses and business interests, intangible assets and financial instruments

The previous sections sought to outline the emergence of globalisation, the role of IFRS, the evolution of valuation standard setting and the role of IVSC and IVSs and to provide an analysis of market value, being the central concept of IVSs, with this section seeking to provide an overview of other IVSs relevant to the valuation of businesses and business interests, intangible assets and financial instruments.

1.4.1 Businesses and business interests

IVS200 *Businesses and Business Interests* is an IVS Asset Standard that applies to the valuation of businesses and business interests, being defined as:

> A business is a commercial, industrial, service or investment activity. A valuation of a business may either comprise the whole of the activity of an entity or a part of the activity. (IVS 220, para C2, page 41)

noting that it is important to distinguish between the value of a business entity and the value of the individual assets or liabilities of that entity (IVS 220, para C2, page 41).

IVS200 provides *Commentary* on the need for clarity concerning ownership rights in the valuation process and the care required in consideration of information received from management, noting the *market approach* and *income approach* to be likely to be the most suitable valuation approaches with extensive commentary provided thereon.

1.4.2 Intangible assets

For some of world's biggest multinational corporations, such as Coca-Cola and Microsoft, intangible assets may be of vastly greater value to the entity than tangible assets. Goodwill, brand names, trademarks, web addresses, customer lists and so forth may all be of value. For some entities, the only assets of value may be their name, reputation and the ideas of their employees which are all intangible assets (Gilbertson and Preston, 2005).

IVS 210 *Intangible Assets* is an IVS Asset Standard that applies to the valuation of intangible assets, being defined as:

> 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 economic benefits to its owner. (IVS 210, para C1, page 49)

noting that it is important to clearly identify an *intangible asset* by reference to its type and the legal right or interest in that asset (IVS 220, para 2, page 47).

IVS 210 provides *Commentary* on the principal types of intangible assets, including goodwill and the following principal classes:

- marketing related *intangible assets* such as trademarks, trade names, unique trade design, internet domain names and non-compete agreements;
- customer or supplier related *intangible assets* such as service or supply agreements, licensing or royalty agreements, order books, employment agreements and customer relationships;
- technology related *intangible assets* such as patented technology, unpatented technology, databases, formulae, designs, software, processes or recipes; and
- artistic related *intangible assets* such as royalties from artistic works including plays, books, films and music and from non-contractual copyright protection,

noting that the *market approach*, *income approach* and *cost approach* to valuation may all be applied to *intangible assets* with extensive commentary provided thereon (IVS 220, para C4–C40, pages 49–55).

Extensive guidance on the principal recognised approaches and methods that are used for valuing intangible assets is provided in TIP3 *The Valuation of Intangible Assets* (IVSC, 2012b).

1.4.3 Financial instruments

IVS 250 *Financial Instruments* is an IVS Asset Standard that applies to the valuation of financial instruments, being defined as:

> A financial instrument is a contract that creates rights or obligations between specified parties to receive or pay cash or other financial consideration, or an equity instrument. The contract may require the receipt or payment to be made on or before a specific date or be triggered by a specified event. An equity instrument is any contract that creates a residual interest in the assets of an entity after deducting all of its liabilities. (IVS 250, para C1, page 79)

noting that valuation reporting should have regard to issues of materiality, uncertainty, complexity, comparability and the underlying assets for those *financial instruments* subject to valuation (IVS 250, para 5, page 77).

IVS 250 provides *Commentary* on the distinction between 'cash instruments' and 'derivative instruments', the market for *financial instruments*, issues associated with credit risk, liquidity and market activity, the role of a control environment and the application of the *market approach*, *income approach* and *cost approach* to the valuation of *financial instruments* with extensive commentary provided thereon (IVS 250, para C3–C36, pages 79–87).

1.5 Summary and conclusions

This chapter sought to outline the emergence of globalisation, the role of IFRS and the evolution of valuation standard setting, the role of IVSC and IVSs and an analysis of market value, being the central concept of IVSs, with an overview of other IVSs relevant to the valuation of businesses and business interests, intangible assets and financial instruments.

Increasingly gaining pace since the end of the Second World War, fostered by greater international economic cooperation through trade and commerce during the latter part of the twentieth century and accelerated by the digital revolution of this century, globalisation has contributed to multinational corporations such as HSBC and Airbus and sovereign wealth funds, pension funds, superannuation funds, REITs and other property fund managers holding vast property portfolios spread across the globe.

As globalising multinational corporations sought a common basis for company accounts that was understandable, comparable, reliable and relevant for internal and external users across different countries for decision making and the allocation of scarce resources, the IASC was formed and then succeeded by the IASB leading to the development and implementation of IFRS for financial reporting in many countries around the world but currently excepting the major economies of the USA, Japan and India.

In order for IFRS to provide a reliable decision-making basis in the context of property, the provision of those inputs concerning property valuation also needed to be undertaken on one common basis worldwide. Starting with RICS in the UK, then expanding across Europe, valuation standard setting became more homogenised with the creation of TIAVSC in 1981/82 leading to the publication of international valuation standards in 1985, the creation of IVSC and the convergence of IVSs with IAS's and IFRS's since 2000. The development of IVSs for assets such as real property and plant and equipment and for purposes such as financial reporting and secured lending facilitated not only convergence with IFRS but also the opportunity for harmonisation with the standards and guidance notes developed by IVSC member valuation professional organisations around the world. Reflecting the valuation of assets and liabilities generally rather than just property, IVSC also developed IVSs for the valuation of business and business interests, intellectual property and financial instruments which are also convergent with IFRS.

The concept and definition of *market value* is the centrepiece of IVSs, being essentially an assessment of what a property should hypothetically transact for on a given date if assumptions are made about the parties, marketing, information, willingness, transaction costs and taxes. The concept of market value evolved in an early Australian High Court decision, *Spencer v Commonwealth* (1907) 5 CLR 418, which enunciated several of the key elements found in today's definition of *market value* by the IVSC that is now adopted globally though not, necessarily, fully integrated with economic theory, finance theory and capital market theory.

The next chapter will develop a conceptual framework for valuation based on economic theory, align this framework with finance and capital market theory, examine the definition of the market and distinguish definitions of cost and price from defined concepts of value before reconciling these to the conceptual framework for valuation.

Chapter 3 will then consider various aspects of valuation standard definitions within IVSs, discuss the definitions of other relevant contextual terms and identify the principal approaches to valuation within IVSs including a focus on the market approach to valuation.

Chapter 4 will describe and analyse those elements of IVSs that are of relevance to the three principal stages of the real property valuation process, being the instruction of the valuer, undertaking the valuation and reporting the valuation.

Chapter 5 will consider IVSs in the context of the valuation of investment property, with particular reference to IAS 40 *Investment Property* and the income approach to valuation, including an examination of IVSC TIP 1 *Discounted Cash Flow*.

Finally, Chapter 6 will focus on IVSs in the context of the valuation of owner occupied property held by operating businesses, with particular reference to IAS 16 *Property, Plant and Equipment* and the cost approach to valuation, including an examination of IVSC TIP 2 *The Cost Approach to Tangible Assets*.

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