13 September 2002

Our Ref: FF/VAL/MISC

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Sirs

The Royal Institution of Chartered Surveyors (RICS) has considered the proposals issued in May 2002 to amend various International Accounting Standards and wishes to comment on the revisions of IAS 16, 17 and 40.

RICS is an international professional body with over 100,000 individually qualified Chartered Surveyors worldwide providing professional advice on all land and property issues. Asset valuation, including the valuation of both real estate, plant and equipment, is a key skill which underlies the services provided by a large number of these members. An independent, not-for-profit organisation, RICS has an obligation to comment independently on matters that it perceives to be relevant to its profession.

Our comments and suggestions are made in the context of the RICS policy, namely:-

"The RICS is committed to a single set of international valuation standards and supporting guidance being produced which provides a common framework for valuers worldwide. To that end it will continue to direct both financial and intellectual resources."

The RICS is a member and major financial supporter of the International Valuation Standards Committee (IVSC), and is aware that that body is making its own response to the Exposure Drafts. This representation makes similar points. However, there are additional matters that the RICS wishes to address.

The RICS does not see its role as commenting on the underlying accounting principles. Our members' expertise lies in the measurement and valuation of assets and we have confined ourselves to commenting on where we believe the Standards, or the proposed improvements, have practical valuation implications.

Although the Standards are presented separately we have found the revisions and their inter-relationship difficult to understand, particularly the relationship between IAS 17 and 40.

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Those areas that we consider to be ambiguous or confusing are identified in Annexe A to this letter.

IAS 16

Question 1
We support the proposal that all exchanges of property plant and equipment should be measured at fair value, except where the fair value of neither of the assets exchanged can be determined reliably..

Question 2
We support the proposal that all exchanges of intangible assets should be at fair value.

Question 3
RICS has no comment to make on this question.

In addition we have the following comments on the draft:

Paragraphs 29 and 34 – Allowed alternative treatment

1 The RICS is pleased to see that the proposed improvements to this standard retain the "Allowed Alternative Treatment" of revaluation, that it continues to require regular revaluation and that all assets of a particular class should be revalued at the same time. In our view the indication that revaluations may be appropriate at up to five year intervals **should be strengthened to a requirement that they are undertaken at not more than five year intervals.**

Paragraphs 60, 61 and 64 - Disclosure

2 We note the proposed new paragraphs 60 and 61 require greater disclosure in financial statements of the measurement bases used for determining the carrying amount. We also note that the proposed new paragraph 64 specifically requires the disclosure of certain minimum information about the valuation basis used, the date of valuation and whether this was undertaken by an independent valuer.

3 **As a matter of principle the RICS supports these proposals**. Since 1995 it has been mandatory for all Chartered Surveyors undertaking valuations for financial statements to draft an acceptable reference to the valuation for inclusion in any published financial statement. This draft reference must contain certain minimum information, including the basis or bases of valuation used, the date of valuation, the status of the valuer, and must also draw attention to any special assumptions, conditions or restrictions that may have had a material effect on the value reported. This has to be submitted with the initial valuation report.

4 Chartered Surveyors are also required to include a statement in the report stating that their written consent is required to any published reference to the valuation, including approval as to the form and context in which it shall appear.

Paragraph 64 – Independent Valuer

5 Whilst supporting the principle of disclosure, **we are concerned at the reference to an "Independent Valuer"**. The RICS requires all its members undertaking valuations to exercise independence and objectivity. There is a similar requirement in the Code of Conduct set out in the International Valuation Standards. This applies whether or not the

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valuer is an "Internal Valuer" or an "External Valuer". Definitions of these terms are in Annexe B attached.

6 For a number of years the RICS has struggled with trying conclusively to define an "Independent Valuer". However, given firstly the overriding requirement for independence in all valuations and, secondly, the need to meet specific qualification requirements for independence set out in different statutes and regulations, this has proved impractical. By way of illustration, the existing RICS Valuation and Appraisal Standards have no less than four different definitions of Independent Valuer, and although these relate to different situations, it does create confusion. These standards are in the process of being revised and in the new edition, due to be published in early 2003, an "Independent Valuer" will simply be defined as a valuer meeting any specific qualification criteria for independence set out in the regulation or statute governing the purpose of the valuation. This follows a similar approach adopted by the IVSC,

7 The RICS also believes that it is important that the identity of the valuer is disclosed and therefore **recommends that paragraph 64(c) of IAS 16 be amended thus:**

"Name and qualification of the valuer or valuation organisation, and whether they acted in the capacity of an Internal or External Valuer."

8 It follows from this recommendation that the IASB may wish to consider including an amendment to paragraph 30 stipulating the extent to which revaluations may be undertaken by Internal or External Valuers. Whilst an Internal Valuer may be bound by the rules of a professional body such as the RICS (or any other organisation adopting International Valuation Standards) to act with independence and objectivity, clearly there will be a perception that any Internal Valuer cannot be truly independent. Whilst the RICS **does not believe that Internal Valuers should be proscribed from undertaking any valuation for inclusion in a financial statement prepared under IAS 16,** it believes that Internal Valuers should be limited to either interim reviews or for their work to be audited and reviewed by an External Valuer. The RICS believes that paragraphs 48 and 49 of FRS15 published by the Accounting Standards Board in the UK is a good model for dealing with this issue.

Paragraph A 12 – Revaluation Project

9 We note with great interest the comment in A12 of the Appendix to IAS 16 which refers to current research on revaluation issues. .

10 IAS 16 currently states that the fair value of land and buildings is usually its market value. The internationally recognised definition of Market Value represents the best price that would be obtainable on an exchange of the asset. Whilst in the majority of cases this is the perfectly logical basis of measurement to adopt, **in a significant minority of cases its use could be misleading or inappropriate for use in accounts.** Market Value requires the assumption of a hypothetical sale and purchase for the use that would generate the highest and best value. This hypothesis can be incompatible with the continuation of the business, and neither does it always provide a suitable proxy for establishing the cost that would be incurred by the entity in providing what it actually needs for its operations.

11 One example is where land and buildings owned and occupied by an entity for the purpose of its enterprise have a higher value for an alternative use. That higher value

would be reflected in the Market Value. This value could only be realised if the business at that site were extinguished, which could involve considerable cost. Whilst the RICS believes that information on the potential alternative use and the extent to which the excess value may be realisable is essential in the notes to the accounts so that users can identify the opportunity cost of the entity remaining in that location, it does not believe it logical that it should be the carrying amount.

12 Another example, typical of some long established industrial operations, is where the land occupied by the entity is contaminated. For as long as the entity remains in occupation the contamination will rarely have a material bearing on its operation and, furthermore, if it were looking to acquire a replacement site in the market, it would almost certainly have to buy one that was not contaminated. However, if the site were to be offered in the market following a cessation of the business, the Market Value would be heavily discounted in order to reflect the costs of decontamination.

13 A third example is where buildings have been subject to special adaptations that are unlikely to be used by another occupier. The Market Value would be depressed by the necessity for other potential occupiers to remove those adaptations. The Market Value would only be relevant if the business at that site is to be extinguished, a policy that would have other significant implications for the entity's accounts.

14 **As a result of extensive research that it has recently undertaken, the RICS is satisfied that there is a sound argument for an alternative basis of value which may be considered more appropriate for measuring the carrying amount of owner occupied property. It therefore welcomes the news that the IASB is undertaking similar research and would welcome the opportunity to contribute to this debate.**

15 Many countries, particularly in Europe, will be adopting IAS by 2005. As a result, many entities may be embarking on the revaluation of assets for the first time. Confusion will result if changes are made after entities and their advisers had started preparatory work on revaluations in order to comply with the proposed IAS 16. In the UK, where an MVEU (entry value) basis currently applies, the implementation of IAS 16 in its proposed form would lead to significant changes to the carrying amount of certain assets. **In both instances, it would be highly undesirable for IAS to be implemented in Europe in its proposed form, only for the valuation basis to be changed subsequently as a consequence of the research now under way. The RICS considers that resolution of this matter should be a priority.**

IAS 17

Question 1.

We do not support the proposal that when classifying a lease of land and buildings, the lease should be split into two elements – a lease of the land and a lease of buildings. Our reasons for this opinion are as follows:

16 *Buildings are, in practice, indivisible from the land on which they stand and therefore cannot be separately traded. Bare urban land may be separately traded, in which case its value derives from the right to construct new buildings upon it. Land on which an existing building stands cannot be separately traded and therefore cannot be separately valued.*

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17 *Hence there is no market-based method for assessing the separate fair values of land and of buildings whether of the whole property or just those elements in the lease; and there is no generally accepted method of apportioning the fair value of a property between the two elements. (This is not equivalent to the process of calculating the depreciable amount under IAS 16. The amount that has to be depreciated is the excess of fair value over the residual amount, that is, the value of the site at the end of the building's life. This is a real-life and meaningful concept and is not the same as seeking to divide the fair value of a let and income-producing investment property into two parts.)*

18 *IAS 17 para 11B refers to the circumstances where "the lease payments cannot be allocated reliably between the (land and building) elements". This will always be the case.* ***In order to achieve consistency in financial reporting, the apportionment method to be adopted for accounting purposes will need to be described in detail within the IFRS.***

19 *Even if an apportionment of the fair value of the property between land and buildings can be made, we believe* ***it is inappropriate in economic terms to apportion the minimum lease payments in the same ratio*** *because the building component of the rent should include an amortisation element whereas the land element will not.*

20 *Our understanding is that the minimum rent attributable to the building is only to be treated as a finance lease if the lease is for the entire economic life of the building. Whether an old building will be refurbished or redeveloped when the leases expire will depend upon market conditions at that time and is difficult to predict long in advance. The classification of leases will therefore be open to manipulation by lessors if the entity chooses to assume that the building will be refurbished rather than redeveloped in order to prevent the building element of the rent being treated as a finance lease.*

21 *We find it strange that the accounting treatment of the lease in the accounts of the lessee will depend upon a supposition as to the lessor's expected actions upon expiry of the lease, perhaps at a long distant date.*

22 *Because of these uncertainties,* ***we believe that the classification of leases will be arbitrary and inconsistent.*** *There will be a strong incentive for entities to apply the provisions of IAS 17 para 11B that "it is clear that both elements are operating leases" in order to avoid the above complications and the cost of obtaining valuation advice.*

23 ***We urge the IASB to delay implementation of the proposed changes and additions to IAS 17 paras 11 to 11D until a fundamental review of lease accounting has been completed.***

Relationship with IAS 40 para 27 (fair value) and IAS 17 para 28

24 An added complication of splitting the land and building elements of a lease arises in respect of investment property. IAS 17 para 11A requires that, in the circumstances that the building element of the receivable rent meets the test of a finance lease, it must be separated out. Para 28 requires this part of the income to be capitalised as a finance lease debtor, although the capital value of the building element is inherent in the fair value (market value). To avoid over-stating the overall net asset value, either (a) the fair value reported under IAS 40 must be that of a hypothetical investment property enjoying a correspondingly reduced rental income under the existing lease or (b) if the investment property is to be recorded at its actual fair value (MV), the finance lease debtor must be contra'd off by an equal and opposite creditor.

25 If approach (a) is adopted, it will mean that values will be not be based on market reality or , in terms of the RICS Red Book, they will be "valuations subject to Special Assumptions". The net asset value obtained by combining the Special Assumptions value with the complimentary IAS 17 accounting entry will inevitably differ from the actual fair value of the property investment. **If it is resolved to adopt the proposal we**

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believe it is essential that the Standards should specify the approach to be adopted and we strongly advocate that it should be approach (b).

Question 2.
We have no comment to make on this question.

IAS 40

Question 1.
We strongly support the proposal that the definition of investment property should be changed to permit the inclusion of a property held under an operating lease.

Question 2.
We consider that the proposed requirement that leasehold investment property held under an operating lease should be accounted for as if it were a finance lease in accordance with IAS 17 para 12 will potentially present practical difficulties for those commissioning and undertaking valuations for the reasons discussed in the following paragraphs.

Relationship between IAS 40 para 27 (fair value) and IAS 17 para 12

26 A requirement to show the PV of the future lease payments for a leasehold investment property as a liability in the balance sheet, does not sit logically with it being recorded as an asset at fair value. The fair value (MV) will reflect only the capital value of the net income to the lessee, and therefore showing the capitalised outgoing as a separate liability will result in the liability being reflected twice. Our preference is that if an asset meets the criteria for Investment Property it should be always recorded at fair value, regardless of the lease classification. However, if the overriding concern is to make the treatment of property leases as consistent as possible with other leases there appear to be two alternatives:

a) that the asset side of the balance sheet records the fair value of a fictional investment property that is leasehold but at a nominal/nil rent or;
b) the investment property is recorded at its actual fair value (MV) and the lease liability is contra'd off by an equal and opposite asset entry.

27 Method (a) would become especially artificial and difficult to apply in a case where the "minimum" lease payments (which is all that is capitalised) do not reduce the pay-away to zero, for example where the head rent is 25% of rental income subject to a minimum. This would require the valuer to estimate the value of an investment that does not exist and for which there is unlikely to be any market evidence, namely an investment subject to a head rent equal to the amount by which 25% of the rental income exceeds the minimum rent.

28 If approach (a) is adopted, this will have significant repercussions for valuers and for asset values. Many valuations for financial statements will become, in terms of the RICS Red Book, "valuations subject to Special Assumptions", divorced from reality. The net asset value obtained by combining the Special Assumptions value with the complimentary IAS 17 accounting entry will inevitably differ from the actual fair value of the property investment.

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29 Either approach has difficulties but if a requirement to capitalise lease liabilities is introduced then approach b) is to be preferred as it allows the fair value to be calculated and reported without any special assumptions.

30 We recommend that if the requirement to treat investment property held under an operating lease as if it were a finance lease under IAS 17 is retained, the IASB should specify which approach is to be used in reporting to enable entities to provide valuers with clear instructions as to what is required.

Question 3.
We have no comment to make on this question.

Conclusion

We would be very pleased to discuss any part of this response with you, and in particular would **wish to contribute to the further research on valuation that you are undertaking.**

The contact for any matter arising out of this letter is Arthur Whatling, FRICS, email: arthurwhatling@waitrose.com or 07985 045537 or myself.

Yours faithfully

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Annexe A

This Annexe comments upon the detailed drafting of the Standards and their interrelationship and draws attention to those areas that have caused us difficulty in interpretation. It is our concern to make sure that we understand the proposals so that we may give practical advice to valuers who are requested to provide the various valuations.

Relationship between IAS 40 and IAS 17

1 At first sight there appeared to us to be some logical inconsistency between, on the one hand, IAS 40 which will require an investment property's head rent, which usually relates solely to the land, to be capitalised as a liability, and, on the other hand, IAS 17 which, in other circumstances, will require lease liabilities to be capitalised save insofar as they relate to the land.

2 On further consideration, we have concluded that the solutions differ because the requirements are driven from opposite directions: In the case of a leasehold investment property, a true and fair view requires the asset to be recorded at fair value but, if so, the existence of the lease liability should also be acknowledged. For other leased assets, a true and fair view requires the lease liability to be acknowledged, which in turn requires the benefit of the lease to be recorded as an asset. If this interpretation is correct, we suggest that something of this kind be included in IAS 40 to assist understanding.

IAS 16, Paragraph 6 (definitions) – Relationship of IAS 16 to IAS 40

3 "Property plant and equipment" is defined in IAS 16 to include "property ... held for rental to others". In so many words, this is also the definition of an investment property in IAS 40. This might be taken to imply that a property held for rental to others may be reported either under IAS 16 or under IAS 40. If, as we assume to be the case, this is not the intention, we recommend that it should be clearly stated that IAS 16 applies to plant and equipment held for rental to others but not to property held for rental to others, save that Para 28 of IAS 16 does apply to an investment property recorded at cost under IAS 40 para 50.

IAS 17, Paragraph 1 (scope) – Relationship of IAS 17 to IAS 40

4 We find it misleading that IAS 17 paragraph 1 states that IAS 17 does not apply to investment properties since, by virtue of IAS 40 para 26A, paragraphs 12 to 18, 23 and 24 of IAS 17 do apply. Rather, the 'scope' section of IAS 17 should identify the sections which apply (or, alternatively, the sections which do not apply) to investment properties.

IAS 17, Paragraphs 11-11C – Definition of a property finance lease

5 It is our understanding that the effect of these paragraphs is that the only lease payments in respect of land and buildings that may fall to be classified as finance lease payments will normally be the rent attributable to the buildings in cases where the lease embraces the entire economic life of the buildings. If that is the case, we suggest that this should be clearly stated.

IAS 17, Paragraphs 11A-C – Definition of fair value of land and buildings

6 It is our understanding that the reference in para 11B is to the land and building components of the fair value of the property, not the fair value of the lease. This needs to be clarified. The problems of allocating the fair value of the lease would be even greater than those that we have described in allocating the fair value of the property.

IAS 17, Paragraph 3 (definitions) – Lease classification

7 A finance lease is defined as a lease that transfers "substantially" all the risks and rewards of ownership. In the case of a long lease at a nominal ground rent, we would expect the fact that title reverts to the lessor after, say, 99 years (representing perhaps 0.1% of the fair value at the reporting date) to be deemed to be "insubstantial". The proposal (that an operating lease "may be accounted for" as a finance lease) meets the need in a roundabout way, but we consider that, to make the rationale of the Standards more understandable, there needs to be clearer explanation as to why the grant of (say) a 99 year lease at a nominal rent is not considered to represent a "substantial" transfer.

IAS 40 Improvements, Commentary para A4 – Rent reviews

8 *The effect of rent reviews on lease classification needs to be clarified, especially the interpretation of the word "minimum" in "minimum lease payments".*

9 *For example, if the rent is subject to upward-and-downward review, do the "minimum lease payments" comprise only those up to the rent review date (when the rent could fall, in theory, to zero)?*

10 In the UK, commercial property leases are customarily for a term of 10, 15, 20 or 25 years, subject to upward-only rent reviews every 5 years. In other States leases tend to be for shorter periods but frequently make provision for the rent to be reviewed by reference to an inflation index, which in practice will usually be an upward only review. There is a suggestion in paragraph A4 of the IAS 40 Improvements document that the fact that a lease contains upward-only rent reviews may preclude it from being "a lease that transfers substantially all the risks and rewards of ownership".

11 *It is not clear to us how the presence of upward-only rent reviews implies that additional risks and rewards of ownership remain with the lessor. Unless the rent is continuously reviewed to market rate, any lease (which reserves a rent rather than a single up-front payment) involves a risk that the contractual rent may be more or less than the market rent at any period during the lease term. A lease subject to upward-only rent reviews simply entails a different risk/reward cocktail under which the lessee enjoys a lower initial rent in return for the risk of a higher rent later.*

12 *If, for whatever reason, leases containing future upward-only rent reviews cannot be finance leases, we suggest that this should be clearly stated and explained in IAS 17 paragraphs 8-9. (Presumably, once the last review date has passed, the disqualification would no longer apply.)*

IAS 17, definitions and paras 10 and 11B – "Inception of the lease"

13 *IAS 17 provides that the following are to be assessed as at "the inception of the lease":*

- *the classification of the lease as a finance lease or an operating lease (para 10)*
- *the allocation of minimum lease payments between land and building elements (para 11B)*
- *calculation of the "interest rate implicit in the lease".*

14 The "inception of the lease" is defined as "the earlier (sic) of the date of the lease agreement or of a commitment by the parties to the principal provisions of the lease".

15 *In some countries, such as the UK, leases are commonly traded. We assume that "date of the lease agreement" refers to the date of the entity's agreement to purchase the*

(lessor's or lessee's) interest, not to the date the lease was granted (which will be of no relevance to the entity if it had no interest in the lease at that time). We suggest that the definition should be clarified.

IAS 17, Paragraph 11B – minimum lease payments

16 ***Amount:*** *Para 11B states the amount that is to be allocated between land and buildings is "the minimum lease payments at the inception of the lease." We would assume that it is the minimum lease payments with effect from the balance sheet date that are relevant. This is supported by para 23 (b) which refers to the "minimum lease payments at the balance sheet date". We recommend that para 11B be reworded accordingly.*

17 Nevertheless, it appears that the minimum lease payments as from the balance sheet date are to be allocated between the land and building components based on the fair values, not at that date, but at the "inception of the lease". The valuation example, below, illustrates how the allocation might typically differ between these two dates.

18 **Duration**: Para 11B refers to an amount equal at the inception of the lease to…the present value of the minimum lease payments. Para 23 (b) suggests, as would seem to be appropriate, that it is only the minimum lease payments as from the balance sheet date that are to be capitalised. We recommend that para 11B be reworded accordingly.

Valuation Example

This example seeks to illustrate the ambiguity as to the date and method of apportionment of a lease that has upward rent reviews

It concerns a property let for a term that embraces the entire life of the building. The minimum lease payments must therefore be "allocated between the land and building elements in proportion to their relative fair values at the inception of the lease."
An entity holds a lease of two floors (around 20% of the floorspace) of a City of London office building. The 20 year lease was granted to the current lessee 10 years ago and the rent is subject to 5-yearly upward-only rent review. The building is nearing the end of its economic life and it is anticipated that, on expiry of the lease (and of the other leases in the building) in 10 years time, it will be redeveloped. The minimum lease payments therefore have to be apportioned in proportion to the fair values of land and buildings to enable the building element to be accounted for as a finance lease.

<u>*Minimum lease payments:*</u>

	Today	At the inception of the lease
Minimum annual rent	£200,000 p.a.	£100,000 p.a.

Fair values:

We assume that reference in para 11B is to the fair values of the land and building components of the property. We further assume that the existence of upward-only rent reviews does not preclude the building element of the rent being treated as a finance lease.

There are only two things that a valuer can measure: i) the fair value of the land and buildings (which are indivisible) and ii) the fair value of a cleared site with the right to build a new building. The fair value of a new building could perhaps be allocated between the land and building elements by allocating interest and developer's profit between the two components.

Economically, land value is a residual (building value less building cost) that reflects/absorbs all rises and falls in property values.

A valuer has provided the following estimates:

	Today	At the inception of the lease
Fair value of the property (existing building, subject to the existing lease)	£10 million	£5 million
Fair value of a cleared site	£8 million	£ 1.2 million
Allocation of the fair value of a new building	£19.0m total £ 7.5m building £11.5m land	£9.0m total £ 7.0m building £ 2.0m land

Based upon these facts and valuations, what is the amount of the minimum lease payment, applicable to the building, that is to be capitalised as a finance lease?

Alternative approaches might be as follows. Note that these are accounting apportionments, not valuations.

	Today	At the inception of the lease
Minimum annual rent	£200,000 p.a.	£100,000 p.a.
Fair value of the property	£10 million	£5 million
Fair value of the land - Method A - Method B	£8.0m £10m x 11.5/19 = £6.0m	£1.2m £5m x 2/9 = £1.1m
% of Minimum Lease Rent attributable to the building - Method A - Method B	£8m/£10m = 80% £6m/£10m = 60%	£1.2m/£5m = 24% £1.1m/£5m = 22%

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Annexe B

Definitions of Internal and External Valuer

Internal Valuer
A valuer who is employed by either the enterprise that owns the assets, or the accounting firm responsible for preparing the enterprise's financial records and/or reports. An internal valuer is generally able to meet all the requirements of independence and professional objectivity required under PS 1 (Qualifications and conflicts of interest)* but, for reasons of public presentation and regulation, may not always be able to fill the role of independent valuer in certain types of assignments.

* This is a reference to the RICS Appraisal and Valuation Standards (the "Red Book")

External Valuer
A valuer who, together with any associates, has no material links with the client company or the subject of the assignment.

Both of these definitions appear in the International Valuations Standards issued by the IVSC, and have been adopted by the RICS in its own Standards.