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ISCA Financial Reporting Bulletin 10

FRB 10:
Real Property Valuation for Financial Reporting – Fair Value Based on the Highest and Best Use

About the Institute of Singapore Chartered Accountants

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Established in 1963, ISCA is an advocate of the interests of the profession. Complementing its global mindset with Asian insights, ISCA leverages its regional expertise, knowledge, and networks with diverse stakeholders to contribute towards the advancement of the accountancy profession.

ISCA is the Designated Entity to confer the Chartered Accountant of Singapore – CA (Singapore) – designation.

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As the national accountancy body, ISCA is committed in supporting our members in their careers as they progress and rise to challenges faced along the way. ISCA's Professional Standards Division provides technical support in areas of audit & assurance, financial reporting, sustainability reporting, ethics and specialised industries such as capital markets, banking and finance and insurance; and communicates insights and views to our members and the wider accountancy community. Through our technical committees that comprise representatives from various stakeholders in the corporate reporting eco-system, we hear issues from the ground and conceive initiatives to promote and enhance quality, consistency and best practices to uphold technical excellence.

About ISCA's Financial Reporting Committee

ISCA's Financial Reporting Committee (FRC) comprises representatives from legal and accounting firms, corporate, regulators and academia in the financial reporting eco-system.

FRC's terms of reference include monitoring policy and implementation issues relating to the development of accounting standards internationally and in Singapore, and to identify, understand and address accounting issues faced by professional accountants in Singapore, and provide support through the issuance of guidances.

The terms of reference are executed through FRC with the support of two Sub-Committees, namely the Core Sub-Committee and the Valuation Sub-Committee.

Note:

- *Although this FRB makes references to SFRS(I) 13 Fair Value Measurement, the guidance in this FRB is also applicable to entities applying FRS 113 Fair Value Measurement.*
- *The fact pattern and example presented in this FRB is illustrative in nature. The determination of 'highest and best use' will be based on the reporting entity's specific facts and circumstances.*
- *References made to publicly available information (including the latest valuation standards issued by IVSC) are accurate as at the date of issuance of this FRB.*

Abbreviations

The following abbreviations are used in this FRB:

Abbreviation	Description
IVS	International Valuation Standards
IVSC	International Valuation Standards Council

Contents

1. Background

Real property such as land and buildings are commonly required by accounting standards to be reported at their fair values in the financial statements.[1] The valuation process for these assets often involves the valuer (as professional service provider), the reporting entity (as client) and the auditor (as reviewer of the valuation as part of the audit of financial statements). To facilitate this, ISCA issued [Financial Reporting Guidance 1 ('FRG 1') *Real Property Valuation for Financial Reporting – Best practices when engaging valuers: Considerations for Scope of Work ('SOW') and Valuation Report ('VR')*] in November 2019. FRG 1 seeks to extend guidance to all involved parties to reach a clear and common understanding of the valuation process and requirements of the relevant accounting standards. The key is **timely planning and communication among the three parties – valuer, reporting entity and auditor** without which, expectation gaps can exist among the three parties.

After the issuance of FRG 1, ISCA received feedback that a common issue faced by an auditor is that valuation reports used are not always 'fit' for financial reporting purposes. For instance, the basis of value used is not 'fair value' as defined under SFRS(I) 13 *Fair Value Measurement*.[2] This has resulted in the auditor having to communicate more extensively with the valuer to understand the valuation work performed by the valuer (as required by the Singapore Standards on Auditing). **The reporting entity should remain actively involved in the valuation process, including the communication process between the auditor and the valuer. This is because the reporting entity is ultimately responsible for preparing the financial statements in accordance with the financial reporting standards.** This includes being responsible for ensuring that the requirements of SFRS(I) 13 are adhered to for reporting fair values of real property.

To better address the above issue, ISCA Financial Reporting Committee ('FRC') has conducted an online survey to obtain insights into the difficulties faced.[3] One key finding from the survey is that there are property valuation reports whose basis of value is <u>not</u> 'fair value' as defined in SFRS(I) 13. In such instances, the basis of value used is 'market value' and the respondents shared that no action is typically taken to 'bridge the gap' as they perceive 'market value' to be similar to 'fair value'.

Although there are similarities between 'fair value' and 'market value', there are differences between the two concepts which might lead to differing results in certain situations.

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[1] When the reporting entity has elected to account for:

- real properties for own use using the revaluation model under SFRS(I) 1-16 *Property, Plant & Equipment*; and
- real properties held for investment using the fair value model under SFRS(I) 1-40 *Investment Property*

The real properties will be reported at their fair values in the financial statements.

[2] SFRS(I) 13 is identical to IFRS 13 *Fair Value Measurement* and FRS 113 *Fair Value Measurement.*

[3] Survey Findings Report: Real Property Valuation for Financial Reporting [link]

1.1 How will it impact the reporting entity and its financial statements?

If the reported market value is materially different from the fair value under SFRS(I) 13, the reporting entity would not comply with the financial reporting standards. The consequences of non-compliance are significant especially for public interest entities or when there is an impending merger and acquisition transaction or related party transaction involving a transfer of value from one party to another.

1.2 What should management do?

'Market value' is commonly used as the basis of value in property valuation reports issued by professional valuers. **It is important for the reporting entity to assess whether the reported market value is materially different from the fair value under SFRS(I) 13.** In particular, the market value determined on other valuation premises such as 'current use or existing use' may be materially different from the fair value under SFRS(I) 13 when certain circumstances suggest that the current use or existing use is not the highest and best use.

Examples (not exhaustive) of possible situations where the highest and best use differs from the current use of the asset:

- the property is currently poorly or underutilised and generates cash flows that are below that achievable from its highest and best use
- recent regulatory changes that will allow a higher use of the existing land (e.g. larger saleable or rentable area)
- recent regulatory changes that will allow better use of the existing land (e.g. change from factory building to high-rise residential apartments)

When performing the above assessment:

- management should engage in open communications with the auditor and the valuer; and
- entities are not required to perform an exhaustive search for other potential uses of a non-financial asset if there is no evidence to suggest that the current use of an asset is not its highest and best use.

Depending on the outcome of the assessment performed, entities may be required to obtain a new valuation report that is based on the highest and best use valuation premise. **It is, therefore, important for entities to communicate to the valuer upfront at the planning phase of the valuation process that the valuation should be performed based on the highest and best use valuation premise.**

1.3 Purpose and scope of this FRB

ISCA, through its FRC, is issuing this FRB to explain the concepts of 'fair value' and 'market value', and to highlight that the valuation premise required under SFRS(I) 13 is 'highest and best use'. If a different valuation premise is used in the valuation report, an assessment needs to be undertaken to determine if the resulting valuation is appropriate for financial reporting purposes. This FRB also includes an example to illustrate the application of highest and best use as the valuation premise.

2. Key concepts – 'Fair Value' and 'Market Value'

When property valuations are performed for financial reporting purposes, the requirements of SFRS(I) 13 are to be complied with. The appropriate basis of value for financial reporting purposes is 'fair value' as defined in SFRS (I) 13 and for non-financial assets, SFRS(I) 13 requires the valuation premise used to measure the fair value to be 'highest and best use'. Notwithstanding this, in practice 'market value' is commonly referred to as the basis of value in property valuation reports issued by professional valuers.

2.1 What is 'fair value' as defined in SFRS (I) 13?

The definition of fair value and the key concepts relevant to this FRB are summarised in the table below.

Exit price	Fair value is defined as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'. Therefore, fair value is the price for the entity to sell the asset or to pay to transfer the liability (that is, exit price).[4]
Market-based measurement	An orderly transaction between market participants in the principal market or in its absence, the most advantageous market.[5]
Highest and best use for a non-financial asset	A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.[6] The highest and best use of a non-financial asset establishes the valuation premise used to measure the fair value of the asset.[7]

<u>Valuation premise</u>
To measure the fair values of non-financial assets, **SFRS(I) 13 requires the consideration of the highest and best use of that asset being valued** – taking into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. Highest and best use is the use that would maximise the real property interest's value and that is physically possible, legally permissible and financially feasible. Highest and best use might provide maximum value through its use in combination with other assets as a group, or on a stand-alone basis. **The current use of a non-financial asset is presumed to be its highest and best use** unless market or other factors suggest that a different use by market participants would maximise the value of the asset.[8]

[4] Ibid, paragraph 9.

[5] Ibid, paragraphs 3, 16, 19, 20 and Appendix A.

[6] Ibid, paragraph 27.

[7] Ibid, paragraph 31.

[8] Ibid, paragraph 29.

2.2 What is 'market value' as defined in valuation standards?

Property valuations are prepared in accordance with applicable valuation standards depending on the property valuer's licensing jurisdiction or affiliated professional organisation. One common valuation standard is International Valuation Standards ('IVS') issued by International Valuation Standards Council ('IVSC'), which are used in more than 100 countries globally. The latest valuation standard issued by IVSC is IVS 2022.[9]

Under IVS 2022, there are six different IVS-defined bases of value[10], one of which is 'market value' as defined below:

The **most probable price reasonably obtainable in the market**	Market value is defined as 'the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion'.[11] '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 and deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale or any element of value available only to a specific owner or purchaser.[12]
Determined based on **willing buyer and willing seller**	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'.[13] 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.[14]
Measured based on an **arm's length transaction**	The transaction is one between parties who do not have a particular or special relationship, e.g., parent and subsidiary companies or landlord and tenant, that may make the price level uncharacteristic of the market or inflated. The market value transaction is presumed to be between unrelated parties, each acting independently.[15]

[9] IVS 2022 is effective 31 January 2022.

[10] IVS 2022 define 'basis (bases) of value' as the fundamental premises on which the reported values are or will be based (in some jurisdictions also known as standard of value) [Glossary of IVS 2022]. IVS-defined bases of value are market value, market rent, equitable value, investment value/worth, synergistic value and liquidation value.

[11] IVS 104, paragraph 30.1.

[12] Ibid, paragraph 30.2(a).

[13] Ibid, paragraph 30.2(d).

[14] Ibid, paragraph 30.2(e).

[15] Ibid, paragraph 30.2(f).

Valuation premises

Under IVS 2022, some common premises of value are:[16]

Highest and best use	The highest and best use is the use from a participant perspective, that would produce the highest value for an asset. The highest and best use must be physically possible (where applicable), financially feasible, legally allowed and result in the highest value. If different from the current use, the costs to convert an asset to its highest and best use would impact the value. The highest and best use for an asset may be its current or existing use when it is being used optimally. However, the highest and best use may differ from current use or even be an orderly liquidation. The highest and best use of an asset valued on a stand-alone basis may be different from its highest and best use as part of a group of assets, when its contribution to the overall value of the group must be considered.[17]
Current use / existing use	Current use/existing use is the current way an asset, liability, or group of assets and/or liabilities is used. The current use may be, but is not necessarily, also the highest and best use.[18]
Orderly liquidation	An orderly liquidation describes the value of a group of assets that could be realised in a liquidation sale, given a reasonable period of time to find a purchaser (or purchasers), with the seller being compelled to sell on an as-is, where-is basis. The reasonable period of time to find a purchaser (or purchasers) may vary by asset type and market conditions.[19]
Forced sale	The term 'forced sale' is often used in circumstances where a seller is under compulsion to sell and that, as a consequence, a proper marketing period is not possible and buyers may not be able to undertake adequate due diligence. The price that could be obtained in these circumstances will depend upon the nature of the pressure on the seller and the reasons why proper marketing cannot be undertaken. It may also reflect the consequences for the seller of failing to sell within the period available. Unless the nature of, and the reason for, the constraints on the seller are known, the price obtainable in a forced sale cannot be realistically estimated. The price that a seller will accept in a forced sale will reflect its particular circumstances, rather than those of the hypothetical willing seller in the market value definition. A 'forced sale' is a description of the situation under which the exchange takes place, not a distinct basis of value.[20]

[16] IVS 2022 defines 'premise of value' as describing the circumstances of how an asset or liability is used [IVS 104, paragraph 130.1]

[17] Ibid, paragraph 140.

[18] Ibid, paragraph 150.

[19] Ibid, paragraph 160.

[20] Ibid, paragraph 170.

Important note

	SFRS(I) 13	IVS 2022
Valuation premise(s)	Required premise: Highest and best use	Allowed premises: • Highest and best use • Current use / existing use • Orderly liquidation • Forced sale *Note: the above are common premises of value. Please refer to IVS 2022 for the complete list of premises of value.*

SFRS(I) 13 requires the valuation premise of non-financial assets to be its highest and best use. IVS 2022 permits the use of valuation premises other than the highest and best use. It is therefore important for entities to understand the valuation premise used in the valuation reports. If the valuation premise used is not highest and best use, an assessment needs to be undertaken to determine if the value reported in the valuation report is appropriate for financial reporting purposes.

3. Valuation premise – Highest and best use

The valuation premise under SFRS(I) 13 for non-financial assets is 'highest and best use' of the asset being valued. This is important as the fair value may vary significantly depending on the premise used about the asset's use.

The 'highest and best use' takes into account the use of the asset that is physically possible, legally permissible and financially feasible, summarised in the table below:[21]

Physically possible	Legally permissible	Financially feasible
Takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (e.g. the location or size of a property).	Takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (e.g. the zoning regulations applicable to a property).	Takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

In addition, the reporting entity needs to consider whether maximum value would be provided to market participants by using the asset on a stand-alone basis or in combination with other assets.[22]

[21] SFRS(I) 13, paragraph 28.

[22] Ibid, paragraphs 31(a) and 31(b).

If the asset's highest and best use requires using it in combination with other assets or with other assets and liabilities, the fair value of the asset is the price that would be received, assuming that the asset would be used with other assets or with other assets and liabilities and that those complementary assets and the associated liabilities would be available to market participants.[23]

The fair value measurement of a non-financial asset assumes that the asset is sold consistently with the unit of account specified in other SFRS(I)s (for instance, SFRS(I) 1-40 *Investment Property* for an investment property). This is the case even when that fair value measurement assumes that the highest and best use involves using it in combination with other assets or with other assets and liabilities because a fair value measurement assumes that the market participant already holds the complementary assets and the associated liabilities.[24]

The reporting entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset. Entities are not required to perform an exhaustive search for other potential uses of a non-financial asset if there is no evidence to suggest that the current use of an asset is not its highest and best use.[25]

In situations where the highest and best use differs from the current use, the fair value is determined based on the asset's highest and best use by market participants.

Important note

SFRS(I) 13 presumes the current use of a non-financial asset to be the highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset. This means that even if the valuation premise indicated in the valuation report is current use, the reporting entity will still need to consider if there are indeed market or other factors that would indicate a different use that would maximise the value of the asset.

[23] SFRS(I) 13, paragraph 31(a)(i).

[24] Ibid, paragraph 32.

[25] Ibid, Basis for Conclusions, paragraph BC71.

3.1 Illustrative example

Below is an illustration of the application of highest and best use as the valuation premise.

Illustration – Determining the highest and best use of land[26]

<u>Fact pattern</u>

- Entity A owns a piece of land along Orchard Road with a shopping mall built on it.
- As part of the Singapore government's initiative[27] to rejuvenate Orchard Road, nearby sites/shopping malls are being redeveloped to mixed-use developments (i.e., comprising office, retail and residential space).

Question – How should Entity A estimate the highest and best use of its land?

<u>Answer</u>

As a start, the current use of the land is presumed to be its highest and best use, unless market or other factors suggest a different use by market participants.

According to paragraph BC69 of SFRS(I) 13, a fair value measurement can assume a different zoning (from the zoning of the asset at measurement date) if market participants would do so (incorporating the cost to convert the asset and obtain that different zoning permission, including the risk that such permission would not be granted).

In Entity A's case, the fact that nearby sites/shopping malls are being redeveloped to mixed-use developments suggests that the current use of the land (with a shopping mall) may not be its highest and best use. Hence, Entity A determines that the land could be developed as a mixed-use development based on recent zoning changes and that market participants would consider the potential to redevelop the site for mixed-use development when pricing the land.

Important note

Entities should be mindful that the current use of a non-financial asset may not be the highest and best use if market or other factors suggest that a different use by market participants would maximise the value of the asset.

The highest and best use is determined by comparing the following:

- The value of the land as currently used (i.e. assuming that the land would be used in combination with other assets, such as the shopping mall, or with other assets and liabilities)
- The value of the land as a vacant site for mixed-use development, taking into account the costs of demolishing the shopping mall and other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (i.e. the land is to be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of the above values. In situations involving real property appraisal, the determination of highest and best use might take into account factors relating to the shopping mall operations, including its assets and liabilities.

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[26] Adapted from Illustrative Example 2 of SFRS(I) 13.

[27] https://www.ura.gov.sg/Corporate/Resources/Publications/Skyline/Skyline-issue11/Rejuvenating-central-area

For reference: ISCA Financial Reporting Codification Framework

In November 2019, ISCA issued the ISCA Financial Reporting Codification Framework (Framework). The Framework establishes a formalised categorisation, degrees of authority and a due process for future issuance of ISCA's technical documents. It provides credence to ISCA's technical content, promulgates ISCA's views on the application of accounting standards as well as promotes quality, consistency and best practices in financial reporting.

The Framework is summarised in the table below.

Category	Nature	Degree of authority	Due Process	Highest level of approval
1. Financial Reporting Practice (**FRP**)	Recommended best practices for financial reporting for specific industries, sectors or transactions	Expected to apply	Public consultation required	ISCA Council
2. Financial Reporting Guidance (**FRG**)	Technical guidance, views and insights on specific financial reporting issues for specific industries, sectors or transactions	Expected to follow or explain departures	Public consultation required	ISCA Financial Reporting Committee (FRC), with authority delegated by the ISCA Council
3. Financial Reporting Bulletin (**FRB**)	Technical bulletin containing discussions and highlight of emerging topical financial reporting issues	For information and educational purposes	Public consultation not required	ISCA FRC

For more details on the Framework and the guidance issued under the Framework, please refer to the following:

- Framework (link)
- FRG (link)
- FRB (link)