

EXPOSURE DRAFT OF PROPOSED REVISED INTERNATIONAL VALUATION GUIDANCE NOTE GN 3 VALUATION OF PLANT AND EQUIPMENT

Comments to be received by 31 October 2004

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International Valuation Standards Committee

12 Great George Street, Parliament Square, London SW1P 3AD

United Kingdom

Fax: +44 (0) 1442 879306

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Exposure Draft of Proposed Revised International Valuation Guidance Note 3, Valuation of Plant and Equipment

1.0 Introduction

- 1.1 The objective of this Guidance Note (GN) is to provide clarification and guidance to Valuers in preparing valuations of *Plant and Equipment*. As defined below, plant and equipment collectively constitute a general class of property other than realty, classified for accounting purposes as tangible assets. International Valuation Application 1 (IVA 1) deals with valuation requirements for financial reporting purposes. This GN is intended to clarify and extend that discussion to tangible assets other than realty, and to distinguish valuations for financial reporting from other valuation bases that may be applied in non-financial reporting situations.
- 1.2 Plant and equipment may be valued for a variety of reasons. When valued for financial reporting purposes, plant and equipment are valued in the same manner as other assets. The *Market Value* of plant and equipment may be estimated by applying one or more of the valuation methods outlined in para. 1.3 below in accordance with IVA 1. When the purpose of the valuation is other than financial reporting, plant and equipment are valued by applying an appropriate valuation basis and by clearly distinguishing the results from *Market Value* if a *Non-Market Value* basis is applied.
- 1.3 Plant and equipment combine to constitute a wide variety of situations requiring skillful assessment of the utility of the property valued and careful consideration of such property's physical, functional, and economic characteristics. As tangible personal property, plant and equipment may be sold in conjunction with a variety

of other tangible and intangible assets, grouped and sold separately, or divided into separate components and then sold. Available valuation methods include:

1.3.1 *sales comparison approach.*

1.3.2 *cost approach (depreciated replacement cost, or in some jurisdictions optimised depreciated replacement cost—see Glossary definition), and*

1.3.3 *income capitalisation approach.*

1.4 IVSC seeks to avoid incidences of international misunderstanding and/or misconceptions within States concerning the valuation of Plant and Equipment. Valuers applying IVSC Standards and this Guidance are responsible for selecting proper valuation methods (in keeping with the agreed scope of the assignment or instruction), enhancing the understanding of valuation users, avoiding circumstances that might mislead the public, and reporting objectively supported valuations.

2.0 Scope

2.1 This GN covers definitions, principles, and important considerations in valuation and related reporting for plant and equipment.

2.2 This GN is to be applied with particular reference to International Valuation Standards 1 and 2 (IVS 1 and 2) and IVA 1. Most notably these Standards and Guidance distinguish between valuations undertaken on the basis of *Market Value*, valuations performed on a basis other than *Market Value*, and between valuations for financial reporting purposes and valuations for other purposes.

2.3 The guidance herein applies to the valuation of the plant and equipment assets of private-sector and public-sector entities.

3.0 Definitions

3.1 *Plant and Equipment.* Fixed tangible assets other than realty intended to generate income for their owner. Relevant definitions appear below.

3.1.1 *Plant.* The assemblage of assets that are inextricably combined and that may include specialised buildings, machinery, and equipment. The combination of such assets may be achieved by means of integrated support structures, cladding and staging that are incapable of being separated from the assemblage.

3.1.2 *Machinery.* Individual machines or collections of machines. A machine is an apparatus using or applying mechanical power, having several parts each with a definite function, and together performing certain kinds of work.

3.1.3 *Equipment.* Ancillary assets that are used to assist the function of the enterprise/entity.

3.2 *Property, Plant and Equipment.* Tangible items that:

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

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

3.3 *Market Value* is defined in IVS 1:

Market Value is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an

arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

3.4 *Entity-Specific Value*. The present value of cash flows an entity expects to arise from the continuing use of the asset and from the disposal at the end of its useful life or expects to incur when settling a liability. (IAS 36, 6) Entity-specific value is estimated by the income capitalisation approach, and may or may not represent *Market Value*.

3.5 *Value in Use* is defined in IVS 2. It may be the valuation basis for plant and equipment when assets are to be valued as part of a going concern under the *going concern premise*. The value of assets to a going concern may differ considerably from the *Market Value* of the assets. Such valuations do not necessarily derive *Market Value* and should be carefully distinguished and explained by the Valuer.

3.6 IVA 1 covers the *Market Value* basis as applied to financial reporting.

3.7 Other *Non-Market Value* definitions that may be applied in various types of plant and equipment valuations include the following:

3.7.1 *Liquidation, or Forced Sale, Value* is defined in IVS 2. Either term refers to the amount which may reasonably be received from the sale of a property within a time frame too short to meet the marketing time frame of the *Market Value* definition. In some States, liquidation, or forced sale, *value* may also involve consideration of an unwilling seller and a buyer or buyers who buy with knowledge of the disadvantage of the seller. These values do not consider *make-ready costs*, the costs required to make the assets productive, since the income stream associated with the assets will not support such costs under this premise of value. Distinctions may be made as to the time over which the sale is to occur and as to its location.

- 3.7.2 *Auction Realisable Value*. The estimated amount that one would expect to achieve at a properly promoted, conducted, and attended auction sale. It normally assumes that the sale is held on the site and substantially all of the assets in the inventory listing are offered for sale at one time.
- 3.7.3 *Salvage Value* is defined in IVS 2. It is the value of an asset, as if disposed of for the materials it contains rather than for continued use without special repairs or adaptation. It may be given as gross or net of disposal/disposition costs. In the latter case it may equate to *net realisable salvage value*. It is assumed that certain components of the asset are capable of reuse. Salvage value may also be referred to as *scrap value*.
- 3.7.4 *Insurance Replacement Cost, or Insurable Value*. See para. 3.7.6 (*Indemnity*) below.
- 3.7.5 *Reinstatement Cost*. The estimated cost at the date of assessment to replace or repair the insured plant and machinery to a condition substantially the same as, but not better or more extensive than, its condition when new. Reinstatement cost assessments should include all insurable contingencies such as transport, installation, commissioning, and non-recoverable taxes. The Valuer will also need to make allowance for the “Additional Costs of Reinstatement” that are usually included in the scope of coverage, i.e., fees and debris removal costs.

Insurance policies containing a reinstatement memorandum undertake to pay replacement at cost new at the date such cost is incurred following loss by the insured. In most cases, therefore, a shortfall will exist between the Valuer’s estimate of replacement at cost new at the date of the assessment and the actual cost incurred at the date of reinstatement. Most modern policies make automatic provision for this contingency. However, the Valuer may be asked to provide an opinion of inflation for the period

of the policy and for the maximum period of reinstatement, assuming a total loss. Where these estimates are provided, they should be stated separately.

3.7.6 *Indemnity*. The cost necessary to replace or repair the insured plant and machinery to a condition substantially the same as, but not better or more extensive than, its condition at the date that the loss occurred, taking into consideration age, condition, and remaining useful life. *Indemnity assessments* should also include all associated costs involved in installing the plant as well as the additional costs of reinstatement (as specified in para. 3.7.5). These estimates should be included at the estimated cost new upon the date of assessment, i.e., no allowance is to be made for depreciation in these elements. Depending on the nature of the plant and equipment, indemnity will be derived by either the Market Value, the Depreciated Replacement Cost, or a combination of both.

Unlike *reinstatement* coverage, an *indemnity* provides compensation at the date the loss occurs and not at the date the reinstatement takes place. The insured is under no obligation to reinstate, and no provision is made, or indeed required for inflation.

In some States, *insurance replacement cost*, or *insurable value*, is the term adopted for coverage essentially of an *indemnity* nature, and the approach the Valuer uses for the assessment will be the same as that outlined above.

When working on any insurance valuation or reinstatement cost assessment, the Valuer should check the policy wording, which can vary, to ensure that the valuation or assessment is done in accordance with policy requirements.

4.0 Relationship to Accounting Standards

- 4.1 Plant and equipment are tangible assets that, when present, will be reflected in valuations for financial reporting. Like other tangible assets, plant and equipment are valued at *Market Value*. When applicable, the sales comparison approach, income capitalisation approach, or cost/depreciated replacement cost (DRC) approach may be applied (See IVA 1).
- 4.2 If another valuation basis is reported, as in insurance, liquidation, or other special applications, the report will define any relevant bases of value applied and distinguish them from *Market Value*.
- 4.3 International Accounting Standard (IAS) 16, paras 31-41, provide guidance on the revaluation of property, plant and equipment; the frequency at which such assets are revalued; the need to revalue the entire class of property, plant and equipment if any asset belonging thereto shall be revalued; and how to credit increases in an asset's carrying amount or to debit decreases in an asset's carrying amount. (IAS 16, paras. 73 and 77, set down special disclosure requirements for each class of property, plant and equipment and for when items of property, plant and equipment are stated at revalued amounts. For discussion of these provisions see IVA 1.)
- 4.4 International Accounting Standard (IAS) 16, paras. 32 and 33, provide specific direction as to the application of an income or DRC approach to plant and equipment:

The fair value of land and buildings is usually estimated from market-based evidence that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value estimated by appraisal.

If there is no market-based evidence because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

4.5 The *depreciated replacement cost* (DRC) or cost approach is typically applied in the absence of comparable sales data. An estimate derived from DRC is referred to as “valued by reference to DRC.” This result is subject to the adequate potential profitability or service potential of the entity from the use of assets as a whole, an assumption that can be accepted or rebutted. If the directors of the entity believe that the potential profitability of the business is insufficient to carry the DRC estimate, they may adopt a lower figure in their accounts in recognition of additional economic obsolescence. The written-down estimate is entity-specific and may represent the asset’s *value in use*. It is incumbent upon the Valuer, however, to state whether the valuation arrived at by DRC was subject to the directors’ test of potential profitability.

4.6 International Accounting Standard 36 deals with impairment. Currently, reporting entities must test carrying amounts of assets for impairment by reference to the lowest level cash generating unit (CGU), at which cash flows can be identified.

5.0 Guidance

5.1 Plant and equipment valuation situations are varied, and circumstances may even require the estimation of more than one type of value in a single assignment. Accordingly, plant and equipment will be valued on a basis that is appropriate for the circumstances, and that basis will be appropriately defined in the Valuation Report.

- 5.2 For financial reporting purposes, items comprising plant and equipment must be separated into operational, surplus, and investment property categories in accordance with IVA 1. Although this process can be extensive and is frequently complicated when there are large inventories of items to be valued, proper and detailed identification and classification of assets constituting plant and equipment are fundamental requisites for a valuation to be performed. Client instructions regarding these classifications should be obtained at the beginning of a valuation assignment.**
- 5.3 If a Valuer accepts an assignment in which no specific instructions were given as to the value definition to be used, the Valuer shall independently carry out the necessary investigation and research to properly identify the relevant value definition.**
- 5.4 Valuers shall make clear, unambiguous, and unequivocal disclosures in communicating plant and equipment valuations as outlined in IVS 1, 2, and 3, and IVA 1. The requirements for valuation reports are addressed in the IVS Code of Conduct, and IVS 3, Valuation Reporting.**
- 5.5 To assure client and Valuation Report user understanding and to avoid potential abuses, Valuers shall take reasonable steps to assure that performance of the assignment will not lead to a conclusion that is misleading or inappropriate for the circumstances.**
- 5.6 While undertaking a plant and equipment valuation, Valuers shall be aware of, understand, and correctly apply those valuation methods and techniques that are necessary to produce a valuation that is not misleading.**
- 5.7 Although the concept, use, and application of non-market bases of value may be appropriate under certain circumstances, the Valuer is responsible to**

ensure that if such value is to be found and reported, it will not reasonably be construed as a representation of *Market Value*.

- 5.8** Valuations will clearly state whether plant and equipment assets have been valued in situ or ex situ (on site or off site).
- 5.9** The *Market Value* of plant and equipment rests upon the belief that a prudent purchaser would pay no more for an asset or a group of assets than the cost of acquiring (an) equally desirable substitute(s) in the market. In the valuation of plant and equipment, the cost of the substitute(s) often includes costs to make the asset(s) productive. These costs are called *make-ready* and/or *indirect costs*. Often included in these costs are necessary, associated expenses such as engineering, interest during construction, transportation, installation, attachment to utilities, and start-up.
- 5.10** Plant and equipment includes installations and support facilities for processes or manufacturing which are designed to perform a specific predetermined function. These include all non-realty devices in fixed or movable form deployed in the processing, manufacturing, or assembling of products from the stage of raw materials to finished goods. Separately reported items such as materials inventories, finished products, patents, and the like are not included. Thus, it is essential to the Valuation Process that all items to be valued are neither omitted nor accounted for twice in the valuation and related reporting.
- 5.11** Plant and equipment may broadly be divided into four categories:
- 5.11.1** Machinery and equipment that may have been installed wholly in connection with the occupier's industrial, commercial or service processes,

5.11.2 Equipment that includes furniture and furnishings, tenants' fixtures and fittings, vehicles, stock, moulds, and loose tools, among others,

5.11.3 Factory and industrial buildings that are highly integrated with the enclosed process or equipment they support and structures of a specialised nature, and

5.11.4 Building services that are normally included in valuations of land and buildings. Building services that are included within plant and equipment may include electricity, gas, water, space heating, hot water, air conditioning and ventilation, fire and security, drainage, and elevators/lifts and gantries, among others when they are provided as part of the industrial processes carried on by the occupier.

5.12 For valuations that deal with liquidation, or forced sale, value, the time frame for required sale is normally specified by the client, and may range from a relatively long period (still less than the period required for *Market Value*) to a shorter, urgent period. In some instances, the sale may be by auction. In others, a sale may be through solicitation or by a combination with other assets for package sale. The manner of offering, time frame involved, and location of the assets at the time of sale are matters for proper disclosure in the Valuation Report.

6.0 Effective Date

6.1 This International Valuation Guidance Note became effective July 1, 1997 and was revised xxxxxx.