

The International Valuation Standards Council – Building Trust in Valuation

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SUMMARY

The financial crisis exposed weaknesses in the functioning and in the transparency of financial markets and led to a much greater understanding of the importance of valuation. Indeed, the need to improve valuation standards, consistency and transparency was identified by bodies such as the G20 and the Financial Stability Board during the aftermath of the crisis.

Sound valuation has been recognised as critical both as an input for the smooth functioning of financial markets and institutions, as well as an output from financial systems in their role of allocating capital efficiently across the economy.

Although valuation issues are now seen as integral to today's financial system, historically it has been an activity that has been taken for granted or even overlooked. The result of this lack of recognition of the importance of valuation has resulted in a fragmented professional and regulatory landscape when viewed from a global perspective. The maturity of the profession varies across asset classes. For example, credentials and the accompanying enforcement framework exist for certain aspects of valuing real estate; however, in many jurisdictions, similar attributes are not prevalent for valuation of businesses, intangibles, and financial instruments.

Inconsistent stipulations as to who may value certain assets for certain purposes, lack of mutual recognition of equivalent qualifications and excessive fragmentation of the organised profession all act to limit competition and the development of consistent high quality practices across borders. They also create complexity and unnecessary expense for entities with assets that require valuation in different countries.

The presentation will examine the work of the International Valuation Standards Council (IVSC) in developing high quality international technical and professional valuation standards. Technical standards include generally accepted principles of valuation and procedures for the undertaking of valuations. Professional standards include establishing codes and benchmarks for the conduct and competency of professional valuers.

The overriding objective behind all of these activities is to protect the interest of the direct and indirect users of valuation services.

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1. INTRODUCTION

- 1.1 Inconsistent and poor valuation practice, with a particular focus on financial instruments, was identified by the (then) Financial Stability Forum and the G20 as a significant contributor to the 2008 global financial crisis. The aim of this paper is to discuss the work of the International Valuation Standards Council (IVSC) in developing high quality international technical and professional valuation standards in response to the challenges posed to the valuation profession as a result of the crisis.
- 1.2 I am presenting this paper at the request of the IVSC and in the capacity as past chairman of the IVSC from 2007 to 2008. However, any views expressed in this paper are my personal, as a practicing Valuer and Property Consultant from Malaysia.

2. THE GLOBAL FINANCIAL CRISIS

- 2.1 The broadest overview of the Global Financial Crisis that I have had so far is from reading a recent book entitled "The Great Inflation and its Aftermath" by Robert Samuelson who traces the rise and fall of inflation in the lead economy of the world, the U.S economy, as the principal background setting for the crisis. According to the report and a review of the book in an article from the Singapore Business Times of 7 February 2010, the 1950's and the 1960's, in the U.S. were periods of great economic stability. Inflation started to slowly creep up in the late 1960's and peaked in 1970 at 13 per cent. This was the first part of the setting. Inflation was then brought down to 4 per cent by 1984 in a hard-won triumph, engineered by then Federal Reserve Chairman, Paul Volcker and backed later by President Ronald Reagan.
- 2.2 By 2001, inflation was down to 1.6 per cent and it was the intervening years, often referred to as the Great Moderation, that gave rise to the sustained prosperity (the second part), as interest rates fell, and the stock and property markets soared. In 2000, the stock market bubble burst, but it was not as impactful as the subsequent housing bubble burst because it was "widely diffused", as Nobel Prize Winning Economist, Paul Krugman explained. Seven years later, when the property market bubble burst, the impact was substantial because it was concentrated in the financial sectors and there was a large edifice of new financial products built upon it, the tentacles of which were global in reach and global in effect.

- 2.3 An underlying fundamental for the crash was inflated property prices/values, whether commercial or residential, and since the taming of inflation, the belief grew that house prices would not fall. The median price for existing homes rose from US\$62,200 in 1980 to US\$143,600 in 2000. By 2006, it was US\$221,900. Feeling enriched by higher home values and stock portfolios, many Americans saved less and borrowed more.
- 2.4 The increased prosperity and economic stability of the 1980s and thereafter, was only half the story. Money managers, regulators, economists and the general public all succumbed to seductive beliefs that house prices would not fall, that the free market had an inbuilt mechanism for self-correction and that severe recessions and depressions had been tamed forever. In fact, even shallow recessions were pounced upon and smoothed as though they had no role to play as correcting mechanisms.
- 2.5 The central message of the book was : thinking the world less risky, people took actions that made it more risky. The pleasures of prosperity backfired and the book concludes with some suggestions, but on the note that if lessons of the past are not properly learnt, the sequel will be even more devastating.
- 2.6 In "The Meltdown Years" by Wolfgang Munchau, he also takes a broad view and refers to Martin Feldstein's six "American" reasons for the crisis, namely that U.S. interest rates had been too low; financial regulation had been insufficiently focused; bad housing policies had set wrong incentives; rating agencies had misled investors; the banking system had failed to account for risk properly; and borrowers had taken on too much debt. He goes on to say that that analysis is superficial because the questions that ought to be asked are why was there regulatory failure, why did people take on so much of debt, etc. He says that in search for answers, one invariably encounters the global economy, the global monetary system, and the global financial system.
- 2.7 If it was a systemic failure, or if systemic failure was a major contributing factor, then upon re-examination, the various component parts of the global financial system needs scrutiny and one of the component parts of the system is a proper valuation framework, not only of real estate but of businesses and financial interests. Valuations undertaken in accordance with generally accepted principles are central to financial stability and provide the basis for decision making by investors in all asset classes. Reliable and consistent valuation is also of fundamental importance to prudential regulators and market participants in determining the capital adequacy of financial institutions. Valuation is an integral part of the risk management processes applied by financial institutions and other businesses and, with the use of fair value and similar measurements, is an integral part of financial reporting.
- 2.8 The crisis emphasized the importance of establishing an international consensus around the input assumptions, models and processes involved in valuation and of recognising that improving confidence in valuation methodologies and practices is a key factor in restoring investor confidence. Consolidation of the emerging recovery in the world's financial markets presents an opportunity to position the global valuation profession as a

key contributor to enhancements in the global financial systems which help foster financial stability and sustainable economic growth.

3.0 THE INTERNATIONAL VALUATION STANDARDS COUNCIL

- 3.1 The IVSC was established in 1981 and successfully completed a major restructure during 2008 with the 'new' organization coming into effect in January 2009. It is currently chaired by Sir David Tweedie. Sir David has been one of the most influential players on the global financial stage in the last 14 years, having been chair of the International Accounting Standards Board from 2000 to 2011. With the goal of creating a universally comparable accounting language, he led the adoption of international financial reporting standards (IFRS) into over 100 countries around the world. He is committed to shaping valuation to be a truly global profession that can hold its head up high in the financial sector.
- 3.2 The IVSC is an independent, not-for profit private sector organisation whose overriding objective is to serve the global public interest. It does this by developing international valuation standards which serve the world's capital markets, regulators and market participants, and by promoting strong ethical values in the valuation profession, encouraging quality practice and supporting the development of strong professional valuation organizations and a competent valuation profession around the world.

4.0 INTERNATIONAL VALUATION STANDARDS

- 4.1 Valuation Standards are important because they enable industry-wide valuations at high levels of integrity and competence. In any country there are usually some Valuers or valuation firms who rise to the challenges, and on their own, develop adequate models and undertake valuations for not only simple properties but for complex properties such as multi tenanted office buildings, shopping centres, oil palm plantations, quarries, copper mines, timber concessions, specialised plant and machinery, steel mills, development rights, hotels, large development lands and so on. But what is needed in the profession as a whole is for high industry-wide levels of integrity and competence, and this is where robust and continuously updated valuation standards play a crucial role. By incorporating codes of ethics, enunciating principles of valuation and supporting best practices, such standards set the parameters for the duty of care a professional Valuer owes to his client, to reliant third parties and to the public at large. High-level, industry-wide valuations also support efficient real estate markets which in turn support the efficient functioning of market based economies.
- 4.2 Valuations underpin the banking sector, where valuations for loan securities depend on proper valuations, accompanied by periodic updates to ensure the maintenance of loan security values. The role that professional Valuers play in supporting the banking and financial system ought to be given greater recognition, and the need for periodic updates

because of the time specificity of valuations to be better coded into the system. The system should also detect bad valuations at an early stage, before loan approval. Too often, it is only at the point when loans go sour that such Valuers and valuations are inconveniently "discovered".

- 4.3 Corporate valuations support balance sheet values and play a significant role in mergers and acquisitions. Such valuations are in fact also becoming more important with the onset of, and rapid progress being made in, fair value accounting for financial reporting purposes. In Malaysia, valuations in the public domain i.e. valuations for submission for approval to the Securities Commission and/or the Stock Exchange by publicly listed companies, require adherence to very strict and mandatory valuation guidelines. These guidelines are, added, user specific guidelines that Valuers are required to follow, over and above the Malaysian Valuation Standards, that is issued by the Board of Valuers, Appraisers & Estate Agents, a statutory body set up by an Act of Parliament, and which regulates the valuation, estate agency and property management profession.
- 4.4 To the Valuer, a set of robust and continuously updated set of valuation standards are his best defence when he is challenged in a court of law, on charges of professional negligence. If he has complied with the standards, the party claiming negligence will be hard put to assert their claim. On the other hand, the client, reliant third parties and the public are protected when the standards secure for them a strong basis to bring action against errant Valuers who are found to be non-compliant with valuation standards. Court decisions in many jurisdictions are well established as to the duty of care a Valuer owes the client, a reliant third party or the public, and the duty of care is best measured against a clear set of standards that are continuously updated.
- 4.5 There is a huge diversity in the standards that govern the valuation process at the national level. Existing valuation standards have sprung up as needed for purposes such as taxation, litigation, transactions, shareholder disputes or financial reporting. Within one country, there may be multiple sets of standards promulgated by different organisations. Standards may have been developed for the valuation of some assets but not others. For example, many countries have strong standards for the valuation of tangible assets as a result of previous property market crises but no standards or guidance for the valuation of intangible assets or financial instruments. Standards may be set by self-regulating professional valuation organisations, various industry bodies, accounting associations, and government or quasi-government boards or indeed through legislation. However the economic and financial crisis has led to demands to apply consistent standards of valuation on a global basis. Unless such standards are established through a strong global standard setter there is a fear of disparate responses arising from the current crisis resulting in multiple sets of standards.
- 4.6 The IVSC is engaged in a programme to promote wider recognition and adoption of its standards. Where statutory standards already exist, the objective is to secure convergence of these with the IVSs. More than ten organisations from different world regions that currently set valuation standards independently of the IVSs have agreed in principle to enter into a memorandum of understanding under which they will commit

to a process of convergence that will either lead to the adoption of the IVSs or that will eliminate difference between the IVSs and the standards that they issue.

- 4.7 The Asia-Pacific Economic Cooperation forum (APEC) Advisory Group on Financial System Capacity-Building has examined, together with the IVSC, how the public and private sectors can collaborate in APEC to support the development of high quality valuation standards based on global benchmarks. The IVS aim to identify concepts and principles that are applicable to all types of valuation in order to improve consistency, transparency and therefore confidence in the valuation process in the region.
- 4.8 The creation of a platform of a high-quality and comprehensive set of global valuation standards will allow the IVSC to move forward on the many complex issues facing valuation today. It also allows the IVSC to take its place in the mosaic of international regulation and financial reporting organisations and infrastructure and to work towards the International Valuation Standards being recognised as one of the key standards designated by the Financial Stability Board as key for sound financial systems and deserving of priority implementation.

5.0 THE DEVELOPMENT OF THE VALUATION PROFESSION GLOBALLY

- 5.1 Many of the regulatory reforms since the global financial crisis refer to the need for an independent or external valuer with the necessary qualifications, ability and experience. This recognizes the importance of the valuation profession in ensuring that the necessary skills, competencies, and ethics are brought to bear in applying the International Valuation Standards. In 2010, the usPublic Company Accounting Oversight Board (PCAOB) estimated that “70% of the issues identified as problems in the audits which it oversees are associated with improper valuations and there is a growing concern that without professional standards there will be a proliferation of unqualified individuals undertaking valuations”.
- 5.2 It is vital to the efficient and smooth running of financial markets and economies that valuations are consistent and accurate and that those undertaking valuations are suitably qualified and regulated in their work. Across many jurisdictions worldwide, the valuation profession is highly fragmented, and the maturity of the profession varies across valuation specialities, asset classes and countries. While credentials and the accompanying monitoring and enforcement framework exist for certain aspects of valuing real estate, there are few professional bodies concerned with the valuation of financial instruments, businesses and intangibles. This is beginning to change. The financial crisis has focused the attention of regulators and governments not just on the need for comprehensive valuation standards but on those who provide valuation services. The skill and experience of the valuer is a major factor contributing to valuation uncertainty. The IVSC is seeking to foster the development of the global valuation profession through providing a definition of the ‘professional valuer’ and by providing international benchmark standards on pre-qualification education, training of professional valuers, and on continuing professional education to help create a strong professional infrastructure around valuation.

- 5.3 In order to start addressing this issue the IVSC is developing International Professional Standards for valuers that will establish codes of conduct and competency benchmarks for valuation professionals. These professional standards, like the IVSs, need to be developed in a manner consistent with the public interest, including through a clearly and transparently specified due process with appropriate public interest oversight.
- 5.4 Professional standards form the bedrock of a profession, but, like the IVSs themselves, require to be implemented. The organizations with the role and responsibility to implement the professional standards for valuers are valuation professional organizations.

6.0 CONCLUSIONS

- 6.1 The global financial crisis was a significant, financial milestone event, and it very nearly resulted in a global depression. The depression was averted by an extraordinary capital injection and stimuli. They cannot last indefinitely and the global economy will have to fall back on a new level of sustainable growth, and as mostly expected, it will be at a lower level than before. The crisis has also unearthed substantial weaknesses in the global financial system and these will have to be resolved, going forward. A new financial architecture? Valuations for real estate, businesses and financial instruments are fundamental to a robust global financial architecture and in line with the restructuring of the system, the valuation framework will need to be further refined and developed to better fit into the new architecture.
- 6.2 Fundamentally, the need for robust valuations run deep and wide in the financial system and it not only supports banking systems but also supports good corporate governance and is key to the efficient functioning of property markets, which in turn support market based economies. Continuously updated standards and best practice guidelines are important.
- 6.3 The valuation profession has grown from strength to strength, and between the different types (for real estate, for businesses, for financial interests, for market value estimates, for calculations of worth, for liabilities) has been converging in the market, but a more coordinated convergence is also being attempted under the banner of the International Valuation Standards Council. While substantial work has been done by the Council thus far, on real estate, some for personal property and businesses, but only an important start has been made for financial interests.
- 6.4 The Fair Value Revolution is advancing at a rapid pace and although there were some questions raised during the recent global crisis about the role of mark-to-market valuations, it may be fair to say that those challenges have been more than met, and mark-to-market will continue its relevance and will be a mainstay for financial reporting, going forward, and with that, a continued need for supporting valuations.

- 6.5 The valuation profession is still in an infancy and will grow substantially in importance, post the crisis. It is a vital cog in the wheel of modern finance. It is a "sunrise" profession.
- 6.6 The signs are there that major players are coalescing around the IVSC. In March it signed a Statement of Protocols with the International Financial Reporting Standards Foundation (the body that oversees the International Accounting Standards Board) that made public the mutual recognition of the work that the each of the parties perform and to recognised the role of the IVSC as the global valuations standard setter. It has a membership of 77, representing 54 countries. The Big 6 auditing networks all provide financial sponsorship to the IVSC. The IVSC project to develop standards for the valuation of financial instruments was discussed by Financial Stability Board at its meeting in November 2013 and mentioned in the press release issued following that meeting.
- 6.7 The valuation profession needs to place trust in the IVSC and support its vision. It is the only valuation body with global reach and has taken a number of steps to realise the goal of developing high-quality global valuation standards. It has diverse representation on its Boards and a history of providing technical guidance across much of the spectrum of valuations. The valuation profession must take the opportunity to raise the standard of valuation and increase public trust and confidence in the work it does.

RECENT PUBLICATIONS ISSUES BY THE IVSC

- 2013 edition of the *International Valuation Standards (IVSs)*
- Supporting Technical Information Papers on *Discounted Cash Flow, Cost Approach for Tangible Assets, Valuation of Intangible Assets, and Valuation Uncertainty*
- Exposure Drafts on *The Valuation of Equity Derivatives, Credit and Debit Valuation Adjustments; and Bases of Value*
- *A Guide to the Audit Process for Professional Valuers*
- *Code of Ethical Principles for Professional Valuers*
- *Competency Framework for Professional Valuers*
- Discussion Paper ‘*Establishing International Professional Standards for Professional Valuers*’

Projects in the current work plan include:

Derivatives Valuation - To provide information on the common methods used for valuing derivative instruments aimed at increasing the understanding of users such as buy side investors, auditors and regulators.

Credit and Debit Valuation Adjustments - New accounting and solvency regulations require counterparty credit risk, and in the case of liabilities own credit risk, to be reflected in reported valuations. The objective of the project is to identify best practice in this emerging area of practice.

Liabilities -The increasing need to value liabilities other than those arising under a financial instrument or lease is revealing a diversity of valuation approaches.

Investment Property - A project to examine the application of the principles in the IVSs to investment property with a view to creating a dedicated IVS and associated guidance.

Extractive Industries - A project to address evidence of diverse valuation practice in the valuation of assets in the extractive sector and consequent concerns expressed by some financial regulators.

Specialist Public Service Assets -The development of guidance on the valuation approaches appropriate for the valuation of assets used for delivery of a public service, which due to their specialist nature, are rarely exchanged in the market.

Commercial Forests - To consider the need for an International Valuation Standard and Technical Information Paper on the valuation of commercial forestry.

Illustrative Examples - A project to develop a series of examples around the principles set out the IVS Framework to assist professional valuers in their application to different assets in different circumstances.

Development of International Professional Standards - As part of its remit to assist the development of the valuation profession globally, the IVSC Professional Board is considering a project to develop a series of International Professional Standards for Professional Valuers. These would be aimed at establishing benchmarks agreed between the various Valuation Professional Organisations in membership of the IVSC for initial professional development and continuing professional development.

BIOGRAPHICAL NOTES

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