Valuation

Ethics in valuation

- **The ethical principles describe the lays down rules of behaviour to be followed by a certified valuer in appraising the value (hereinafter: the valuation) of companies, real estate or machines and equipment.**
- **Professional ethics require professional valuers to be fully devoted to their work and care for continuous improvement of quality and efficiency of their work.**
- **The Code guides professional valuers in the performance of professional tasks and determines the fundamental elements of their ethical and professional behaviour in the profession and in public.**
- **Valuation assignments differ significantly in their nature and, consequently, different threats arise that require the application of different safeguard.**

- **When a professional valuer identifies a potential threat to their ability to comply with the fundamental principles they should evaluate the significance of that threat. Some threats may be eliminated or reduced to an acceptable level by taking appropriate safeguards.**

- **If threats to the professional valuer's ability to comply with the Fundamental Principles cannot be eliminated or reduced to an acceptable level, either because the threat is too significant or because appropriate safeguards are not available or cannot be applied, the valuation assignment should be declined or discontinued.**

- If a professional valuer encounters unusual circumstances in which the application of a specific requirement of the Code would result in a disproportionate outcome or an outcome that may not be in the public interest, it is recommended that the professional valuer consults the bodies of the Institute or, if appropriate, the relevant regulatory body.

- If, after exhausting all relevant possibilities, an ethical conflict remains unresolved, a professional valuer would need to decide whether, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

FUNDAMENTAL PRINCIPLES OF VALUER PROFESSIONAL ETHICS

- **A professional valuer maintains high standards of professionalism, ethics and dignity proclaimed by the Institute. As members of the Institute they shall implement its decisions and/or act in compliance with its guideline.**

- **Professional valuers continuously monitor theoretical and practical achievements in the profession and develop their professional knowledge. They pay special attention to the training of younger peers and transfer to them their professional expertise.**

- **Cooperation between professional valuers is based on openness and exchange of experience. A professional valuer never denies assistance to a peer by giving advice or opinion.**

- **It is fundamental to the integrity of the valuation process that those who rely on valuations have confidence that those valuations are provided by professional valuers who have the appropriate experience, skill and judgement, who act in a professional manner and who exercise their judgement free from any undue influence or bias accordingly.**

- **Professional valuer is expected to comply with the following ethical principles:**

i) **Integrity: To be straightforward and honest in professional and business relationships.**

ii) **Confidentiality: To respect the confidentiality of information acquired as a result of professional and business relationships and not to disclose such information to third parties without proper and specific authority (unless there is a legal or professional right or duty to disclose), nor to use information for the personal advantage of the professional valuer or third parties.**

iii) **Objectivity: Not to allow bias, conflict of interest or undue influence to override professional business judgement. The principle of objectivity obligates all professional valuers, not to compromise their professional or business judgement by bias, conflict of interest or undue influence.**

- ✓ A professional valuer may be exposed to conditions which may be a threat to objectivity. All such conditions cannot be identified and determined in advance.

- ✓ Professional valuers shall not perform professional services if any such circumstance or relation distorts or exercises undue influence over their professional opinion in relation to that service.

iv) Professional behavior: **Includes acceptance of a responsibility to act in the public interest.**

- ✓ **A professional valuer's duty is not limited just to satisfying the needs of a particular client or employer.**
- ✓ **There is also a need to consider if professional decisions have a wider impact on unidentified third parties.**
- ✓ **For example, valuations are frequently undertaken that can directly impact upon third parties such as stockholders in a company or investors in a fund.**
- ✓ **While the client's needs are normally paramount, a professional valuer should avoid knowingly accepting any instruction that appears to be harmful to the interests of the wider public, and which could discredit their own reputation and that of the profession generally.**

PRINCIPLES OF PROFESSIONAL BEHAVIOUR

- **Professional valuers efficiently perform their professional tasks, meet their obligations and consistently observe the ethical principles and rules in line with relevant code of practice.**

- **Principles of professional behaviour contain common positions regarding a professional valuer's responsibility, public interest and/or confidentiality, integrity, objectivity and independence, and due professional care or professional competence.**

- **Principle of integrity: A professional valuer may only accept the assignments for which they can reasonable expect to carry them out with professional integrity.**

- ✓ **They verify any valuation with full sensitivity from both the professional and ethical aspect, regardless of the type of assignment.**

- ✓ **A professional valuer plays an important role in the society and is accountable to any user of their services.**
- ✓ **A professional valuer is never knowingly associated with any illegal valuation activity.**
- ✓ **In the performance of the tasks assumed, a professional valuer is reliable in all aspects related to the valuation.**
- ✓ **They verify any valuation with full sensitivity from both the professional and ethical aspect, regardless of the type of assignment**

❖ Principle of confidentiality

- ✓ A professional valuer accepts responsibilities in a manner that serves the public interest, justifies the confidence of the public and demonstrates devotion to the profession.
- ✓ Public interest refers to the common well being of individuals and organisations served by the profession.
- ✓ Responsibility for the confidence shown to the profession by the public is demonstrated by the professional valuer's continuing efforts for professional excellence.
- ✓ A professional valuer may not disclose confidential information obtained through their work to unauthorised persons, except upon an explicit permission or if required to do so by law.
- ✓ Information obtained in the performance of work shall be prudently applied.

- ✓A professional valuer shall not use confidential information either to their personal benefit or to the benefit of third parties.
- ✓ The need to comply with the principle of confidentiality continues even after the end of a relationship between a professional valuer and a client or employer.
- ✓ When a professional valuer changes employment or acquires a new client, the professional valuer is entitled to use prior experience.
- ✓ The professional valuer should not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

- ✓ Professional valuer should maintain confidentiality, including in a social environment, being alert to the possibility of careless disclosure, particularly to a close business associate or a close or immediate family member.

Principle of competence

- **To maintain and boost public confidence, a professional valuer shall perform their obligations with the highest professional competence.**
- **Professional competence is the result of education and experience.**
- **The maintenance thereof requires commitment to professional training.**
- **Professional competence is one of the fundamental conditions for public recognition of the profession.**
- **A professional valuer is required to know and observe professional rules, i.e. professional principles, standards and ethical principles of the profession.**
- **Any omission to observe these rules means that professional judgement is subject to other, non-professional interests.**
- **Professional valuers undertake continuous professional development throughout their active life and are personally responsible for their training.**

- Performance of valuation assignments requires competence at a level that provides high quality of professional work.
- Such level of competence is required by professional rules, i.e. by professional principles, standards and ethical principles of the profession.
- In performing their obligations to the client, a professional valuer is distinguished by diligence, which means the performance of services with due care, on a timely basis and in accordance with professional rules, i.e. professional principles, standards and ethical principles of the profession.
- Professional valuers shall strive to improve their knowledge and skills and to increase the quality and efficiency of their work.
- If a professional valuer does not have the professional knowledge and necessary experience to competently undertake a valuation assignment that is offered, the professional valuer should decline that assignment.

Principle of objectivity

- ✓ **It is based on the concept that integrity and objectivity are essential for the performance of this profession.**
- ✓ **Objectivity is a principle that requires honest way of thinking and avoids conflict of interest.**
- ✓ **Independence prevents a relation to the client that might harm objectivity in the performance of services.**
- ✓ **In the performance of other services, a professional valuer shall maintain objectivity and avoid conflict of interest.**
- ✓ **A professional valuer shall in no case whatsoever subject their judgement and decision to the interest and benefit of a client, which might prevent objective valuation.**

Other Principles of Valuer professional behaviour

- ✓ **A professional valuer observes professional rules, i.e. professional principles, standards and ethical principles of the profession.**
- ✓ **Professional valuers continuously develop their professional knowledge, increase the quality of services and perform professional tasks to the best of their ability.**
- ✓ **Professional valuers are distinguished for their broadest, most complete and most comprehensive knowledge of theory and practice in valuation.**
- ✓ **This principle requires professional valuers to perform their professional tasks with due professional competence and diligence.**
- ✓ **Professional valuers shall never allow to be prevented in their achievement of justified and honest goals in the profession.**

- ✓ A professional valuer is personally responsible for perfect implementation and operation of the valuation activity in their organisation.
- ✓ Professional valuers are committed to organisational solutions that observe their independence in the performance of professional tasks.
- ✓ Due professional care requires proper planning, implementing and supervision of the activity.
- ✓ The professional valuer's reports and opinions are drawn up carefully and honestly, and are sufficiently understandable to the intended users.

UNETHICAL AND UNPROFESSIONAL VALUATION

- A professional valuer's behaviour is deemed to be unethical and/or unprofessional if it is contrary to the rules below:

- **Unethical payment for professional valuer's service**

Confidence into the results of a professional valuer's work requires that **a professional valuer is never paid on the basis of**

i) the appraised value of the company, machine, equipment and/or real estate

ii) the opportunity for the client to obtain extremely favourable financing due to the professional valuer's services,

iii) realisation of any decision or conclusion of the client,

iv) submission to the client of adjusted important reports, opinions, data or testimonies in court proceedings.

ii) **A professional valuer behaves unethically if**

- **They negotiate compensation for their services or receive it in the form of commission** or part of commission for intermediation or in any other similar pecuniary or other form related to the transaction with the appraised assets (company, machine, equipment and/or real estate);
- **They negotiate payment of their services or receives such payment as a fixed percentage of the appraised value** and/or estimated expenses determined by themselves in the conclusions of the work done;
- **Determine the price of their services in agreement with other professional valuers**.

Biased valuation

- ✓ **It is unethical if the professional valuer has any current or future interest in the appraised assets and the valuation report is bias or made to its own purpose.**
- ✓ **A professional valuer must avoid all doubts and allegations concerning the objectivity and validity of the conclusions reached.**
- ✓ **It is unethical if a professional valuer has future interests in the appraised assets that could be a threat to objectivity of valuation.**
- ✓ **A professional valuer may exceptionally accept the work if, after complete disclosure by the professional valuer of their current or future interest in the assets, the potential client still wants that professional valuer to perform the job and if the professional valuer explicitly excludes their interest and specifically states that in the valuation report.**

Responsibility with regard to signing the report on the appraised value

- ✓ **Confidence in the report on the appraised value is based on the signature by the professional valuer who is responsible for the conclusions contained therein.**
- ✓ **The client who commissioned the valuation is entitled to assume that the signer of the report is responsible for the conclusions contained therein, regardless of whether or not the valuation was carried out by the professional valuer in person or by others under their supervision.**
- ✓ **If a joint report on the appraised value was prepared by several professional valuers, all the signers are co-responsible for the validity of all conclusions.**
- ✓ **If differences of opinion exist, they must be written in the report since the client has the right to know of various opinions.**

- **When a client asks for valuation from several professional valuers who should prepare independent valuations of the same assets, the client has the opportunity to receive from professional valuers separate independent opinions and apply them for the assessment and definition of a range of appraised values.**

- **In connection with these rules, it is unethical:**

i) **to present a false professional valuer by adding the signature of a person who did not carry out the valuation, or of a person who did not supervise such valuation;**

ii) **to delete from a joint report any signature or any different opinion;**

iii) **to prepare two (or more) separate reports, when two or more professional valuers participated in the valuation of the same assets;**

iv) **for a professional valuer to sign a report on the appraised value prepared by another professional valuer.**

v) **When the valuation is entrusted to an appraisal firm, the report on the appraised value must be signed by the person who appraised the value.**

Unethical advertising

- Unethical behaviour of a professional valuer is demonstrated in inaccurate, misleading and false statements, promises and presentations, for example in:

i) **false self-presentations (in any form) of the professional valuer as a member of the Institute, a professional association or some other entity;**

ii) **false presentations of one's own professional competence and/or ethical values or of somebody else's professional competence and/or ethical values;**

iii) **false presentations of one's own past and current services to clients or in advertising by references made to clients without their permission and listing of clients;**

THREATS AND SAFEGUARDS

- **Categories of threats**

i) **Self-interest threat** – the threat that a financial or other interest will wrongly influence the professional valuer’s judgement or behaviour;

ii) **Self-review threat** – the threat that a professional valuer will not appropriately evaluate the results of a previous judgement made or service performed, or by another individual within the same firm or employing organisation, on which the professional valuer may rely when forming a judgement as part of providing a current service;

iii) **Client conflict threat** – the threat that two or more clients may have opposing or conflicting interests in the outcome of a valuation;

iv) **Advocacy threat** – the threat that a professional valuer will promote a client’s or employer’s position to the point that their objectivity is compromised;

v) **Familiarity threat** – the threat that due to a long or close relationship with a client or employer, a professional valuer may be too sympathetic to their interests.

vi) **Intimidation threat** – the threat that a professional valuer will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the valuation opinion.

- **Please note:** The extent to which any of the categories of threat listed above will impinge on a professional valuer's ability to comply with the Fundamental Principles will depend upon the facts surrounding the potential assignment.

Safeguards

- Safeguards are actions or other measures that may eliminate threats or reduce them to an acceptable level. They fall into the following broad categories:

i) Safeguards contained in regulations relating to the purpose for which the valuation is to be executed;

ii) Safeguards contained in rules of behaviour (the Code of ethics) issued by a professional valuers' association to which the professional valuer belongs; and

iii) Safeguards, contained in a firm's internal working procedures and quality controls.

- Typical examples of safeguards contained in internal working procedures of the firm within which the valuation is carried out include:

✓ structuring a firm in which a professional valuer is operating in a way that the professional valuer or valuation team dealing with a valuation assignment is operationally separate from parts of the firm providing any potentially conflicting service.

✓ separation of managerial control, access to data and support services should all be considered as appropriate to the circumstances and level of threat;

✓ requirements for maintaining a register of the material personal interests of professional valuers and his related parties and other staff engaged in valuation assignments;

- ✓requirements for internal peer review of valuations;
- ✓ periodically changing of professional valuers responsible for recurring valuation assignments;
- ✓ controls on the acceptance of gifts or hospitality from clients commissioning valuations.

- ❑ The foregoing safeguards are not intended to be exhaustive, nor are they capable of avoiding or mitigating every threat that a professional valuer may encounter to their ability to comply with the fundamental principles.

- **To provide effectiveness of a safeguard**, **consideration should be given to the disclosure of any safeguards appropriate to the assignment that are in place or that are proposed before an assignment is commenced.**

- Consideration should also be given to including reference to these safeguards in the 15 valuation report or any published reference to the report, especially where the valuation is to be relied upon by parties other than the commissioning client.

- **Certain safeguards may increase the likelihood of identifying or deterring unethical behaviour. Such safeguards include:**

i) adoption of internal rules of professional behaviour and ethical behaviour within the firm in which a professional valuer is employed;

ii) an clearly stated duty on professional valuers to report breaches of ethical requirements and to submit to the Institute initiatives for control and supervision of work performed by professional valuers in compliance with the Auditing Act; and

iii) effective complaint procedure which enables the public to draw attention to unprofessional or unethical behaviour of a professional valuer

Valuation

Ethics in valuation

- **The ethical principles describe the lays down rules of behaviour to be followed by a certified valuer in appraising the value (hereinafter: the valuation) of companies, real estate or machines and equipment.**
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iii) **Objectivity:** **Not to allow bias, conflict of interest or undue influence to override professional business judgement. The principle of objectivity obligates all professional valuers, not to compromise their professional or business judgement by bias, conflict of interest or undue influence.**

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THREATS AND SAFEGUARDS

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ii) an clearly stated duty on professional valuers to report breaches of ethical requirements and to submit to the Institute initiatives for control and supervision of work performed by professional valuers in compliance with the Auditing Act; and

iii) effective complaint procedure which enables the public to draw attention to unprofessional or unethical behaviour of a professional valuer

EDS522

Expert Witnessing

- **In the administration of justice, the judges are pleased to look out for the truth of any matter put before them to decide on.**

- **The regular courts, rent control, tribunal, arbitration panel, panel of inquiry, Land Use and Allocation Committee and Valuation courts are however prone to relying on the aid of expert witness in certain areas as a vital part of the machinery for administration of justice.**

- **Valuers fall into the category of professionals from whom such facts and opinions are required by any of these courts.**

- **It should be recalled that, Property valuation is the art or science of determining or estimating the monetary worth of a particular interest in a given property for a particular purpose at a specific date.**
- **Witness is somebody who can attest to the facts and information as it happened and present the same to the court in litigation.**
- **There are two types of witness:**

i) Lay witness

ii) Expert witness

- **Lay witness have to do with events happening circumstances, having present at the place and time of action that prompted the litigation, which placed him at vantage position to give eye witness account.**
- **The basic principle is that he has the ability to make observations, but he cannot proffer opinion on the cause and effect of what happened.**

- **The expert witness on the other hand is a skilled professional in the fields of the litigation that requires court evidence.**

- **An expert witness is expected to furnish the court with both scientific and technical information that is likely to be outside the experience and knowledge of the presiding judge.**

- **An expert witness in furtherance to rendering facts and happening within his personal knowledge is permitted and encouraged to include in his evidence the opinion he has formed and the conclusion he has drawn.**

- **A witness must be objective and tell the truth and nothing but the whole truth disregarding how such truth would affect the party engaging him.**

- **There is therefore a need for Valuer to maintain professional dignity rather than the wish of the client.**

- **Please note that ‘it is necessary that expert evidence presented to the court should be, and should be seen to be, independent product of the expert, uninfluenced as to the form or content by the exigencies of the litigation.**

- **Valuer’s loyalty is to his profession but not to the party engaging him/her.**

- **If a Valuer is found to deliberately alter the facts or states an opinion, which does not hold purposely to mislead the court, he shall be liable to perjury.**

- **For the opinion of an expert witness to be accepted and acted upon by court, it must not be challenged by other evidence and must not contradict to common sense and the usage of mankind.**

- **An expert witness cannot argue, he only needs to take the guide as given by the advocate.**

- **It is only the advocate that can present his client’s case the way he thinks and can argue without misleading the court.**

- **An expert witness is only to present the facts and opinions and to speak the truth according to his sworn oath, first as to the facts and secondly as to the objective conclusion he has derived from them.**

Court cross examination of the witness:

- **Cross examination is the most effective means of testing the truth of the matter of litigation and advocate is permitted to ask leading questions**:

- **In cross examination, questions may be asked to:**

i) test the accuracy, veracity or creditability of the evidence;

ii) discover who the witness is and what is and is his opinion in life; and

iii) shake the credibility of the witness by injuring his character.

- **In cross examination, slang and abbreviations should be avoided as much as possible, and the answer to the cross examination questions should be short and direct to the point.**

- **The Valuer should not be panic, take offence or be intimidated by questions like ‘your report shows that you lack experience’, ‘you are incompetent’.**

- **All these are attempts to throw the Valuer off-balance and to test his steadfastness.**

- **The valuer should be calm, well-mannered, firm, and bold with a good focus of truth.**

- **He should rather concentrate on the facts and leave the weight of evidence to the court.**

- **The Valuer should know his professional limitations and must strictly confine himself to the matter in which he is specially skilled.**

- **Valuer can not rely solely on the transaction in which he has been informed (whether orally or by letter) or which he read in the press.**

- **Valuer can draw inferences or conclusions from documents which are of universal application, though he may not be a party to its preparation e.g maps, survey plans, valuation tables etc.**

- **When Valuer is undertaking any Valuation task, he or she should be guided by the principle of accountability because he may be called upon at any time to give account for his stewardship.**

- **Please note: No matter the length of Valuer's litigation experience, it does not make him a lawyer.**

- **His business is only ‘to give an unbiased opinion of the subject placed before him and not to become in any way an advocate.**

- **Valuer must have it in his/her mind that being a professional, he owes his client a duty of care and as such, should always guide against ‘sordid deal’, professional misconduct and negligence of duty.**

The Nature of Value

- **The word value is used in many well-established meanings.**
- **The value of a thing to a person is the importance he attaches to it.**
- **To the economist, value means the exchange worth of a commodity in terms of any other commodity.**
- **In the modern world the relative values of commodities and services are measure in terms of money.**

Relationship of Cost to Value

- The words cost and value need to be dinstingushed from each other.
- Price is the amount of money paid to the seller by the purchaser in the acquistion of the property.
- Cost is price paid plus all other expenses incurred by the purchaser in the acquisition of property.
- The cost of the property is not necessarily equal to the value; on the other hand, cost is considered as an evidence of value.
- While establishing value of a property it is customary to investigate both original cost and reproduction cost.
- The cost represents the minimum value to the purchaser, because a purchaser pays less than maximum value to him to acquire his property.

Points to be Noted Regarding Value

- **Value is not a fixed and permanent part of the thing to be valued, but depends on outside factors; the chief of such factors are:**

i) Location of the property

ii) Time

iii) Supply and demand condition

i) Location of the property

- **Value of a piece of land or building is dependent to a large extent on the locality in which it exists.**
- **A building situated in a good residential area will fecth more price than other similar buildings situated in a bad residential area.**
- **The value of a property situated in a business area will be much higher compared to a similar property elsewhere.**

ii) Time

- Money, the medium of exchange, itself has changing value in its purchasing power.

- Each year sees some changes in monetary value.

- The changing of value with time comes about not only because of the changing of value with money, but in many cases, due to the rise or fall in the value of property in general or due to supply and demand conditions.

iii) Supply and Demand

- The desire of others to possess a property to be valued, and their ability to pay for it creates demand.

- Value depends on the extent to which the supply of the particular type of property is capable of meeting the demand.

- The effect of supply and demand on value is that where demand exceeds supply, value will tend to rise and where supply exceeds demand, value will tend to fall.

Supply and Demand in Respect of Land and Buildings

A) Land

- ✓ **Land is a commodity with the following peculiarities**

i) **Total quantity of land can neither be increased nor diminished, as the most more use can be made of it.**

ii) **Land of a particular type cannot be made available where we please**

iii) **Even available land may be further limited by town planning, zoning and similar restrictions.**

On the other hand, supply of land can, in effect, be increased by:

i) more intensive use;

ii) conversion from other uses to the required use, e.g., de-forestation, reclamation, non-agricultural uses, etc.;

iii) cheaper transport thereby reducing the pressure on a particular locality.

Generally speaking, as the population in a country increases and its wealth increases, the value of land of all types tends to appreciate.

B) Buildings

- **An important point in relation to the supply of buildings is that while demand for houses, shops, factories, etc. can ultimately be made by the erection of a sufficient number of buildings of the particular type required**, **the length of time required to make good deficiencies in supply will often result in high prices being paid over a considerable period.**

- While, **if conditions are reversed and the number of buildings of a particular type should exceed the demand for them,** there is no quick or easy method of reducing the supply and lengthy period of depressed values may be the result.

Factor which affect the demand of a particular class of buildings are as follow:

i) A change in the economic conditions,

ii) A change in the break up of population e.g., breaking up of joint families

iii) Rise and decay of industries.

iv) Social changes such as shortage of domestic servants.

v) Movement of population from one area to another owing to change in fashions or facilities.

Freehold and Leasehold Properties

1) Freehold

- **Freehold is the highest form of ownership.**
- **The owner of a freehold property – freeholder-usually holds the property without any payment in the form of rent.**
- **The freeholder has the right to do what he likes with his property, that is, he may develop it, sell or transfer it or lease it without the consent of any other person.**
- **However, the freeholder's power, to do as he likes, with his property is limited by:**

i) The law of the land, and

ii) By the rights of others

- **A freeholder can be forced to sell his land, by the Acts of Parliament, for various public or semi-public purposes.**

- **Similarly, the freeholder is not allowed to develop his property unless the development plan is approved by the proper authorities of the town planning department and local bodies.**

- **Also, while developing his property he must not interfere with the natural rights of others as, for instance, erecting a structure on his land in such a way as to seriously diminish the access of light to the windows in the adjoining buildings.**

2) Leasehold property

- When the freeholder, instead of occupying the property himself, grants the exclusive possession of the premises to another for a certain period, usually in consideration of the payment of rent, he/she is said to have let the property. Such a letting is known as lease.

- The person who grant the lease is called “lessor” and the person who takes it the ‘lessee’ or ‘leaseholder’.

Forms of lease

- **Building lease**

✓ **In this case the lessor grants the lease of the land for the purpose of erecting suitable buildings and the lessee undertakes to pay yearly "ground rent", to erect buildings, maintain them in good condition and pay all outgoings in connection with them throughout the term of lease which is generally 99 to 999 years.**

✓ **On erecting buildings the difference between the net rent and ground rent will constitute the lease's profit or rent income.**

- **Occupation lease**

✓ **The term is used when a freeholder grants the lease of the land and building for occupation by the leaseholder.**

✓ **The period of occupation lease is shorter than the building lease and may vary from 3 years in the case of dwelling houses to 21 years in the case of shops.**

- ✓ In this case if the rent reserved for land and building represents the full rental value of the property it is called 'rank rent' and if it is less than the full rental value (of course not a ground rent) it is termed as a head rent.

- Sublease

- ✓ If terms and conditions of the lease permit, a leaseholder may sublease the property, for any less term than he himself hold, at any rent he may be able to obtain.

- Leases for life

- ✓ When the period of the lease granted by the freeholder is the duration of life of the lessee or some person it is called a lease for life.
- ✓ Such a lease for life is determinable on the death of the party in question.
- ✓ A lease is much more restricted in his dealings with the property than is a freeholder.
- ✓ For this and other reasons leaseholds are less attractive to an investor than freeholds.

Process of Valuation

- **Progress in the engineering valuation can be made only after knowing the purpose of valuation and what property is to be valued**.
- **The basis of valuation is controlled largely by the purpose for which the valuation is being made**.
- **Although the valuation process for specific property will follow a plan appropriate for that property and the purpose of valuation**, the overall steps are common for all properties.

These steps are:

i) Determination of the purpose of valuation, the parties thereto, the date and place of valuation

ii) Preliminary examination of the enterprise and its property

iii) Determination of the original cost of all fixed capital and physical property excluding land;

iv) Determination of the depreciation of the property

v) Estimating the reproduction cost of property, excluding land,

vi) Estimating the fair market value of all land

vii) Determination of fair rate of return for the enterprise

viii) Estimating market value on the basis of average market price and its outstanding securities, or on the basis of market values of similar properties.

ix) Finding the capital value by capitalizing the net income from the property.

x) Finding the fair value by giving such weight as may be just and right in each case to each item and to all other factors affecting the value.

Depreciation

- The word depreciation is often applied loosely and in several meanings. Currently it is used in the following three distinct meanings:

i) **Depreciation is the *loss in value* which is not restored by current maintenance and which is due to several factors such as wear and tear, decay, inadequacy and obsolescence that cause the ultimate retirement of the property.**

ii) **Depreciation is the *loss in cost* of a property as entered on the books. When used in this sense such loss in the cost is charged to expenses of operation.**

iii) **Depreciation is related to the physical condition of the property**.

- ✓ **It is define as the *loss in service* capacity of the property.**
- ✓ **A property which shows a high degree of wear and tear is highly depreciated and vice versa.**

- ❑ Please note: **It must be clearly understood that the physical condition of a property is neither depreciation nor the sole measure of depreciation but one evidence upon which either cost depreciation or value depreciation may be based.**

Methods of Estimating Depreciation

- There are several methods of estimating depreciation such as

a) Good- as- new
b) Direct appraisal
c) Arbitrary lump sum
d) Sum of he digits
e) Declining balance
f) Straight line depreciation
g) Sinking fund depreciation
h) Present worth depreciation

- There is much controversy over the methods of estimating depreciation because each of the above methods, being based on some assumptions, is not suitable under all circumstances and for all purposes.
- Many of the above methods have some serious drawbacks and limitations.

- The methods which are commonly used are explained below.

- It should be noted that depreciation is normally required for two major things namely:

i) Cost accounting

ii) Valuation

- The best methods suitable for these purposes are **straight line depreciation method and sinking fund depreciation method**.

a) Straight Line Depreciation Method

- Of all the methods mentioned above the straight line method has found universal acceptance for depreciation cost accounting.

- This method allocates the depreciable base (Original cost –Salvage value) of a property unit, uniformly throughout its service life except when the estimate of service life is changed.

- It is simple and easily understood.

- **The basic concept of the straight line method is that, as long as the useful service life and salvage value on which the depreciation allocation is based remain unchanged, the depreciation provision remains the same for the each year.**

Let $B = Original\ cost$

$Vs = Scrap\ or\ salvage\ value$

$Bd = Depreciation\ base$

$n = Life\ of\ property\ in\ years$

$D = Anual\ depreciation\ allocation$

By definition the annual allocation is

$$D = \frac{B - Vs}{n} = \frac{Bd}{n}$$

The total depreciation up to age $x\ is\ x\left(\frac{Bd}{n}\right)$

- ❑ In addition to cost accounting the straight line method is also used for valuation.
- ❑ However, the sinking fund method is extensively used in valuation and economy studies.

b)Sinking Fund Depreciation Method

- **In the sinking fund depreciation method, the total depreciation of a property at any date is assumed to be equal to the accumulation of sinking fund and compound interest thereon up to that date.**

- If s is the equal-annual-year-end payment and i represent the interest rate per period on the sinking fund then:

- Depreciation at the end of the $nth\ year$ would amount to:

$$S = \frac{i_1}{(1+i_1)^{\mathrm{n}} - 1}$$

- To calculate Years' purchase (YP)

$$Year's\ Purchase = \frac{1}{i + s}$$

Where:

$$i = rate\ of\ interest\ in\ decimal$$

$$s = equal - annual - year - end\ payment\ to\ replace$$

$$S = \frac{i_1}{(1+i_1)^{\mathrm{n}} - 1}$$

Determination of Depreciation as per Life of Building

- A suitable depreciation can also be allowed on the cost .
- Generally for the first 5 to 10 years there is hardly any depreciation of a building but the rate of depreciation increase with age.
- Thereafter a building, if properly maintained may have the following depreciation rates considering the life of the building as 80 years.

	Period	Depreciation	Total Depreciation
1	For 1st five years (0 to 5 years)	Nil	Nil
2	For next five years (5 to 10 years)	@ 1/2% per year	2.5%
3	For next 10 years (10 to 20 years)	@ ¾ per year	7.5%
4	For next 20 years (20 to 40 years)	@ 1 % per year	20%
5	For next 40 years (40 to 80 years)	@ 1 ½ per year	60%
		Total	90%

- Beyond this period, the balance 10% value of the property is taken as scrap value at the end of utility period.

Example 1:

A person purchase a property for #20, 000, 000.00. Assuming that its net salvage value after 30 years will be # 200,000.00. Determine amount of depreciation each year considering it to be uniform.

Solution:

Assuming straight line depreciation

Annual depreciation = $\frac{Original\ cost\ -Salvage\ value}{Life\ of\ asset\ in\ years}$

$$D = \frac{B - Vs}{n}$$

B = 20,000,000.00; Vs = 200,000.00; n = 30 years

$$D = \frac{20{,}000{,}000 - 200{,}000}{30}$$

$$D = 660{,}000.00$$

Example 2:

The total cost of machinery including the installation charges in a factory is 180,000.00. Calculate the depreciation cost of the above after 20 years. The salvage value 10,000.00. The span of life 40 years.

Solution:

Cost of machinery “B” = 180,000.00

Salvage value Vs = 10,000.00

n = 40

Annual Depreciation: $D = \frac{B - Vs}{n}$

$D = \frac{180000 - 10000}{40}$ = 4250

Depreciation for 20 years = 4250 x 20 = 85000

Depreciated cost of the machinery after 20 years = 180,000 – 85000

$= 95{,}000$

Book value after 20 years = 180000 - 10000 - 85000 = # 85,000.00

Example 3:

Find out the book value, after 35 years, of an asset costing 200,000.00 assuming 100 years as life of the asset and the salvage value of 10,000.00. What would be the book value (after 30 years life) if the salvage value is nil?.

Solution:

i) Assuming straight line depreciation

Annual depreciation = $\frac{Original\ cost\ -Salvage\ value}{Life\ of\ asset\ in\ years}$

$$D = \frac{B - Vs}{n}$$

$$D = \frac{B - Vs}{n}$$

$$D = \frac{200,000 - 10,000}{100}$$

$$D = 1900$$

Depreciated cost in 35 years = 1900 x 35

= 66500.00

Book value after 30 years = Original cost – depreciated

$$= 200000 - 66500$$

$$= 133500$$

ii) If salvage value is nil

Annual rate of depreciation = $\frac{200000}{100} = 2000$

Depreciation cost in 30 years = 2000 x 30

= 60,000

Book value after 30 years = 200000 – 60000

= 140,000

Example 4:

Find the value of tenement premises consisting of land a well-built house, let 20,000 per mouth inclusive of all taxes. The house is recently built and the rent by comparison with other premises is fair and likely to be maintained.

Solution

i) Gross annual income = 20,000 x 12 = 240000.

Outgoing may assumed to be 30% of the gross rent.

Outgoings = 240000 x $\frac{30}{100}$ = 72000.00

Net income = (240000 – 72000) = 168,000.00

ii) The net yield (or rate of return) expected from this property is 6%.

iii) Years' purchase:

Assuming the future life of the building to be 50 years and using a single rate of interest:

$$S = \frac{i_1}{(1 + i_1)^{\mathrm{n}} - 1}$$

$= \frac{0.06}{(1+0.06)^{50}-1}$ = 0.003444

$Y.P = \frac{1}{i+s}$

$= \frac{1}{0.06+0.003446}$ = 15.76

iv) Capital Value = Net income x Y.P

$$= 168{,}000\ x\ 15.76$$

$$= 2{,}647{,}680$$

If the rate interest on sinking fund is assumed to be 3%

$$S = \frac{i_1}{(1 + i_1)^{\mathrm{n}} - 1}$$

$$S = \frac{0.03}{(1 + 0.03)^{50} - 1}$$

and

YP = $\frac{1}{i+s}$

Year’s Purchase $= \frac{1}{i+s}$

YP = $\frac{1}{0.06+0.0069} = 14.95$

It may be noted that the YP in this case is lower than before

Capital value = 168,000 x 14.52

= 2,511,600.00