Understanding Valuation and It's Professional Challenges in Context of Nepal

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Chapter-1: Valuation Profession in Nepal

1.1 Nepalese Valuation Scenario

- Valuation profession is not duly recognized as specialized profession by Nepalese Government. Financial institutions also have no clue about the qualification and expertise a valuer requires to carry out an authenticate and reliable valuation and thus engaging person without proper valuation qualification, knowledge and training to carry out valuation works for secured lending.

- There is no "Valuers or Valuation Act" promulgated in Nepal similar to "Nepal Chartered Accountants & other professional services Act" to monitor and issue professional standards for valuation. As a result, several unwanted incidences are occurring knowingly or unknowingly which is defaming the valuation & banking professions.

1.2 Assertion of Nepal Valuer's Association (NVA)

NVA being the only not for profit valuer's professional organization in Nepal, is committed to raise the standard of valuation and increase public trust and confidence in the work and make the valuation profession respectable.

a) NVA has come forward to develop a mechanism of evaluation and training of valuation professionals in consonance with international norms and practices so as to make the valuation profession respectable and reliable by expanding activities as below:

- adopted International Valuation Standards (IVS),
- adopted valuation guidance similar to RICS Professional Standards,
- adopted code of conducts to encourage the members,
- training its members to understand and practice in accordance with adopted valuation guidelines,
- conducting periodic workshops and interaction programme to discuss related issues & to impart basic, refresher & advance valuation knowledge,

b) Apart from NRB, NVA is also meeting and lobbying with all concerned ministers, law makers & officials to play active roles to promulgate a “Nepal Valuation Act”.

1.3 Professional Ethics, competency, objectivity and disclosures

As it is fundamental to the integrity of the valuation process, all members practising as valuers must have the appropriate experience, skill and judgment for the task in question and must always act in a professional manner free from any undue influence, bias or conflict of interest.

NVA has come forward to accept, adopt and issue a “Professional Ethics, competency, objectivity and disclosures” which includes followings:

- Responsibility for the valuation
- Professional and ethical standards
- Member qualification
- Independence, objectivity and conflict of interest
- Terms of engagement

Chapter-2: Introduction to Valuation

2.1 What Is a Fixed Asset

A fixed asset is a long-term tangible piece of property or equipment that a firm owns and uses in its operations to generate income. Fixed assets are not expected to be consumed or converted into cash within a year. Fixed assets most commonly appear on the balance sheet as property, plant, and equipment (PP&E). They are also referred to as capital assets.

2.2 What is Value

"Cost" is the amount required to acquire or create the asset. "Price" is the amount asked, offered or paid for an asset.

"Value" is not a fact but an opinion of either:

- the most probable price to be paid for an asset in an exchange or
- the economic benefits of owning an asset.

In order that a commodity can have value, it must possess three essential qualifications namely:

- It must possess utility,
- It must be scarce, and
- It must be transferable & marketable.

2.3 Factors affecting the Value

Value is affected by several factors which only an expert can analyse:

(a) Based upon user's perception:

* Utility,
* Substitution &
* Anticipation

(b) Based upon Land and Improvement:

* Movement in population &
* Improved accessibility

(c) Economic and legal factors:

* Inflation,
* Economic activity,
* Change in taste and social circumstances,
* Supply & demand/necessity & availability
* Cost of production,
* Occupational value,
* Rent control act,
* Urban land ceiling and regulate acts,
* Town and country planning acts,
* Abnormal conditions,
* Transferability,
* Location,
* Utility/ to suit to certain industry or institution,
* Marketability,
* Physical characteristics of land &
* Development anticipation

2.4 Application of Valuation

List below provides some of the fields where valuation knowledge is required:

- Banking (for secured lending),
- Purchase for occupation,
- Disinvestment,
- Privatization,
- Net worth,
- Liquidation of company,
- Insurance,
- Financial Reporting,
- Distress Assets / Non-performing Asset,
- Management info. & Strategic Planning,
- Impairment (damage/loss) Studies,

* Mortgage,
* Purchase for investment,
* Partition,
* Sale of asset,
* Merger and acquisition,
* Auction bid,
* Arbitration,
* Court & Litigation support,
* Initial Public Offerings,
* Cost Investigations

2.5 Knowledge required to carry out proper Valuation

In order to carry out proper fixed asset valuation a valuer should acquire knowledge of following subjects:

- Planning & designing,
- Construction work,
- Surveying and levelling,
- Quantity surveying and estimating,
- Estate development,
- Building Bye-laws of local authority,
- Land acquisition & Town planning act,
- Local and Government Taxation,
- Insurance,
- Condition of money market and rate of interest available on investments in general investment market,
- Knowledge to carry out Feasibility study &
- Report writing

2.6 Scope of a Fixed Asset Valuer

Following are the scope of works of a valuer to carry out proper fixed asset valuation:

- Complete understanding of valuation purpose,
- Collection of data and documents,
- Physical inspection of subject assets,
- Market survey and collection of data pertinent to the valuation exercise,
- Collection of technical details for the subject assets,
- Analysis of technical data and the supporting information,
- Assessment of balance economic life of the subject assets,
- Determination of valuation parameters, methodology, basis of valuation and key assumptions,
- Estimation of market value of the subject assets in situ and as-is where-is basis,
- Preparation of a report outlining methodologies employed and assumptions utilized in analysis,
- Submission of the draft report (if asked for) and review of client’s observations (if any) on draft report &
- Submission of the Final Report.

2.7 The Qualified Valuer

- Carryout valuation in accordance with the Standards adopted by a valuer’s professional body,
- Maintain the highest standards of honesty and integrity,
- Able to show professional skill, knowledge, diligence and ethical manner,
- Must provide an informed and independent opinion of value,
- Recognising Limits on Expertise &
- Adhere to the Valuers’ Code of Ethics and Conduct

Chapter-3: IVS-General Standards

3.1 Bases of Value (Standards of Value)

A. **IVS-Defined Basis of Value**

a. Market Value,
b. Market Rent,
c. Equitable Value,
d. Investment Value/Worth,
e. Synergistic Value, and
f. Liquidation Value,

B. **Other Value Terminology in Use (non-exhaustive list)**

a. Fair Value (IFRS),
b. Fair Market Value (OECD)
c. Fair Market Value (US IRS)
d. Secured Lending Value
e. Mortgage Lending Value (EU Capital Requirements Regulation)
f. Goodwill value
g. Replacement Value
h. In use or Going concern Value
i. Book Value
j. Sentimental Value
k. Monopoly Value
l. Insurable Value
m Guideline Value
n. Salvage Value
o. Scrap or Junk Value
p. Distress Value

3.2 Premise of Value/Assumed Use

The value of the property varies with time and purpose. The same property can have different value depending on its purpose.

A. Highest and Best Use,
B. Current Use/ Existing Use,
C. Orderly Liquidation, and
D. Forced Sale.

3.3 Valuation Approaches and Methods:

A score of approaches and methods are being used to assess valuation and named accordingly, however, IVS has classified only three main approaches which incorporates all approaches in use.

A. MARKET APPROACH: The market approach provides an indication of value by comparing the asset with identical or comparable (that is similar) assets for which price information is available.

Market Approach is a valuation method in which a value estimate is based upon price paid in actual market transactions and current listings. Ideally the comparative method should only be used when the properties being compared are similar and in the same area; where there are efficient records of frequent recent transactions; and where the market is relatively stable. No two properties can ever be identical, because their locations will always differ.

3.3 Valuation Approaches and Methods:

B. INCOME APPROACH: The income approach provides an indication of value by converting future cash flow to a single current value. Under the income approach, the value of an asset is determined by reference to the value of income, cash flow or cost savings generated by the asset.

The value derived by Income Approach method indicates to the clients of what they ‘should ' pay in order to purchase whereas the value derived by other methods indicate what they 'need' to pay.’

Following methods fall under this approach:

a. The Investment Method
b. The Residual Method
c. The Profits Method
d. Discounted Cashflow Method (DCF)

Capitalization Rate & Discount Rate: The rate at which the forecast cash flow is discounted should reflect not only the time value of money, but also the risks associated with the type of cash flow and the future operations of the asset.

3.3 VALUATION APPROACHES AND METHODS:

C. COST APPROACH: The cost approach provides an indication of value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction, unless undue time, inconvenience, risk or other factors are involved.

Cost approach is used for valuation of real properties when there is either no evidence of sale transaction for similar property or where no identifiable actual or notional income stream of similar asset is available. It is used for valuation of specialized property that is rarely sold in the market.

This method has the inherent disadvantage of attempting to equate cost to value, as well as certain practical difficulties involved in making the various estimates, and in particular the correct depreciation allowance.

3.3 VALUATION APPROACHES AND METHODS:

C. Cost Approach
Depreciation/Obsolescence

Difference of depreciation considered in Accounting & Appraisal

Depreciation in Accounting is a method providing for systematic allocation of recovery of cost over an asset life.

Depreciation in Appraisal is loss of market value of an asset relative to its cost. It may stem from any cause that results in actual loss.

Depreciation adjustments are normally considered for the following types of obsolescence, which may be further divided into subcategories when making adjustments:

Physical deterioration/ obsolescence: Any loss of utility due to the physical deterioration of the asset or its components resulting from its age and usage.

Functional obsolescence: Any loss of utility resulting from inefficiencies in the subject asset compared to its replacement such as its design, specification or technology being outdated.

External or economic obsolescence: Any loss of utility caused by economic or locational factors external to the asset.

3.3 Valuation Approaches and Methods:

C. Cost Approach

Methods and Procedures used for determining the depreciation

Non-interest procedures

- Straight line: This method allocates the depreciable amount as a function of time, which produces a constant expenses charge.
- Declining Balance or Written Down Value (W.D.V.): This method uses a constant depreciation rate and applies it to the carrying amount of the asset at the beginning of the period.
- Sum of the Year's Digits: In this method, the annual depreciation charges are computed on the basis of a fraction which changes over time (declines) applied to the initial depreciable cost of an asset.
- Production unit method: This method assumes that depreciation is a function of use or productivity instead of a function of time elapsed.

Procedures based on interest theories (Economic Depreciation)

- Sinking Fund: In the sinking-fund depreciation method, the total allocation of the base to any date is equal to the corresponding accumulation in a hypothetical equal-annual-year-end-payment sinking fund, in which the total accumulation at the end of the service life of the unit would be just equal to the depreciable base of the unit.
- Present Worth: The present-worth method of depreciation is based on the fundamental concept of value. The principle is that a single sum of amount which accumulates to Net Replacement Cost of an assets at the end of its remaining economic useful life at assumed rate of interest would be just equal to the economic depreciation of that asset.

Chapter-4: Limitation of Valuation Opinion

- NRB has still not issued Collateral Valuation Guidelines as announced in the Monetary Policy of 2018/19 in order to bring uniformity in the valuation while disbursing loans against the collateral of fixed assets or land and building.
- The Collateral Valuation Guidelines will clearly explain that the valuation is a scientific analysis of available data and information gathered from market source and it is an art of judgment and forecast.
- Most of the FIs in Nepal often talk about a "Forced Sale" and like to term it as "Distress Value".
- A 'forced sale' is a description of the situation under which the exchange takes place, not a distinct basis of value which a valuer can't evaluate.
- The value from "Forced Sale" is not a fixed percentage of "Market Value".
- If engaged by Client (FIs), the valuer will conduct valuation for the purpose of acquiring an indication of Market Value of the said property to the Client that will be used internally which the Client may utilize to form their opinion for secured lending to their borrower.
- The opinion of valuer is totally dependent on the accuracy of the information which has been supplied by the Client &/or the owner &/or representative of the owner of the property and upon the assumptions set out herein.
- It is an internationally accepted practice that

    * The valuers are only responsible to verify the location & physical features of the property based on the documents supplied to them by FIs.

    * The legal verification of the documents of the property to be mortgaged are not the domain and responsibility of the valuers which must be checked, scrutinized and verified by legal & related experts of FIs before accepting it as fit for collateral.