POSITION STATEMENT

VALUATION OF ASSETS FOR FINANCIAL STATEMENTS

Comments to be received by 19 March 2004

This Position Paper is published by the International Valuation Standards Committee (IVSC) for comment only. The conclusions and recommendations made by this paper are subject to consultation and subsequent ratification by the IVSC Management Board.

Comments should be submitted in writing so as to be received by 19 March 2004. All replies may be put on public record unless confidentiality is requested by the commentator. If commentators respond by fax or email, it would be helpful if they could send a copy of the response by post. Comments should preferably be sent by email to:
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1.0 Introduction

1.1 The following paper sets out the initial conclusions of a working party of the International Valuation Standards Committee (IVSC) that considered the responses received to the IVSC consultation paper produced in 2003 and the publication of a revised IAS 16, Property, Plant and Equipment, in December 2003. The IVSC Management Board approved the early release of the working party's conclusions in this Position Statement for consultation. The conclusions and recommendations made by this paper remain subject to ratification by the IVSC Management Board.

1.2 Comments are invited on this paper by Friday 19 March. In the meantime work is progressing on the necessary revisions to IVS 2003. The IVSC will publish early drafts of proposed revised material on its web site for comment and information.

1.3 At present the working party has confined its deliberations to real estate assets. IAS 16 also deals with plant and equipment, and consequential changes to current IVS guidance on valuing these assets is also under review.

2.0 Background

2.1 IVSC Consultation Paper 2003

In May 2003, IVSC published a Consultation Paper, "Valuation of Owner Occupied Property under International Financial Reporting Standards". This paper had been prompted by continuing debate on the use and application of depreciated replacement cost valuation techniques, and whether "fair value" under IAS16 could, or should be, determined using a modified form of Market Value. Some thirty questions where posed in the consultation paper, mainly designed to solicit views on the following principal issues:

- Is depreciated replacement cost (drc) correctly described as a method, a basis, or both?
- Should the current IVS definition of drc be changed so as to require the current Market Value of the land element to be used, not its Market Value for the existing use?
- If the definition of drc were changed, would it then be valid to reflect any difference between the value of the land for the existing use and its Market Value in the depreciation adjustment made to the buildings and other improvements?
- Did respondents support an alternative approach for determining Market Value of owner occupied property that assumed a notional sale and leaseback?

2.2 Responses were received from individual practitioners, academics, international accountancy firms, accountancy standard setters, valuation standard setters and from government bodies.

2.3 Analysis of the responses has not been straightforward as many of the respondents wished to comment on some of the underlying concepts that were not specifically addressed in the questions. They felt that their answers to some specific questions posed in the paper were dependent on the resolution of wider issues. Others clearly felt that certain questions, particularly those dealing with the notional sale and leaseback, were either outside their experience or competence, i.e. these were methodology issues for the valuation profession to resolve.

3.0 Changes to International Accounting Standards

3.1 There have been some recent significant changes to accounting standards. In 2002, the IASB had published a consultation draft on its proposed changes to IAS 16 arising from the 'Improvements Project'. Although the closing period for comments was some months before IVSC produced its own consultation paper, the revised version of IAS 16 published in December 2003 contains a number of alterations that had not been previously signposted in the consultation document. The most relevant of these changes to valuers are:

- Formerly historic cost was the "benchmark" or preferred treatment, with revaluation by professional valuers permitted as an "allowed alternative treatment". This distinction has now disappeared, i.e. there is no longer an implicit preference for the historic cost approach.

- Previously IAS 16 stated that the *"fair value of land and buildings is usually market value"*. Although no explicit reference was made in the accounting standard to IVS, most valuers agreed that the only logical interpretation of this was that the IVS definition of MV was to be used for valuing all property assets. However, this has now been amended to *"the fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers"*. The Accounting Standard has thus moved away from specifying a single basis to describing the process necessary to establish fair value.

- The previous IAS 16 made no reference to the use of depreciated replacement cost for land and buildings, the only reference being in relation to plant and equipment. Now it provides that *"If there is no market-based evidence of fair value because of the specialized 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"*.

- The section of IAS 16 dealing with depreciation has been extensively altered. Of most interest to valuers is confirmation that, when establishing the residual value of an asset as part of the depreciation calculation, it is the current value that has to be calculated on the assumption that the asset was already at the end of its useful life to the entity, not a projection of what that figure might be at some future date.

4.0 Convergence of IAS and USGAAP

4.1 Apart from the changes to IAS, the agreement reached in late 2002 between IASB and Financial Accounting Standards Board (FASB) in the US to converge International Accounting Standards and USGAAP over the next few years is also relevant. Previously valuation has been of minor relevance in USGAAP, but it is apparent that FASB is looking to increase use of fair value as a measurement yardstick as part of the changes being made to USGAAP under the convergence project. To that end it is also collaborating with a project being undertaken by the Accounting Standards Board of Canada (AcSB) on behalf of IASB, the "Canadian Measurement Project."

4.2 A summary of FASB decisions on Fair Value Measurement are published on its web site [1.] Amongst the tentative decisions reached by December 2003 are:

- That all estimates of fair value should be based on the results of valuation techniques that maximize market inputs in active markets, even if the asset (or liability) being measured is not exchanged in an active market.
- That valuation techniques consistent with a market approach, an income approach, and, where applicable a cost approach may be used for all fair value estimates.
- That the valuation premise describes the actual or hypothetical condition and location of an asset affecting the exchange price at which willing parties would agree to transact and provides additional guidance for selection of relevant market inputs. In general:

  (1) a going concern or in-use valuation premise should be used to estimate the fair value of assets held and used and,
  (2) an in-exchange valuation premise should be used to estimate the fair value of assets held for sale.

4.3 The second part of the current IASB project on Business Combinations is a joint project with FASB. Both IASB and FASB, in accepting the working principle for the project, agreed to use fair value as the measurement objective for valuing the assets acquired and liabilities assumed in a business combination. The Boards also agreed that their exposure drafts resulting from this joint project should provide guidance for measuring fair value in the form of a hierarchy to ensure the consistent application of the fair value working principle. The tentative decisions outlined in paragraph 4.2 have been accepted by the IASB in the context of the Business Combinations project.

[1] http://www.fasb.org/project/fv_measurement.shtml

5.0 Conclusions

5.1 In preparing this statement, the IVSC working party has therefore considered not only the representations received on its own 2003 consultation paper, but also the recent changes to IAS 16 and the emerging FASB material. It has reached the following tentative conclusions:

5.1.1 that while the fair value definitions used by both IASB and FASB are superficially similar to the definition of Market Value in IVS, they are not synonymous. Each may refer to a hypothetical exchange, but that exchange has to be considered in a specific context in order for a figure to be reliably estimated.

5.1.2 that in the case of owner occupied property, the IVSC definition of Market Value, unless modified by any additional limiting or qualifying assumptions, reflects the price obtainable for the highest and best use of the property in an arm's-length transaction unfettered by any enterprise currently in occupation.

5.1.3 that references to fair value in accounting standards should reflect that financial statements are prepared on a "going concern" basis, unless management intends to either liquidate the enterprise or to cease trading.

5.1.4 that there can be a difference between the fair value of an asset that is held and used as part of a continuing enterprise and the Market Value of an asset that is surplus and held for disposal. In the context of owner occupied real estate this arises because the entity owns the property as a means to achieving a wider objective, rather than as an objective in its own right. The value of the service potential of a property as part of the continuing enterprise may well differ from its value for another purpose on the assumption that the operations had ceased and it had been declared surplus.

5.1.5 In cases where there is a significant difference between the value of an asset as part of the continuing enterprise and its value if had been declared surplus, this essential information should be provided by the valuer when reporting, as it may be relevant to future decisions made by the entity in relation to the asset.

5.1.6 that wherever possible, fair value should be determined using market based data, although it must be recognised that for some categories of assets there may be no market based evidence available. In these circumstances, other techniques, e.g. income analysis or depreciated replacement cost may be used to determine fair value.

5.2 In the light of these conclusions the IVSC working party will be proposing that changes are made to IVS 2003 to incorporate a new valuation basis (reflecting its understanding of an 'in-use' premise), Continuing Use Value (CUV) and to make consequential alterations to IVA 1, Valuations for Financial Reporting.

6.0 Continuing Use Value (CUV)

6.1 Scope:

A basis of valuation to be used only to establish the fair value of property assets owned and occupied by an entity for use in Financial Statements under International Accounting Standard IAS16. Surplus property is to be valued to Market Value. Investment Property is valued in accordance with IAS 40.

6.2 Definition:

6.2.1 CUV 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 acted knowledgeably, prudently and without compulsion, subject to the following additional assumptions:

a) The buyer requires the property in its current state for the continued operation of the enterprise, and
b) That enterprise will continue for the foreseeable future.

6.2.2 This definition is the same as that of Market Value, and should be applied in accordance with the conceptual framework set out in International Valuation Standard IVS 1 (para. 3.2), except as modified by the additional assumptions cited above.

6.2.3 Where there is insufficient evidence to reliably assess the CUV using market comparison, as for example in the case of Specialised Property, CUV may be determined using an income or depreciated replacement cost approach

6.3 Additional Reporting Requirements for CUV:

6.3.1 Where the valuer considers that the Market Value of property owned and occupied by the entity is materially different from the CUV, this shall be disclosed in the report.

6.3.2 The method adopted and any significant assumptions made in the valuation shall be disclosed, together with the extent to which the CUV was determined either directly by reference to observable prices in an active market, to recent market transactions on arm's-length terms, or by means of another valuation approach.

6.3.3 The CUV of a cash generating asset using depreciated replacement cost methodology should be accompanied by a statement that it is subject to the adequate potential profitability of the enterprise, having due regard to the value of the total assets employed.

6.3.4 The CUV of a non cash generating asset using depreciated replacement cost methodology should be accompanied by a statement that it is subject to the prospect and viability of the continued occupation and use.

6.3.5 Properties valued using different approaches should be separately categorised in the report.

6.4 Commentary on CUV

6.4.1 CUV is Market Value subject to additional assumptions, which are necessary to reflect the overriding requirement for financial statements to be prepared on the basis of a going concern, unless management either intends to liquidate the enterprise or to cease trading.

6.4.2 In the majority of cases, the additional assumptions will have no material impact on the valuation, and therefore no difference will occur between CUV and MV. However, the assumptions do mean that factors that would only impact on the Market Value if the entity ceased operations at the property are irrelevant to the assessment of CUV and should be ignored as they are incompatible with the going concern basis on which the financial statement is prepared. The result could mean that CUV is higher or lower than MV.

END