



# Memorandum

<b>To:</b>	<b>AASB and FRSB members</b>	<b>Date:</b>	17 August 2010
<b>From:</b>	<b>Natalie Batsakis</b>	<b>Agenda Item:</b>	16.1
<b>Subject:</b>	<b>IVSC ED for new International Valuation Standards</b>	<b>File:</b>	

## Action

1. Consider discussion points identified by AASB staff to determine whether either Board should make a submission to the International Valuation Standards Committee (IVSC) regarding its Exposure Draft *Proposed New International Valuation Standards* and, if so, the nature of either submission.

## Background

2. The International Valuation Standards Board (IVSB) is responding to concerns raised by the G-20 that there is a lack of clarity and consistency in the application of valuation standards internationally. The IVSB felt there was a need to develop effective and robust standards that can be widely recognised, accepted and understood, so that those making financial decisions based on valuations can do so with greater confidence.
3. In rewriting the Standards, the IVSB considered who the International Valuation Standards (IVSs) are aimed at. The existing IVSs are aimed at the valuer, with instructions as to what that person should or should not do. However, the IVSB agreed that the prime beneficiaries of IVSs are those who rely on valuations, such as investors, lenders etc. Also of increasing importance, in the wake of the recent global financial crisis, is the lack of understanding of valuations by financial market regulators.
4. In light of this, the focus of the proposed new standards has been changed to address the subject of valuation rather than the steps a valuer needs to take for a valuation. The objective is to make them accessible not only to valuation practitioners, but also to their clients and any third parties who may rely on valuations.
5. The IVSB:
  - (a) aims to set out a clear specification of the matters that should be addressed in the valuation process;
  - (b) provide some high level guidance on factors that influence value in different sectors; and
  - (c) identify matters that need specific consideration when valuing for different purposes.

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6. The proposed Standards cover the following topics:
- IVS 101 General Concepts and Principles
  - IVS 102 Valuation Approaches
  - IVS 103 Bases of Valuations
  - IVS 104 Scope of Work
  - IVS 105 Valuation Reporting
- Introduction to Application Standards*
- IVS 201.01 Fair Value under IFRSs
  - IVS 201.02 Valuations for Depreciation
  - IVS 201.03 Valuations for Lease Accounting
  - IVS 201.04 Valuations for Impairment Testing
  - IVS 201.05 Valuations of PPE in the Public Sector
  - IVS 202.01 Valuations of Property Interests for Secured Lending
- Introduction to Asset Standards*
- IVS 301.01 Valuations of Businesses and Business Interests
  - IVS 301.02 Valuations of Intangible Assets
  - IVS 302.01 Valuations of Plant and Equipment
  - IVS 303.01 Valuations of Property Interests
  - IVS 303.02 Valuations of Historic Property
  - IVS 303.03 Valuations of Investment Property under Construction
  - IVS 303.04 Valuations of Trade Related Property
  - IVS 304.01 Valuations of Financial Instruments

## Issues

### Defining fair value

7. The existing IVS defines fair value as "...the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction" (paragraph 3.2 of IVS 2 *Bases Other Than Market Value*), which is the same as the definition of fair value in IFRSs. However, paragraph 6.2 of IVS 2 notes that the meaning of fair value for IFRS purposes is normally equated to the IVS term 'market value'.
8. The existing IVS defines market value as "...the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion."

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9. The difference between the IVS terms 'fair value' and 'market value' is articulated in paragraph 6.3 of IVS 2, which states that fair value "...requires the assessment of the price that is fair between two specific parties taking into account the respective advantages or disadvantages that each will gain from the transaction." Therefore, the IVS notion of fair value is broader than market value, because fair value will involve taking into account matters that have to be disregarded in the assessment of market value, such as advantages or disadvantages that would not be available to market participants, including synergies between the assets of a particular party that may mean that the price the party is willing to pay is different from the price that might be obtainable in a wider market.
10. This has been confusing for users of IVSs because although fair value has the same definition in IVSs and IFRSs, they do not have the same meaning. For this reason, the IVSB decided to develop a different definition of fair value to emphasise the distinction from the usage of the term in IFRSs, even though the IASB is also in the process of revising its definition of fair value.
11. The definition of 'fair value', which now appears in the Glossary to the IVSC ED, is:  
"...the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that properly reflects the respective interests of those parties."
12. The definition of fair value in the IASB's Exposure Draft ED/2009/5 *Fair Value Measurement* (FVM ED) is "...the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."
13. The Glossary to the IVSC ED also carries forward the definition for 'market value' noted above. Consistent with current IVSs, the IVSC ED notes that for valuations, other than those undertaken for financial reporting purposes, fair value (as defined in the IVSC ED) is distinguished from market value because fair value (as defined in the IVSC ED) requires an assessment of the price that is fair between two identified parties taking into account the respective advantages or disadvantages that each will gain from the transaction. So fair value = market value + special value [being defined as "...an amount that reflects particular attributes of an asset that are only of value to a special purchaser"].
14. The commentary in paragraphs 19 – 23 of IVS 103 *Bases of Value* notes that the IVSC definition of fair value considers any advantages/benefits/synergies/special value of the asset to be relevant to other market participants. This appears to be consistent with the in-use' valuation premise/unit of account notion in the IASB's FVM ED. Paragraph 22 of the IASB's FVM ED states that using an in-use valuation premise requires the fair value of the asset to be measured "...on the basis of the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets and liabilities as a group and that those assets and liabilities (complementary assets and liabilities) would be available to market participants."

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15. It is believed that in many cases the price that is fair between two parties will equate to that obtainable in the market. However, there will be cases where the assessment of fair value will involve taking into account matters that have to be disregarded in the assessment of market value (such as any element of special value/synergy arising because of the combination of the assets).

## *Staff comment*

16. Staff do not believe that it is appropriate for, nor is it the role of, the IVSC to define fair value. Valuations are undertaken for a variety of purposes and it is too difficult to develop a definition that can be used in all contexts.
17. However, if the IVSC is to retain its definition of fair value, staff believe that the IVSC should revisit the definitions of fair value and market value and reconcile them with the definition of fair value for IFRS purposes (particularly with the proposed revised definition of fair value) to help minimise any confusion with their intended meaning.
18. Nevertheless, staff believe that the following wording from paragraph 5.2 of the current version of International Valuation Guidance Note No. 1 *Real Property Valuation* should be incorporated into IVS 103:

“Where a type of value other than Market Value is the purpose of a valuation, the Valuer shall apply the appropriate definition of value and shall follow IVS 2 and applicable GNs. It is the responsibility of the valuer to avoid potential misunderstandings or misapplications of the valuation estimate in situations where a value other than Market Value is the purpose of the assignment. Proper disclosures, identification and definition of terms, and stated limitations on the applicability of the valuation and the Valuation Report normally ensure compliance.”

[N.B the reference to IVS 2 will need to be amended to the relevant new standard - likely to be IVS103]

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## Own credit risk

19. IVS 304.01 *Valuations of Financial Instruments* considers the incorporation of credit risk in assessing the value of debt instruments. Paragraph 11 notes that the credit risk of the issuer is relevant and should be incorporated into the valuation of an entity's financial liabilities. However, the proposed Standard does not go into detail about the methods that can be employed to determine the impact of own credit risk on the value of financial liabilities. Paragraph 11 notes that, where it is appropriate to assume a transfer of the liability, potential sources for determining own credit risk include the yield curve for the entity's own bonds or credit default swap spreads. However, the paragraph does not provide guidance on how to determine the impact of changes in an entity's own credit risk where the issuer of a liability does not have the ability to transfer the liability and can only settle with the counter party. This scope differs from the IASB's FVM ED, which in accordance with the proposed definition, requires the assumption that a liability can be transferred where it is measured at fair value, even when the liability will only be settled with the counter party.
20. Currently IFRS 7 requires preparers of financial statements to disclose the portion of a change in the fair value of a financial liability that has resulted from a movement in the entity's own credit risk. In addition, IFRS 7 provides a proxy for determining the amount of fair value associated with a change in the entity's credit risk in the application guidance to the Standard. However, the IFRS 7 methodology poses practical difficulties for determining the effect of changes in credit risk specific to the entity because in most instances the amount determined as 'own credit risk' will incorporate the impact of other market factors that also lead to changes in interest spreads, including demand and supply for the financial instrument (liquidity), market sentiment and traded volumes.
21. The IASB issued Exposure Draft ED/2010/4 *Fair Value Option for Financial Liabilities* earlier in the year, proposing to require the separate presentation in other comprehensive income (OCI) changes in the fair value of financial liabilities due to changes in credit risk for financial liabilities designated at fair value through profit or loss. ED/2010/4 proposes to retain the IFRS 7 methodology as a proxy for measuring the change in fair value due to own credit risk.
22. In its Exposure Draft to replace the financial instruments requirements, the FASB rejected the IFRS 7 methodology as a proxy for determining the impact of own credit risk on the fair value of financial liabilities. The FASB identified other methods that can be employed, but did not want to prescribe a methodology.

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## Staff comment

23. Determining the impact of own credit risk on the fair value of an entity's financial liabilities is often extremely difficult, if not impossible. As such, staff believe that the IVSC could play a useful role in providing guidance on the methods for determining own credit risk in the valuation of financial liabilities, especially since most entities do not have access to credit default swap spreads in order to separate and accurately value the change in their own credit risk from other market factors. This would be particularly appropriate if the FASB approach were adopted of providing broad parameters within which the impact of own credit risk must be determined, but without giving guidance. Accordingly, staff believe that the IVSC should work closely with the IASB and the FASB in this area so that comprehensive guidance can be developed and help ensure a converged outcome across the Boards.

## Questions for the Board

**Question 1: Does either Board want to make a submission to the IVSC on its ED?**

**Question 2: Should there be a staff response to the IVSC on its ED?**

**Question 3: Are there any other issues that Board members would like to raise about the IVSC ED?**

## Attachments

The IVSC Exposure Draft *Proposed New International Valuation Standards* is available at [http://www.ivsc.org/pubs/exp\\_drafts/ivs\\_20100610.pdf](http://www.ivsc.org/pubs/exp_drafts/ivs_20100610.pdf)

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