Australian Accounting Standards Board
Exposure Draft ED 181 June 2009

Fair Value Measurement

Answers to Questions

From

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Please Note:
VGV is the Victorian State Government's independent valuation provider. The organisation is responsible for carrying out or overseeing the majority of Financial Reporting valuations in the Victorian public sector. This includes all real estate property type assets as well as plant and equipment type assets. Average total value of assets valued per year for financial reporting is over $10 billion.

Definition of fair value and related guidance

Question 1

The exposure draft proposes defining fair value as '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' (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs.

Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

It is understood that there is a need to have a definition that tries to cover all things regarding property, plant and equipment. The view expressed herein is mainly in relation to real estate type assets.
In Australia, as elsewhere, court precedent has provided the definitions regarding market value, especially in relation to real estate. In Australia, the definition is formed from the case Spencer V The Commonwealth 1907. Over time the definition has been modified slightly but at present the Australian and international definition of Market value is: "Market Value 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 arms length transaction after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion."
This definition accords with International Valuation Standards and in Australia is accepted across the Country by all real estate valuers. It covers all the aspects in the proposed changes to Fair Value Measurement but it retains the "should exchange" premise rather than mention anything about "exit price or sale price".

The notion of exit price, while it is understood is not meant as a 'fire sale' version of exchange will, it is believed, unless the concept is very clearly explained, possibly lead practitioners to apply the wrong meaning to the definition.
The preference would be to stick to the open market transaction as enunciated by the Spencer case in Australia (for Australian conditions) and the International Valuation Standards definition and say nothing about buying or selling price. Just leave the definition to talk about market value of a property in exchange.

In the public sector there is also a need to take into account relevant legislation when carrying out valuations. In Victoria the Valuation of Land Act 1960 sets out what needs to be taken into account. Other States will have their own Acts to follow. All will be generally based on the Spencer case and its view of Market Value. If the accounting profession is going to get professional real estate valuers to value real estate assets for financial reporting, then at least let the valuers use the Australian and internationally accepted definition of market value.

Scope

Question 2

In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts: (a) In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 Share-based Payment and reacquired rights in IFRS 3 Business Combinations) (see paragraph BC29 of the Basis for Conclusions). (b) The third context is the requirement in paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?
The use of the term fair value is OK as long is it refers to the measurement of the market value in exchange. That is, a market value based on a willing seller to a willing buyer, at a point in time, not so anxious to sell or buy that they overlook any normal business considerations and all parties are aware of the current and potential uses of the property. Market value is understood by the real estate profession. Need to make sure that the definition used for financial reporting equates to the real estate term.

The transaction

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?
The preference is to not use the term "sell the asset". Transfer the asset at a market price is a better way of looking at the process. The transfer should take place in a market where there are sufficient arms length transactions to enable a well informed view of the market place to be seen.

A most advantageous market to which an entity has access may be construed as meaning that the asset does not have to compete in the normal market of supply and demand. An advantageous market could be regarded by some as meaning that a higher price could be paid for the asset or that there are more opportunities to sell the asset. The current use of the terms 'active and liquid', although not ideal, is acceptable to describe a normal real estate market that contains sufficient arms length transactions between willing, not anxious, buyers and sellers. Is there a need to change? Any change to terms, even small subtle ones will need proper explanation so that both valuation and finance professions are thinking in the same way.

Question 4

The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions).

Is the description of market participants adequately described in the context of the definition? Why or why not?
The description is useful as long as participants are not just looking at what something could sell for. Any market is made up of buyers and sellers. Market participants should reflect the views of both buyer and seller, not just seller. Exit price or sale price is not always regarded as market related, just as the market buying price (some referred to that as the deprival concept in the past) provided opposite expectations.

The process of FR assessments (definitions etc) is coming full circle from market buying price, to market related value to exit or sales price. All very confusing to the valuing fraternity who have different views on the meanings to the finance world. Please just stick to market value or fair market value based on international and Australian real estate market value definitions.

Application to assets: highest and best use and valuation Premise

Question 5

The exposure draft proposes that:
(a) the fair value of an asset should consider a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).
(b) the highest and best use of an asset establishes the valuation premise, which may be either 'in use' or 'in exchange' (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).
(c) the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

(a) Need to be careful about adopting Highest and Best Use (HBU) without mention of the other factors. These are that the use must be economic, physically, socially and politically (legal) feasible and sensible. For eg a literal take on the premise would suggest that the land that a Parliament House, Treasury building, school etc may sit on may be valued at a highest and best use for multi story offices or housing projects. In real terms these alternate HBU scenario's can not be considered outright. Discounts must be made to allow for the differences between sales evidence (from other land markets) and the current use. Pure comparable sales or rental evidence will not be available. The Public sector has many specialised assets, some Heritage listed. Their continued use is required to fulfil a number of Community Service Obligations (CSO).

(b) The 'in use' premise, as currently used in FR valuations allows valuers in the public sector to value properties as they are. Properties that are designated for a use such as a public school should not be valued as if they could be immediately turned into residential subdivisions. In that scenario, if valuing a school for its HBU, the land may generally have a higher, unencumbered value, while the buildings may be worth nil. If the school is to be a core asset for a number of years to come, then the value as a school is surely what is required. The buildings still add value. There is a continued economic use into the future. There is a need to be careful about the use of the terms. In the school situation, there would be difficulty in finding 'complete' school sales to give an indication of the total 'value in exchange'. The current methodology is reasonable, as it allows valuers to adopt values for land and buildings on an in use basis. Is there a need to change?

(c) Comments to ED 181 have been kept to real estate type assets.

Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions).

Is the proposed guidance sufficient and appropriate? If not, why?

The guidance assists in a limited way in terms of public sector type assets.
Perhaps more consideration could be given to public sector type assets being valued for Financial reporting.
For example.
A government property used as a school.
The land and buildings are regarded as separate asset classes so must have separate reportable figures.

The land is reserved for a school purpose and that restriction on use (from a Highest and Best Use) must be allowed for in the value, if value is to be derived from sales evidence of similar type land which does not have the restricted reservation or zoning. Restricted use sales are difficult to find in view of the fact that governments generally change the zoning from a public purpose reservation (restricted) to a more open HBU zone, prior to sale.
If the land was not used as a school, its HBU may be for residential purposes. The value in this case is not as residential land however as the school is required as a school for an extended period. Its continued use is its best use to government but not necessarily its highest and best alternative use. So the value is the residential inglobo value per ha, based on comparable inglobo sales but discounted to allow for the change in zoning and removal from government imposed implications.
The buildings are to be valued as school buildings based on the depreciated replacement cost method as they will have a continued use. In the case of Heritage listed buildings, Reproduction cost is sometimes used as the starting point. From an Asset management point of view and on a cost benefit basis, once the replacement /

reproduction cost has been established, insurance values can be allocated. This saves agencies time and cost.

In Victoria the difference between the value 'in use' subject to the reservation for a public purpose and the value of the land for its underlying HBU alternative use is the CSO. It is believed that government agencies should report the HBU figure (what the land would exchange for in an open market transaction without government restrictions in place) and the Best Use figure (subject to restrictions in place for its current use). In this way the public will be advised of the alternatives and the CSO. The CSO represents the amount the State is willing to forgo to supply the asset for the use as a school. This reporting of both figures is happening now as it provides some transparency as well as assisting in asset management, for reporting entities and the public.

Application to liabilities: general principles

Question 7

The exposure draft proposes that:

(a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).

(b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).

(c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

Comments to this ED are limited to Real Estate type public sector assets.

Application to liabilities: non-performance risk and Restrictions

Question 8

The exposure draft proposes that:

(a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfil the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).

(b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

Comments to this ED are limited to Real Estate type public sector assets.

Fair value at initial recognition

Question 9

The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions).

Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

Comments to this ED are limited to Real Estate type public sector assets.

Valuation techniques

Question 10

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples).

Is this proposed guidance appropriate and sufficient? Why or why not?

There has to be guidance to make sure that Finance and Valuation practitioners alike fully understand the concepts as required. Guidance on valuation techniques has to relate to valuers if its expected that real estate valuers will continue to value assets for financial reporting purposes. Accounting and finance people will need to understand the subtle differences between terms. Something that needs much more work on.

Note the subtle differences in the terms used by Real estate valuers in Australia. 'The Market Approach' is generally called valuation by 'Direct Comparison'. The Income approach is also called the Capitalisation method. The 'cost approach' is also called the Summation Method or approach.
Note that for the income approach the (market derived) net income stream (or yield) is capitalised at an appropriate market derived rate (%) of return to arrive at a Capitalised Value (Capital Value). The assumption in this approach is that the net rent will continue on at the same level in perpetuity. If rental income streams are likely to alter over time in planned and specific ways (such as a long term lease) then discounted cash flow (DCF) models can be utilised to input the rent streams and discount back at appropriate market derived rates.
In the public sector, for specialised assets there are few, if any, active markets available to use as comparisons.

In BC82 there is a reference to the cost approach. The Summation or cost approach is generally used where directly comparable sales evidence is hard to come by. Its used as a check for the Direct comparison and capitalisation approaches at times. In real estate valuation work the summation approach generally means the summing up of the component parts. Eg 1. The value of the land obtained from vacant land sales evidence. 2. The added value of the buildings obtained from replacement/reproduction cost estimates less an appropriate amount of depreciation to get to added value. 3. The added value of any other items that are present on the site. The 'summation' or addition of these becomes the Market Value. It can be seen that valuers are generally dealing with added value or depreciated value rather than new cost. As it stands the guidance on valuation techniques will not necessarily make the situation clear to valuers.

Disclosures

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

Disclosure reports are a valid way of explaining to the reader the what, why, how, when, where and who of the asset valuation process. Their use should be continued and further developed.

Convergence with US GAAP

Question 12

The exposure draft differs from Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157.

Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

In terms of real estate, caution is required with the use of the term 'advantageous market'. Assuming a transaction takes place in the most advantageous market will, I believe, lead to a misunderstanding amongst valuation professionals about what that really means. Market value is usually assessed on the basis of an open market. In the Public Sector context the term Highest and Best Use (HBU) also needs careful understanding. The HBU could be the current existing use as a public asset but not the HBU if the asset could be 'sold' into the private sector – which is where the market evidence would generally come from. As Public Sector assets are generally held for a long time and remain core to requirements, care needs to be taken in selecting markets from which to draw comparative sales evidence from.

Other comments

Question 13

Do you have any other comments on the proposals in the exposure draft?

The subtle change of terms to a 'sale price' might confuse some professionals. If possible it would be better to not mention purchase or sale price but stick to a neutral market value.
Any subtle changes to terms will need to be handled carefully. Experience shows that there are differing views of the interpretation of accounting terms between finance and valuation professionals. All terms must be explicitly explained in future to alleviate any potential misunderstanding. This is especially so when dealing with Real Estate terms used in a financial context. Care is also required when applying financial concepts between public and private sector real estate assets. Unfortunately, they don't always seem to match.

Level 2 input B3 (g). Building held and used. While assets are split between land and buildings for accounting purposes, in 'real life' they generally come as a package deal. Sales are for the total value of the land and buildings. The sellers or buyers do not normally work out numbers to apply to each asset. Therefore the concept of the price per square metre derived from observable market data is a difficult concept for some to grasp. To get the 'added value' of the building value (per sqm) from comparable sales information, an analysed land figure will need to be applied first. Sales of buildings, without land, don't often occur. The other method to apply will be a depreciated replacement cost ie new cost less depreciation = added value. The two methods don't always reach the same conclusion as to value.

Public sector assets, such as those that our office deals with for financial reporting, are often specialised, non market assets. In general there are few if any feasible alternatives. In deciding where to get evidence from for comparative purposes, our valuers need to be careful in their selection. It is sometimes difficult to equate these specialised assets to their future service potential. In the past, it has been difficult to read AASB116 and apply the concepts to the Public Sector.

The Community Service Obligation for Public Sector assets needs to be considered in Financial Reporting valuations.

In view of these issues, the final outcome of the Exposure draft should be structured in such a way that the concepts are understandable for all readers including valuers. Simple to follow Guidance notes would be very useful for the valuation profession. While there has obviously been input from valuation professionals to get to this point, further development of the meaning of the terms used to better serve professionals will be productive.

FAIR VALUE MEASUREMENT
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[Draft] International Financial Reporting Standard X *Fair Value Measurement* ([draft] IFRS X) is set out in paragraphs 1–64 and Appendices A–D. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its core principle and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.