Director, Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
Toronto
Ontario
M5V 3H2
Canada

Also by e-mail: ed.accounting@cica.ca

17 May 2006

Dear Sirs,

Response by the Royal Institution of Chartered Surveyors to the Discussion Paper on Measurement Bases for Financial Accounting – Measurement on Initial Recognition

Introduction

The Royal Institution of Chartered Surveyors (RICS) has given careful consideration to the Discussion Paper: Measurement Bases for Financial Accounting and welcomes the opportunity to make comments.

RICS represents the views and interests of over 120,000 chartered surveyors worldwide covering all aspects of land, property and construction. Under the terms of its Royal Charter RICS is required at all times to act in the public interest. Valuation is a core discipline of our members and is a compulsory part of our qualification criteria. A significant proportion of the membership provide valuations for Financial Statements and our response reflects considerable expertise in the valuation of all types of assets, but more specifically property, plant and equipment.

RICS has, since 1974, published standards for the preparation of valuations for financial statements. These are now incorporated into Standards that cover the whole range of the valuation process published as RICS Appraisal and Valuation Standards (5th Edition), colloquially known as "The Red Book". These Standards fully recognise the role of the International Valuation Standards Committee (IVSC) and have been developed, so far as they apply to financial statements, alongside and in cooperation with Accounting Standard setters, particularly in the UK.

We have debated for some time the issues surrounding the interpretation of Fair Value and welcome this opportunity to respond to your Consultation Paper.

We consider that market based evidence is very relevant to the measurement of Fair Value. However, it needs to be borne in mind that “Fair Value” and ”Market Value” have distinct meanings. We urge the project team to be aware of the distinction between the two concepts and to avoid giving the impression that they are synonyms. Our responses to Questions 1 and 2 provide more detailed comment on this point.

Land and buildings are particular asset classes that have been the subject of valuations for very many years. This is not surprising. Each parcel of land is potentially unique, having a monopoly on its particular location. Property assets usually take time to buy and sell, so the market in which they are traded can be seen as "thin" compared with some other asset classes. Land cannot be taken away by the purchaser: it can only be used in situ. Land and buildings are rarely homogenous assets, which reduces market perfection. Land can be used for a variety of purposes and therefore one parcel of land potentially could be traded in different markets at any one time. Finally, land usually does not depreciate. All these characteristics, coupled with the economic importance of land, means that valuers'[1] services are required frequently on this asset type. Many of the valuation issues surrounding the concept of Fair Value are familiar to our members. Whilst there may be distinctions between land and other asset classes, there are also many similarities. We believe that if standards can be devised that are workable for a "difficult" asset class such as land and buildings, they will also work for many other asset classes.

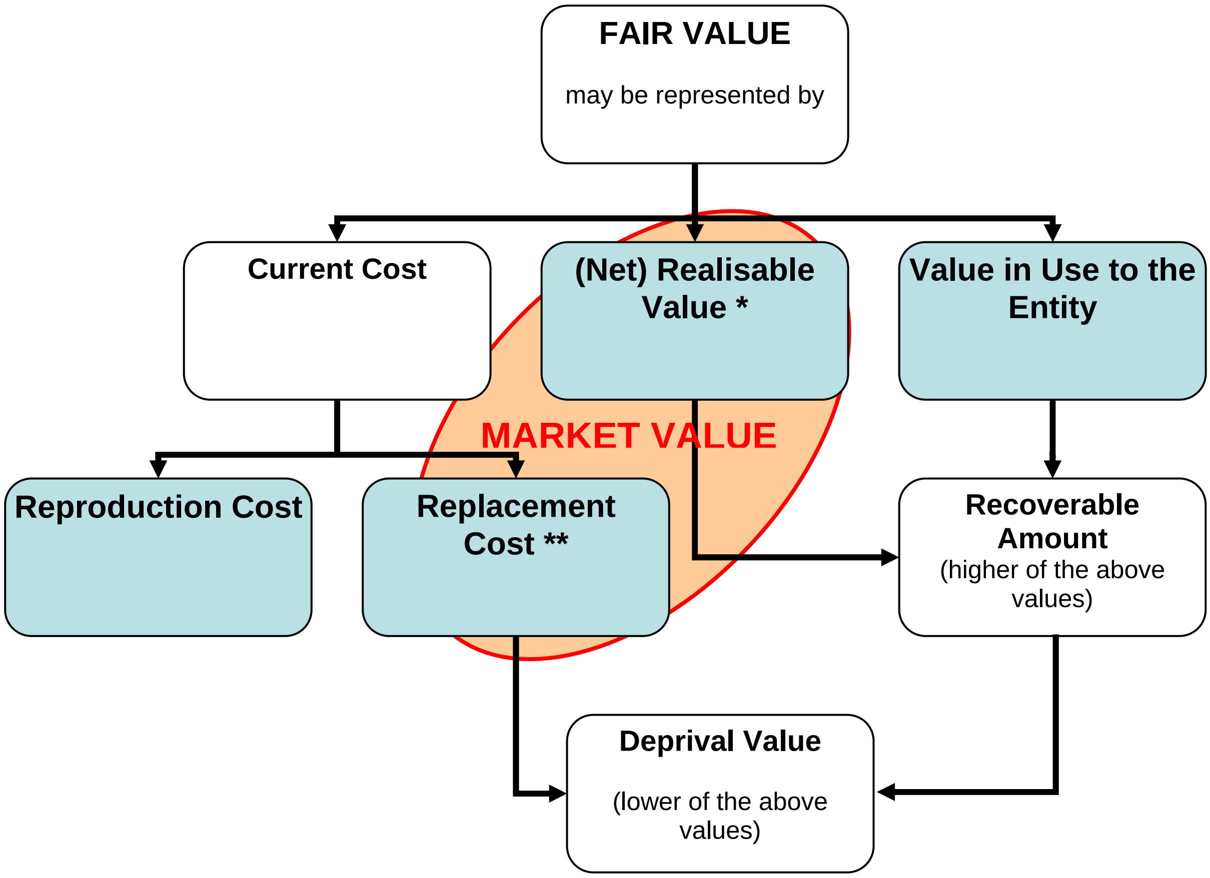
1 Question 1

1.1 Fair Value is recognised as a conceptual measurement basis for accounting purposes but its relationship with established valuation bases as used by our Members needs clarifying. It is not a mutually exclusive basis as compared with the other listed bases.

1.2 Thus the term "Fair Value" could encompass a range of values depending on the valuation framework required by accounting standards. We train our Members that any valuation must be accompanied by a statement of the necessary assumptions that have to be made together with a full disclosure of how the value has been arrived at in each particular case.

1.3 The list of terms in the Paper includes the commonly recognised bases of valuation, but also "derived" terms, some of which are actually subsets of others. Adopting a "tree" format we would express the relationship between the measures in this way:

[1] We use the term "valuer" throughout this response, which we intend to be synonymous with "appraiser" in the relevant context.



Notes

Those terms shown in the shaded boxes are distinct measures of value. Those in uncoloured boxes are generic terms or measurement concepts that use a combination of value measures.

* The definition of Market Value means "estimated price received", before the costs of realisation. This is consistent with the comments in paragraph 199 of the discussion paper (long version) that states that costs of realisation are not to be treated as part of the Fair Value of an asset but accounted separately. Therefore we are surprised to see the use of the term "net" attached to this valuation basis. We have therefore treated this basis as if it were "Realisable Value".
** In some circumstances this may be the same as (Net) Realisable Value.

We have omitted the term "historical cost" from the above diagram because this is not a basis of measurement within Fair Value. Historic cost will often equal Replacement Cost on initial recognition.

1.4 It is perhaps worth noting that, on initial recognition of a new asset purchased in a deep liquid market, Reproduction Cost, Replacement Cost, Recoverable Amount, Realisable Value and Deprival Value could all be the same.

1.5 As there may be circumstances when any of the above terms and definitions might be described as "Fair Value", we consider that the valuation premise to be adopted for each financial reporting purpose, together with the appropriate valuation assumptions (e.g. regarding lotting, use and aggregation) must be unambiguously stated in the accounting standards, thus removing any discretion of the valuer as to the assumptions and therefore the value.

2 Question 2

2.1 We support the revised IASB definition of Fair Value.

2.2 As mentioned in our introduction and response to Q1 we have a general comment on the use of the terms “Fair Value” and “Market Value” in the paper. Frequently they seem to be used interchangeably, and indeed seem to be regarded almost as synonyms. It is important that the paper emphasises the difference between the two terms. Fair Value is a generic concept that encompasses Market Value. Market Value is a basis of valuation / measurement.

2.3 Fair Value is generally recognised as the price that would be deemed as “fair” in a transaction between two (or more) parties acting at arms length. The price may be that obtainable in the market but there are occasions where assessment of “fairness” requires factors specific to the particular parties to be taken into account. An appropriate value for an asset involving a vendor or purchaser with a special interest can exceed Market Value.

2.4 Market value is the price that could be obtained in the general market, ignoring any additional price that may be paid by a purchaser with a special interest. It therefore does not include any additional value that could potentially be released through synergies available to a particular potential purchaser, even where that counterparty can be identified. Therefore the price obtainable in the market is not necessarily one that would be reported under a “fairness” valuation; it is simply the price that would be obtainable at the date of valuation, and which the seller is deemed to be prepared to accept regardless of the value to them of retaining the asset.

2.5 Both Fair Value and Market Value have their place for different purposes. Because Market Value does not depend upon the motives and characteristics of the particular parties to the transaction, it is a more sustainable and consistent measure in most circumstances. However, for some purposes (perhaps, for example, to reflect the synergies in a business combination on initial recognition) a different Fair Value measurement may be the most appropriate approach. Neglecting to identify (and potentially realise) the additional benefit of transferring an asset to a particular party with a special interest could amount to a failure by the entity properly to advise shareholders or other beneficiaries of the sale. Further, on initial measurement, it may be appropriate for an entity to reflect Fair Value including an amount over and above the Market Value of an asset. The treatment of such an asset at future re-valuation is not covered in the paper but is clearly an important issue.

3 Question 3

PARAGRAPH (A)

3.1 We agree that there can be differences between market valuations and entity specific valuations. However, a clear distinction needs to made between

(i) a valuation based on the specific entity’s trading position, expectations, cost of capital etc – the Value in Use to that entity; and

(ii) a valuation to Market Value which adopts the entity’s trading history and prospects as a starting point in estimating the price that would be agreed in the open market between a willing vendor and a willing hypothetical purchaser.

3.2 Point (ii) above applies particularly to real estate valued on the basis of trading potential, where the starting point for a valuation is often the trading history of the unit. A similar point arises more widely from the assumption of a willing purchaser, something common to both Market Value and Fair Value. There are situations where it would be difficult to define the market without having regard to the position of the entity owning the asset. A willing purchaser, if coupled with the assumption that the asset is required for continued use by the business, is an entity that has a business need for the asset. This enables the valuer, when valuing a specialised asset for which it is recognised that there is no evidence of an active market, to report a Market Value based on the principle of substitution. Thus Market Value can include entity specific considerations. In either case a valuer would not label these as "entity specific" valuations, because although the need for the asset might be defined in terms aligned with the actual owner's, or having regard to the trading history of the asset, the valuation will proceed as far as possible using objective market-led inputs and expectations.

PARAGRAPH (B)

3.3 We also agree that it is fundamental that the value-affecting properties of assets and liabilities are defined before a valuation can take place. An example to clarify this point is that of a particular item of plant or equipment. The valuation will differ according to the assumptions made: in situ, in working order, it will have a value to the entity as a unit of production or as part of a transfer of the business as a going concern; its value as an individual item for removal from the current location may very low (or potentially even negative); or a replacement item separately purchased may have a value between, or above, the first two. Thus the application of any specific standard must be accompanied by clear guidance as to which approach should be adopted in financial statements.

4 Question 4

4.1 Having regard to our previous comments we agree that Fair Value encompasses the market value objective and agree with item (a).

4.2 In (b) we prefer the shorter, Webster's, definition of "market" because the proposed definition given leads to a supposition, incorrect in our view, that markets have a degree of perfection. A market is created when two or more entities are able to bid for assets such that the price will be affected by their decisions. There is no need to take the definition further to include the concept of equilibrium price. Probably no market is perfect, even in such frequently traded commodities as stocks and shares.

4.3 With regard to (c) our comments on the distinction between Fair Value and Market Value are relevant here. If the terms are clarified as suggested then the objective is accepted.

5 Question 5

5.1 We broadly agree with the definition and discussion.

5.2 In our opinion there is a distinction between entity specific measurement objectives and management's intentions. Even though the measurement basis may be Market Value, management's intentions, in so far as they are relevant and rational, may be reflected. For example, if management intends to retire an asset and dispose of it as soon as possible, the appropriate value for reporting purposes could be different from its value as part of a transfer of the whole business as a going concern, as noted in the response to Question 3.

6 Question 6

6.1 It is our view that the table in paragraph 122 fully supports the conclusion that market value measurement is to be preferred.

7 Question 7

PARAGRAPH (A)

7.1 We do not agree that there can be only one Market Value for an asset on a given date. All valuations are based on a hypothetical transaction and if the terms of the hypothesis are altered, then the consequent Market Value may vary.

PARAGRAPH (B)

7.2 We believe that (i) correctly identifies the reasons for the differences in the Market Value on a given date. As entity specific charges or credits are irrelevant to a Market Value assessment, (ii) is false.

8 Question 8

8.1 We do not agree with this suggestion. The present value of a liability to make future payments will often be higher than the present value of the right to receive those payments as the paying party will reflect the full cost of making the future payments whereas the receiver may discount to reflect the risk of default.

9 Question 9

9.1 We broadly agree with the proposals but there is a need to recognise valid exceptions.

PARAGRAPH (A)

9.2 It is quite common in the property market for a portfolio to have a higher value than the sum of its parts. A particular example being a portfolio of licensed property, or hotels, where it is the nature of the business of the entity that such a portfolio will have a greater value to any purchaser due to economies of scale and intangible benefits such as branding and purchasing power in the market for supplies (e.g. beer).

9.3 It is also true that a portfolio value may be the same as the sum of its parts, particularly in investment scenarios where the owner of the interest is not running a business using the properties.

9.4 The degree of aggregation can have a fundamental effect on value and although on initial measurement one approach may be appropriate it is possible that on subsequent revaluation a different approach may be adopted and difficulties could arise. This is an area where careful wording of a standard is required coupled with a clear instruction to disclose the fact that in some instances the “break up” value of a portfolio may be less than the aggregated figure adopted.

PARAGRAPH (B)

9.5 It follows from the above comments that, due to the portfolio effect, it may not be appropriate to adopt in all cases the lowest level of aggregation, such as an individual property asset that contributes to the generation of future cashflows. The asset should be viewed at the level of aggregation that would accord with the assumption of a willing purchaser with a similar requirement as the actual owning entity.

9.6 It must be recognised, however, that valuing assets at this level of aggregation will distance them from the "market" in which the assets were originally (individually) acquired. If there is a material difference in the values of the aggregated or disaggregated assets, this might be something that should be disclosed in financial statements.

10 Question 10

10.1 In principle, we agree with your analysis. It is implicit in this discussion that there is a full understanding of what comprises a particular market for an asset and the interaction between that market and other potential markets for the same asset. The other potential markets may encompass those already referred to in the paper and others yet to be identified from further research, as suggested in paragraphs 152 and 161 of the paper. However, again reflecting property specific matters, there is a question about how to deal with the situation where land is acquired and a property constructed. Presumably on initial recognition this would be accounted for at the land value plus construction costs but on subsequent re-valuation the Market Value could be considerably different.

11 Question 11

11.1 In the markets in which our members practice, Market Value is always expressed without addition for the costs of purchase or deduction for the costs of sale. Accounting standards should give clear guidance on how such costs should be accounted for.

12 Question 12

12.1 We agree. We would emphasise that the issue of relevance is of paramount importance, and the basis of valuation adopted should be directed solely to that purpose. The reliability of the valuation can be expressed additionally and through classification within the valuation hierarchy, but the relevance of the value should not be reduced by selecting a more reliable measure which is nonetheless less useful.

13 Question 13

13.1 We agree.

14 Question 14

14.1 As valuers, we have no comment on this question. When accounting standards are clear on what the relevant measure of value is to be, a valuation will be provided on that basis.

15 Question 15

15.1 As a generality we agree that Fair Value may not be capable of reliable estimation in some circumstances and it would be appropriate to have an hierarchy of reliability. We will make further comments about the suggested hierarchy in our response to question 18.

15.2 With regard to (a) we consider that the opposite of the comment made is more appropriate i.e. that a single transaction price will be strong evidence of an asset's Market Value unless there is some contrary indication (for example that the price was affected by the purchaser having a special interest, or the transaction not meeting any of the other conditions in the definition). As explained in 2.5 above it may, on initial recognition, be appropriate for Fair Value to include an amount over and above Market Value.

15.3 A similar comment can be made with regard to paragraph (b). There still can be situations where the Fair Value of an asset may be more appropriate for reporting purposes than its historic cost. If the only means of determining the Fair Value is to employ some entity-specific measures, then this might be acceptable unless it can be demonstrated that these are inconsistent with market expectations.

16 Question 16

16.1 We draw attention to our comments to Question 1 where we indicate that, in our opinion, Fair Value is not a separate basis of valuation but a generic term which incorporates, subject to reliability, all the various other definitions, with the exception of historic cost.

17 Question 17

17.1 It will be apparent from our previous comments that the various bases and definitions listed are not considered to be "substitutes" for Fair Value. Any of them may represent Fair Value in particular circumstances.

18 Question 18

18.1 We agree with the principle of an hierarchy, as this is the most effective means of conveying the idea of valuation reliability. We are aware that the most recent FASB proposal has reverted to a three level hierarchy. Although there are differences in detail between the proposed levels we consider that, in principle, they should be

(i) Directly observable prices for identical assets;

(ii) Observable prices for similar assets that can be adjusted by the valuer to apply to the subject asset;

(iii) Values derived from observable market data;

(iv) Values based on more subjective inputs.

18.2 We would expect that land and property valuations would normally be in Level 2 with some, for instance where there is no market and a depreciated replacement cost method is used, in Level 3.

19 Question 19

19.1 In general terms, although the valuation of real estate has properties that distinguish it from other classes of asset the underlying measurement principles are the same. Therefore underlying our discussions there is a concern that there needs to be greater clarity in accounting standards as to what is the purpose of the valuations and hence the nature of the valuation assumptions before the valuer is instructed. For instance we have assumed that the intention is to provide information that will protect investors in an entity but note that different information is required for use in calculating depreciation or disposal values.

19.2 In all these deliberations we also recognise that accounting standards have to reflect the valuation of all types of assets at their Fair Value but that there are difficulties in applying the definitions when considering property valuations. Thus we fully endorse your proposal, as per paragraph 275 in the long paper, to undertake a project to examine the IVSC body of standards and practice in light of financial accounting measurement objectives. Considerable expertise on these matters is available within our membership and RICS is willing to contribute to that research.

19.3 Paragraphs 131-135 discuss the concepts of “entry” and “exit” values and conclude that under the market value measurement objective an asset can have only one value. We agree with this only to the extent that there is only one price per market. Land and buildings can simultaneously have a value in several markets, each of which can be described as Market Value, and this makes the “entry” and “exit” value debate particularly relevant. We would reiterate the points made in response to earlier questions that the result may differ dependent on the hypothesis that is adopted as to the nature of the asset. For example, in the case of a property, is it the property in isolation from (sold by) the business or is it the property used by (sold as part of) the business? The same question arises for items of plant and equipment. In effect, it is the sale hypothesis that gives rise to distinct “entry” and “exit” values. We believe that the valuation hypothesis must be clearly defined; otherwise the values that appear in financial statements will be ambiguous and/or inconsistent.

19.4 We have commented in Question 5 on the difference between value as part of the going concern and disposal value. Sometimes the Market Value of a property will reflect a potential use that differs from its current use by the entity. In order to realise that value the business would need to close or relocate and various costs will have to be incurred. In our opinion it is inappropriate to include the property in the accounts at a value based on the hypothesis of a sale away from the business without also reflecting the financial and other consequences of such a course of action.

19.5 One additional area that we have discussed which has a secondary impact on initial recognition is the method by which real estate asset valuations are apportioned between land and buildings. We would make the point that apportionments are not always market evidenced valuations (as land and buildings are usually bought and sold as a single asset) but are a calculation which allocates an actual valuation on a reasonable basis between the parts.

We trust these comments are of assistance to you and if you would like further clarification please contact Stanley Booton, Chairman of the Valuation for Financial Statements Group, RICS.

Yours sincerely

Stanley Booton

Digitally signed by Stanley Booton
DN: cn=Stanley Booton, c=GB, o=King Sturge, ou=Valuation Department, email=stanley.booton@kingsturge.com
Reason: I am the author of this document
Date: 2006.05.17 15:27:09 +01'00'

Stanley Booton MA MRICS
Chairman, Valuation for Financial Statements Group
RICS Valuation Faculty

Tel. (+44) (0)20 7529 6906 (direct)
Fax. (+44) (0) 7409 7458
E-mail. stanley.booton@kingsturge.com