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17 May 2006

Dear Sir,

Discussion Paper – Measurement Bases for Financial Accounting – Measurement on Initial Recognition

The IVSC welcomes the opportunity to comment on the *Discussion Paper: Measurement Bases for Financial Accounting - Measurement on Initial Recognition*, as prepared by the staff of the Canadian Accounting Standards Board (AcSB).

Our responses to the questions raised in the Discussion Paper are set out in the Appendix to this letter.

If you have any questions concerning our comments, we would be pleased to discuss these with you.

Sincerely,

Joseph J Vella

Joseph J Vella
Chairman, International Valuation Standards Committee

Email: ivsc@ivsc.org

APPENDIX

MEASUREMENT BASES FOR FINANCIAL ACCOUNTING – MEASUREMENT ON INITIAL RECOGNITION

1. Do you agree that the list of identified possible measurement bases (see paragraphs 69-74) sets out the bases that should be considered? If not, please indicate and explain any changes that you would make.

We agree that the eight bases listed in paragraph 69 represents a comprehensive list of measurement bases that have been used for financial reporting. However, although each represents a distinct concept, they are not all mutually exclusive. For example, there will be circumstances where there is no difference between the reproduction or replacement cost and others where net realisable value and value in use coincide. Further, depending upon the circumstances and the measurement objective, virtually all the other bases identified could represent the fair value of an asset or a liability.

2. Do you agree with the working terms and definitions, in supporting interpretations of each identified measurement basis (see paragraphs 77-96)? If not, please explain what changes you would make. In particular, do you have any comments on the term "Fair Value" and its definition in the light of the discussion in paragraphs 88-93?

We are comfortable with the established definitions of the different bases provided in the paper. On the specific question of the definition of "Fair Value" we are happy with the change proposed and the reasons given.

There does seem to be some uncertainty in the paper as to whether Fair Value and the Market Value are interchangeable. We believe that there is a clear distinction.

IVSC settled a definition of Market Value in 1993 and this is now widely recognised and adopted.[1] It 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, i.e. one who already holds another asset or assets that, if combined with the asset being valued, would release additional value.

In contrast, the concept of Fair Value requires the assessment of a price that would be fair to the two particular parties to a transaction. If the seller and buyer are in a position to release additional value by the combination of their existing interests then a Fair Value between them must reflect this synergistic element. In many transactions the price that could be obtained within the wider market will also be the price that is fair as between two particular parties. However, particularly in business combinations or the transfer of blocks of shares, Fair Value may be quite different from Market Value.

Even though a party may be identified with a strategic holding that could release additional value if combined with the asset being valued, it cannot automatically be assumed that that party will be either willing or able to transact at the date of valuation. Because Market Value requires this potential interest to be ignored, it is a more sustainable measure than Fair Value. Market Value simply assumes that there will be a buyer in the market, not any particular buyer

In IAS16 it is stated that the Fair Value of land and buildings is normally based on "market evidence" and of plant and equipment its "market value". In IAS 40 the Fair

[1] The market value definition and conceptual framework are annexed to this response

Value of investment property is required to reflect current market conditions. We have no difficulty with this clarification of how Fair Value should be applied to the classes of assets covered by these standards. However, these statements should not be taken to mean that the two bases are synonymous. Care must be taken to recognise the difference between the two concepts.

We also note that FASB is likely to introduce a further definition of Fair Value in its forthcoming “Fair Value Measurement” standard. Although IVSC supports this definition in the context of the proposed standard as it brings greater certainty to the objective of Fair Value Measurement for financial reporting, it does not invalidate the fact that in considering transactions between individuals and businesses generally, Fair Value does not always equate to Market Value.

3. It is proposed that there are two fundamental sources of differences between the identified bases for measuring assets and liabilities on initial recognition:

a) Market versus entity-specific measurement objectives, and

b) differences in defining the value-affecting properties of assets and liabilities. This proposal and its conceptual implications are the subject of chapters 4 and 5. Do you agree that these are the fundamental sources of differences between asset and liability measurement bases on initial recognition? If not, please indicate the fundamental sources of differences you have identified, and provide basic reasons for your views. For any different fundamental sources you have identified, please indicate how these might be examined and tested.

a) We agree that market versus entity-specific measurement objectives can give rise to totally different valuations, as the benefit to a particular entity of owning certain assets may be significantly different from the price that could be obtained for them in the market. However, it does not necessarily follow that entity-specific objectives are always irrelevant to the assessment of Market Value. If the objectives and performance of the entity are in line with those of most market participants, a valuation based on the entity’s actual performance may still be relevant to the assessment of Market Value as it may be a guide to the performance of a typical market place participant.

b) Differences in the “value-affecting properties” of assets and liabilities are the fundamental reason for potential differences in value on a given date. All valuations are based on a hypothetical transaction. It follows that the assumptions made in building that hypothesis will fundamentally alter its conclusion. It is for this reason that IVS requires assumptions made to be clearly stated when values are reported.

4. The paper analyses the Market Value measurement objective and the essential properties of Market Value.

a) Do you believe that the paper has reasonably defined the Market Value objective and the essential properties of Market Value for financial statement measurement purposes (see paragraphs 99-110 and 236-241)? If not, please explain why not, and what changes you would propose, or different or additional considerations that you think need to be addressed.

b) Do you agree with the proposed definition of “Market” (see paragraphs 107-110)? If not, please explain why you disagree, and indicate any changes you would make and any issues that you believe should be given additional consideration.

c) Do you agree with the Fair Value measurement objective as proposed, and its derivation from the Market Value measurement objective (see 228 & 229 of the main discussion paper)?

a) We generally agree that the paper has identified the fundamental economic principles behind Market Value Measurement in paragraphs 99-110, subject to reservations on paragraph 107. We refer you to the definition of Market Value in the IVS and, in particular, its conceptual framework, which examines these fundamental principles.

b) We dislike the proposed definition of the market. We are concerned that a prerequisite of there being "sufficiently extensive exchange transactions" could lead to many markets being excluded from the definition of market, especially where the products in a market are not homogenous. By way of example, products in the real estate market are more heterogeneous than most, but market participants have evolved analysis techniques and valuation methodology to reflect this. We point out that the IVSC definition of Market Value simply requires the assumption of a willing seller and a willing buyer. The focus of the definition is on the motivation of the parties and their assumed knowledge. We consider that the concept of a market is simply the mechanism that gives the ability for goods or services to be traded without undue restriction. Markets can be of many types and sizes, and activity in those markets can also vary significantly. Introducing subjective qualifications on what may be validly considered a market will potentially cause distortion of the intellectual purity of the concept of Market Value.

c) The answer to this question depends entirely upon the purpose of measuring assets and liabilities. That is not a valuation issue. If the requirement is to record assets and liabilities at a figure that best represents the price that could be achieved for those assets either in a sale of the whole enterprise or, if surplus, as individual assets in the market, we believe that Market Value as defined in IVS is the most objective and widely understood measure. If the purpose of measurement is to provide investors and others with information of how management has used money previously invested, or to measure an appropriate charge against profits for depreciation, it may not be so appropriate.

The paper has not explained why IASB and others are keen to retain the term Fair Value (see para 93(a)). If it is because it is believed that there are occasions when elements of synergistic, or special value, need to be reflected, for example in a purchase price allocation after a business combination, we can understand this, although explicit explanation of this in the appropriate standards would assist entities and the valuers advising them.

We have also heard that it is because it is believed that confusion may arise because the term Market Value, or derivations of it, are used in tax legislation in various jurisdictions and there is concern that confusion could result, and even that interpretations of the tax law by Courts could influence the application of Market Value in financial statements. We believe this latter reason is totally unfounded. If a clear and robust definition of value if provided in IFRS there will be no need to look into unconnected bodies of knowledge for precedent. We are not aware of any body of law, whether based on Common Law or Roman Law that would support the use of precedents drawn from regulations prepared for one purpose being used to support the interpretation of regulations prepared for another.

5. Do you agree with the definition and discussion of entity-specific measurement objectives (see paragraphs 112-116) and their relationship to management intentions (paragraphs 117-121)?

We agree that there is a clear distinction between market and entity-specific measurement objectives, and that the former is far more relevant as a measurement basis on initial recognition. However, a clear distinction has to be drawn between entity-specific measurement objectives and management intentions. The latter are still relevant to the assessment of Market Value. For example, if management considers a particular asset to be surplus and intends to dispose of it, its Market Value could be quite different from its Market Value if management intended to retain it as part of the operational entity, where its Market Value would be assessed on the assumption that it was sold as part of the transfer of the whole operation as a going concern. This distinction is recognised in the FASB Fair Value Measurement draft.

6. Do you agree with the comparison of market and entity-specific measurement objectives (see paragraph 122) and with the proposed conclusion that the Market Value measurement objective has important qualities that make it more relevant than entity-specific measurement objectives for assets and liabilities on initial recognition (see paragraphs 123-129)?

We agree with the table in paragraph 122 and with the conclusion that this illustrates that Market Value has important qualities that make it preferable to entity specific measurement objectives on initial recognition.

7(a) It is reasoned that there can only be one Market (Fair) Value for an asset or liability on a measurement date (paragraphs 131-138). Do you agree with this conclusion? If not, please explain why you disagree.

We agree that conceptually that there can be only one Market Value for an asset or a liability on a measurement date on the basis of a given set of assumptions. We endorse the observation in para 134 that it is fundamentally inconsistent with an open and competitive market for there to be any sustainable difference between entry and exit prices. However, in practice an asset can have more than one Market Value on a given date depending upon the assumptions made about how the asset is to be transferred, the state in which it is transferred or any other conditions that may attach to the sale. Variations in these factors, identified in the paper as "value-affecting properties" will have impact on the Market Value.

7(b) It is proposed that differences between apparent Market Values for seemingly different assets or liabilities on initial recognition may be attributable to:

i The difference between the value-affecting properties of assets or liabilities traded in different markets, or

ii Entity-specific charges or credits

See paragraphs 131-138. However, the paper notes the existence of multiple markets for some assets and liabilities, and the possibility that they may be due to market access restrictions that require further investigation, see paragraphs 95-109 of the main discussion paper.

Do you agree with these proposals, within the caveats and discussion presented?

(i) is correct.
(ii) is incorrect. Entity specific issues have to be ignored in assessing Market Value.

8. Do you agree that a promise to pay has the same Fair Value on initial recognition whether it is an asset or liability, and that the credit risk associated with a promise to pay enters into determination of that Fair Value with the same effect whether it is an asset or liability, see paragraphs 142-147?

No. A paying party will reflect the full current cost to it of making future payments. A receiving party may further discount future receipts to reflect the risk of default.

9. The paper makes the following proposals with respect to finding the unit of account for the asset or liability to be measured on initial recognition:

a) The appropriate individual item or portfolio unit of account on initial recognition is generally the unit of account in which the reporting entity had acquired the asset or incurred the liability (paragraphs 149-151).

b) The appropriate level of aggregation for non contractual assets on initial recognition is the lowest level of aggregation at which an identifiable asset is ready to contribute to the generation of future cashflows through its sale or use, see paragraphs 157-161.

Do you agree with these proposals within the caveats and discussion presented?

a) We generally agree with this proposition for initial recognition. However, because the degree of aggregation can have a fundamental effect on value, and because it is quite proper for a business to look to re-engineer assets and liabilities to maximise or minimise value, difficulties could arise on subsequent recognition.

b) We can see a problem with the "lowest level of aggregation" principle because there are examples where a single asset may be capable on its own of contributing towards future cashflows, but still have a higher Market Value as part of a portfolio, and therefore would normally be traded as part of that portfolio. We believe that the paper provides an analysis of how and why the value of similar assets or liabilities can vary on the same depending upon the circumstances. Refer to our response to question 7(a).

10. It is suggested that, in many cases, the best market source on initial recognition is the market in which the asset or liability being measured was acquired or issued. However, some significant situations are noted in which a different source may be appropriate, and research is proposed into possible multiple markets, see paragraphs 162-182. Do you agree that the paper provides a reasonable analysis of market sources and their implications on initial recognition?

We agree that the paper provides a reasonable analysis of the possible effect that different circumstances may have on the market value of a particular asset or portfolio, although we would argue that in many cases these are not different markets as such but different assumptions about how the asset is to be presented to the market.

11. The paper concludes that transaction costs are not part of the Fair Value of an asset or liability on initial recognition, see paragraphs 193-200. Do you agree

with the proposed definition of transaction costs? Do you agree with the above conclusion?

We agree that Fair Value and/or Market Value is the figure that would be agreed between the parties in a hypothetical transaction, i.e. the price on the contract. It will therefore take no account of the directly attributable costs involved by the parties in the transaction. The question of whether these costs should be reflected as capital expenditure or a revenue cost in the financial statements is an accounting, not a measurement, issue.

12. Do you agree with the proposal that, when more than one measurement basis achieves an acceptable level of reliability, that the most relevant of these bases should be selected, see paragraph 202.

We agree. Indeed we consider that relevance rather than reliability should be the test. Because cost is normally capable of being proved factually, it is reliable, but if that cost is historic it is almost certainly less relevant than the current value, even though the current value can never be proven as fact and therefore may be thought less reliable.

13. Do you agree with the two proposed sources of limitations on measurement reliability, estimation uncertainty and economic indeterminacy, see paragraphs 204-216?

Yes.

14. Do you agree that Fair Value is the most relevant measure of assets and liabilities on initial recognition and therefore should be used when it can be estimated with acceptable reliability, see chapter 7 and paragraphs 410-415?

We refer to our answer to question 4(c). Fair value is a relevant measure but whether it is the most relevant depends entirely on the purpose of measuring assets and liabilities. There is no clarification of this fundamental question in the paper.

15. Do you agree that Fair Value is not capable of reliable estimation in some common situations on initial recognition, see paragraphs 232-237? More specifically do you agree that:

a) A single transaction exchange price should not be accepted to be equal to Fair Value unless there is persuasive evidence that it is, see paragraphs 243-252, and

b) The measurement model technique could not be considered to achieve a reliable estimation of the Fair Value of an asset or liability when the estimate depends significantly on entity specific expectations that cannot be demonstrated to be consistent with market expectations, see paragraphs 263-268.

Please provide explanations for your views on these questions if they differ significantly from the conclusions in the paper.

a) We believe the emphasis here is wrong. Often a recent transaction exchange price is the best evidence of current value unless there is clear evidence to the contrary. We agree that it would be unusual, and indeed bad practice, for a valuer to rely solely on the evidence of a single transaction, and valuers must take steps to satisfy themselves as to the degree to which the terms of the transaction equated to the current valuation objective. However, to reject the evidence unless there is persuasive evidence that it is equal to Fair Value is too strong a statement.

b) We agree. As mentioned in our answer to question 3(a), evidence of the performance and expectations of the specific entity can often be evidence of the performance of that asset in the hands of an averagely competent operator in the market, and therefore can be used to obtain a reliable estimate of Fair Value. Second, the degree to which the entity specific performance is typical of the market is part of the essential skill and knowledge of the professional valuer.

16. Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:

a) Historical cost, see paragraphs 281-319;

b) Current cost – reproduction cost and replacement cost, see paragraphs 320-361;

c) Net realisable value, see paragraphs 362-375;

d) Value in use, see paragraphs 376-392; and

e) Deprival value, see paragraphs 393-409.

Please provide reasons for any disagreements, any advice you may have as to additional analysis or research that you believe should be carried out.

While we do not necessarily agree with all the points made in the commentary on each of the identified bases, as the overall conclusion is that Fair Value is the most relevant measure on initial recognition, we do not consider that discussion of these points would serve any purpose.

17. The paper discusses substitutes for Fair Value when the Fair Value of the asset cannot be reliably estimated on initial recognition. Do you agree that, when other measurement bases are used as substitutes for Fair Value on initial recognition, they should be applied on bases as consistent as possible with the Fair Value measurement objective, see paragraph 417.

We agree with this statement.

18. Do you agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition, see chapter 8?

We believe that the hierarchy proposed is not as helpful as similar valuation hierarchies that have been published recently by both IASB and FASB. We believe that there is insufficient distinction between the various levels and we believe that certain assets could conceivably fall under two or more levels. Of the hierarchies we have seen, we generally prefer that included in the most recent FASB Fair Value Measurement draft.

19. Do you have comments any other issues or proposals?

We note the comments under the heading *"Professional Valuations and Property Valuation Standards"* (paragraphs 269-275) *with* particular interest. IVSC supports, and has been actively pursuing, closer liaison with IASB to try and establish mutual understanding of the measurement criteria for different financial reporting objectives.

However, we see this as a process of continuing liaison and iteration of ideas between the relevant bodies rather than a specific project as envisaged by the paper. We make the following observations on the paper:

i) Although IVSC was founded originally by professional organisations concerned primarily with the valuation of property, it has become clear to IVSC that although real estate has properties that distinguish it from other classes of asset and liability, the fundamental principles of valuation, whether they be best practice in procurement and reporting, or in the techniques adopted, are common to most assets and liabilities. Differences in the characteristic of an asset or a market will affect the way in which exchanges take place but do not alter the basic economic principles of measurement. IVSC is actively broadening its scope to include input from valuers active in other markets.

ii) Although the current IVSC standards include applications for other purposes, e.g. loan security, the principal driver for their creation and development has always been the development of international financial reporting standards. Indeed, in a number of states, including the UK, Australia and New Zealand, there has been a long tradition of collaboration between accounting and valuation standard setters. More recently IVSC has actively engaged with both IASB and FASB in responding to practical measurement issues arising in IAS40 *Investment Property*, IAS17 *Leases* and most recently on the FASB *Fair Value Measurement* draft. While IVSC acknowledges that there is a need to develop its standards for valuations used in financial reporting, the current uncertainty as to how Fair Value concepts should be applied under various IFRSs has limited our ability to produce better guidance.

iii) There is a suggestion at the end of paragraph 275 that "…property valuations could be carried out on the basis of established standards…. to provide the equivalent of models that have been developed for estimating the fair value of many types of financial instruments." Although we have already made the point that in our experience there is little fundamental difference between the techniques used in different markets to establish value, we would caution against any suggestion that valuation or accounting standards should stipulate the use of specific models or techniques. Standards should focus on the criteria to ensure that valuers are suitably independent, qualified and experienced, the fundamental objectives of the valuation and best practice in procurement and reporting. Countless valuation models have been developed in different sectors and this is a fruitful area of continuous academic research. The models used by the valuer must reflect the behaviour of market participants. Markets are dynamic and techniques of measurement evolve. Bodies such as IVSC and IASB may be a catalyst for debate or research on technique, but we would oppose any restriction on a professional valuer's ability to select the most appropriate method or technique to achieve the objective of the standards in any particular situation.

Finally, we regret that although the paper shows that thorough research has been undertaken into the merits of different types of measurement that have been used or mooted for use in financial statements in the past, the scope of the study has not included consideration of why measurement is needed, or considered if different measurement approaches may be required for different purposes.

The difficulties that valuers experience in providing relevant advice to clients on values for use in financial statements is due to confusion over what the figure is supposed to represent and how it is to be used. For example, a valuer experienced in the relevant market will quickly recognise if an asset is being under-utilised by the entity and capable of achieving a higher value for another purpose. Clearly this information is important for investors and management. However, if that asset is an essential component used to generate the cash flows upon which the rest of the financial statement is constructed, entering a value on the balance sheet that could only be realised if the enterprise ceased using the asset could conflict with the principle of the statements being prepared on the basis of a going concern. It could also introduce inconsistency into the statements, as the carrying amount would be based on a different assumed use to the one used to generate the cash flows and profit & loss statements. If that value is then used to assess the depreciable amount over the useful life of the asset for another purpose, the inconsistency is compounded.

These are not valuation problems, as appropriate values can be produced for all these purposes. What is needed is clarity as to the appropriate assumptions (or "value-affecting properties") that need to be made in each case. Providing the questions are clearly articulated, professional valuers have the skills to provide the answers, and IVSC can produce the standards necessary to provide the consistency of approach and professional credibility required.

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IVSC MARKET VALUE DEFINITION AND CONCEPTUAL FRAMEWORK

The following definition is reproduced from International Valuation Standard, IVS 1 *Market Value Basis of Valuation* (2005)

3.0 Definitions

3.1 *Market Value* is defined for the purpose of these Standards as follows:

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 arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

3.2 The term *property* is used because the focus of these Standards is the valuation of property. Because these Standards encompass financial reporting, the term *asset* may be substituted for general application of the definition. Each element of the definition has its own conceptual framework:

3.2.1 *"The estimated amount..."* refers to a price expressed in terms of money (normally in the local currency), payable for the property in an arm's-length market transaction. *Market Value* is measured as the most probable price reasonably obtainable in the market on the date of valuation in keeping with the *Market Value* definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of *Special Value* (defined in IVSC Standard 2, para. 3.8).

3.2.2 *"...a property should exchange..."* refers to the fact that the value of a property is an estimated amount rather than a predetermined amount or actual sale price. It is the price at which the market expects a transaction that meets all other elements of the *Market Value* definition should be completed on the date of valuation.

3.2.3 *"...on the date of valuation..."* requires that the estimated *Market Value* is time-specific as of a given date. Because markets and market conditions may change, the estimated value may be incorrect or inappropriate at another time. The valuation amount will reflect the actual market state and circumstances as of the effective valuation date, not as of either a past or future date. The definition also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might otherwise be made.

3.2.4 *"...between a willing buyer..."* refers to one who is motivated, but not compelled to buy. This buyer is neither over-eager nor determined to buy at any price. This buyer is also one who purchases in accordance with the realities of the current market and with current market expectations, rather than in relation to an imaginary or hypothetical market that cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than the market requires. The present property owner is included among those who constitute "the market." A Valuer must not make unrealistic assumptions about market conditions nor assume a level of market value above that which is reasonably obtainable.

3.2.5 *"...a willing seller..."* is neither an over-eager nor a forced seller, prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in the current market. The willing seller is motivated to sell the property at market terms for the best price attainable in the (open) market after proper marketing, whatever that price may be. The factual circumstances of the actual property owner are not a part of this consideration because the 'willing seller' is a hypothetical owner.

3.2.6 *"...in an arm's-length transaction..."* is one between parties who do not have a particular or special relationship (for example, parent and subsidiary companies or landlord and tenant) that may make the price level uncharacteristic of the market or inflated because of an element of *Special Value*. (See IVS 2, para. 3.8.) The *Market Value* transaction is presumed to be between unrelated parties, each acting independently.

3.2.7 *"...after proper marketing..."* means that the property would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable in accordance with the *Market Value* definition. The length of exposure time may vary with market conditions, but must be sufficient to allow the property to be brought to the attention of an adequate number of potential purchasers. The exposure period occurs prior to the valuation date.

3.2.8 *"...wherein the parties had each acted knowledgeably and prudently..."* presumes that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the property, its actual and potential uses, and the state of the market as of the date of valuation. Each is further presumed to act for self-interest with that knowledge, and prudently to seek the best price for their respective positions in the transaction. Prudence is assessed by referring to the state of the market at the date of valuation, not with benefit of hindsight at some later date. It is not necessarily imprudent for a seller to sell property in a market with falling prices at a price that is lower than previous market levels. In such cases, as is true for other purchase and sale situations in markets with changing prices, the prudent buyer or seller will act in accordance with the best market information available at the time.

3.2.9 *"...and without compulsion..."* establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.

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