

GLOBAL VALUATION ISSUES

NEWSLETTER FROM

THE
INTERNATIONAL
VALUATION STANDARDS
COMMITTEE

SEPTEMBER 1999



MESSAGE FROM THE CHAIRMAN

These are important times for the IVSC. The last three years have been spent raising awareness of the need for international valuation standards and promoting the IVSC as the most appropriate organisation to produce such standards. We have scored some major successes. Now we must deliver the product.

The efficient collection, processing and dissemination of financial information on a global scale is one of the greatest challenges facing the modern corporation. It is becoming increasingly accepted amongst the world business community that an internationally accepted financial language, accompanied by a rigorous global system for ensuring its consistent application, will become a reality for those doing cross-border business

The lack of comprehensive international valuation standards and guidance undermines the credibility of the property profession generally world-wide and does a disservice to both our home institutes and to the needs of users of valuations everywhere.

The absence of a clear and undisputed set of rules is

also fast becoming unacceptable to managers and investors, and to the international regulators.

The Management Board has released a conceptual business plan for debate - **Global Valuation Standards – Target 2002**. The key objective is to publish a comprehensive set of high quality standards and guidance by the year 2002 that require the disclosure of significant, transparent, relevant, reliable, and comparable information which will help participants in capital markets and others to make economic decisions.

‘Global Valuation Standards – Target 2002’ has been widely circulated – to IVSC member institutes, to the wider business and financial community who either prepare or use valuation reports, and to the international agencies.

We anticipate wide support. The International Monetary Fund has called for the development of asset valuation standards to strengthen both domestic and international financial systems.

There are indications of growing support from

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This Newsletter is produced on behalf of The International Valuation Standards Committee (IVSC) twice a year. The views expressed are not necessarily those of the IVSC Board or of the members of IVSC.

Further information may be obtained from

firms offering valuation services as well as from some of the larger IVSC member institutes.

Sir Bryan Carsberg, Secretary General, International Accounting Standards Committee, has indicated his personal support in a recent letter to me: *“IASC also values a close relationship between our two organisations and attaches high value to the contribution which IVSC can make to effective financial reporting. The concept of your three-year project, mentioned in your last paragraph appears to be very welcome and something with which we would wish to be associated. I note that the SEC in the United States as well as IOSCO have frequently said that they attach importance to our being able to show that our Standards are rigorously interpreted and applied and your work seems likely to help us with this goal. We should be happy to develop common terminology and concepts. No doubt, when the time is ripe, you will put forward a more detailed suggestion for discussion so that I can get any necessary approvals at this end.”*

The production of standards is obviously a key priority for

platform for world-wide debate on issues that are newly emerging from the global optic – thus creating a true rallying point for a global valuation response to an ever more global market.

John Ross, Executive Vice President, Appraisal Institute, addressed the Management Board at its April meeting in San Diego, on the challenges facing the valuation profession in a ‘globalized, securitized, technosized world’. The AI response to the challenges is summarised on pages 5-9 in this Newsletter.

Two emerging debates covered in this Newsletter are:

Assessing credit risk

The banking community is seeking to develop and promote sound practices for assessing credit risk. Real estate is the basic collateral for most loans. Major upheavals in the property sector expose everybody to risk. The dangers of this were illustrated in the Far East two years ago, when a succession of devaluation’s led to the collapse of property prices and a financial crisis. It is tempting to think that western economies are beyond this, but in the UK, for example, alone, the

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commercial property sector is reckoned to be worth £300bn and to account for 70% of all secured bank debt and 40% of tangible balance sheet assets.

The current debate is not only concerned with the risks associated with more traditional property lending. Modern financial systems have altered the international requirements for assessing, monitoring, and managing financial risk. The Basel Committee on Banking Supervision has become increasingly concerned, for example, with some banks’ use of structured financing or asset securitisation to avoid maintaining capital commensurate with their risk exposures.

Public Sector Financial Reporting

Moves to harmonise reporting for the private sector are being mirrored by moves to harmonise public sector financial reporting across jurisdictions, and to improve comparability of information both within and

the IVSC. But the Board is also seeking to create a services consumed during the reporting period, in preference to the cost based reporting.

The IMF and the Public Sector Committee of the International Federation of Accountants acknowledge one of the areas likely to cause most difficulty to governments in adopting accrual accounting is property, plant and equipment.

The IVSC is moving to participate fully in both of these debates.

I look forward to receiving your support to our Business Plan and to seeing many IVSC member delegates at the 1999 AGM to be held in Beijing.

The growing interest in IVSC by our members, shown in the numbers attending the 1998 AGM, has been maintained. Registrations at the time of writing for the 1999 AGM stand at 50 – another record number.

The 1999 AGM sees the end of my three-year term as IVSC Chairman. I thank all IVSC member institutes for their support during this period. Thanks in particular must go to the members of the IVSC Management Board for their commitment to the work of the Committee on behalf of the international valuation profession.

1999 also sees the retirement from the IVSC

between jurisdictions and, where appropriate, between the public and private sectors.

More governments are moving to adopt accrual accounting with the focus on measuring and reporting the costs of goods and

of two prominent members. Don Dorchester has represented the Appraisal Institute on the IVSC for over 20 years. During that time he not only served as Chairman but contributed greatly to the preparation and production of the IVSC Standards. Immediate Past Chairman, Lincoln North, also retires. During his time as chairman, Linc did much to increase the membership base of the Committee, welcoming many of the countries of Central and Eastern Europe into membership.

My very best wishes go to our incoming Chairman, Greg McNamara, Australia

PHILIPPE MALAQUIN
IVSC Chairman

FORTHCOMING MEETINGS AND SEMINARS

12/13 October 1999 IVSC Management Board and 1999 AGM, Beijing

30 Mar/1 Apr 2000 IVSC Management Board, Auckland

2 - 7 April 2000	Twentieth Pan Pacific Congress, Auckland, New Zealand. For more information see New Zealand Institute of Valuers homepage http://www.nziv.org.nz or fax +64 4 382921410
13 July 2000	Valuation 2000, Las Vegas An international conference sponsored by the American Society of Appraisers, the American Society of Farm Managers and Rural Appraisers and the Appraisal Institute. For more information, see http://www.appraisers.org.val2000
3/4 October 2000	IVSC Management Board and 2000 AGM, London

IVSC NEWS

UPDATE ON IVSC PROJECTS

PROJECT	STATUS
Guidance to Valuers Required to Report under International Accounting Standard 16, <i>Property, Plant and Equipment</i>	Commentary Number 2 issued May 1999. Deadline for comments is 30 November 1999
Guidance on Business Valuation	Applications and Performance Guidance (APG) 4 – Business Valuation - published August 1999.
Amendment to IVS 3	Amendment to IVS 3 – Valuations for Financial Statements and Related Accounts – published in August 1999. This amendment was in response to changes in International Accounting Standard (IAS) 16, <i>Property, Plant and Equipment</i>
Code of Conduct	Exposure Draft issued August 1999. Deadline for comments is 29 February 2000
Glossary of Real Estate Terms for Use with IVS	Exposure Draft issued August 1999. Deadline for comments is 29 February 2000
Guidance on the Valuation of Lease Interests	Exposure Draft issued August 1999. Deadline for comments is 29 February 2000
Application and Performance Guidance – Disclosure Requirements	Exposure Draft to be issued Autumn 1999.

Guidance on Intangible Assets	Internal Board Exposure Draft issued for discussion at October 1999 Board meeting
Guidance on the Valuation of Specialised Trading Properties	Internal Board Exposure Draft to be issued in October 1999
Guidance on Agriculture/Forestry Valuation	Working Party established to advise Board on action
Guidance on Insurance Valuation	Working Party established to advise Board on action

THE WALL STREET REPORT BY THE APPRAISAL INSTITUTE

Members of the Appraisal Institute (AI) Wall Street Team, headed by President Bert Thornton, MAI, met in New York City in late April with representatives from investment banks, pension funds, conduit lenders and rating agencies. The following is a summary of a report prepared by the Team. It is reproduced with the permission of the AI.

I. OVERVIEW

Commercial Real Estate Market

Today's commercial real estate market is characterised by increased globalisation of capital sources, investor desire for liquidity, growth of risk aversion instruments, and technology that delivers more, less-expensive, information. Banks, pension funds, and insurance companies continue to provide traditional sources of financing for commercial real estate; while securitization, which seeks to disseminate real estate risk and add liquidity, has allowed the public debt and equity markets to flourish.

The commercial mortgage-backed securities (CMBS) market has seen unprecedented growth in recent years. Currently, about 19% of all commercial mortgage loans are pooled and sold as securities. This compares

analysis and insight to future revenue projections. Because securitization offers less risk to investors, less weight is placed on historical value.

Role of the Appraiser

Today, the full narrative appraisal product is delivered to a wide variety of audiences with different needs. By law, federally insured financial institutions must have an appraisal that conforms to Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). In addition, investors of lower grade bonds, typically B-tranche and below, want a full appraisal, as do syndicate investors. Although banks require a full appraisal to "move money", they are looking for real estate consulting services and advisory or summary opinions of value.

to 63% in the residential market. Many experts believe that the CMBS market will continue to expand, with some predicting 50% within the next ten years. For example, one third of Teachers Insurance and Annuity Association's real estate holdings are securitized products.

Through securitization, CMBS and real estate investment trusts (REITs) have changed the real estate valuation needs of issuers and investors. Commercial real estate investors are increasingly seeking information that provides detailed market important information, regardless of the value conclusion. They are primarily focused on measuring downside risk and are more concerned with the market data that is contained in the appraisal. That data is used in an analysis that focuses on debt service coverage and loan-to-value ratios. Value, in this context, is determined by a cash flow analysis applied to a capitalisation rate based on property type, not from the appraisal report.

“Third-party due diligence materials, including the appraisal, environmental, engineering, and seismic reports, are reviewed. In the appraisal review, Duff & Phelps focuses on the market analysis of the property as well as the trade area. Emphasis is placed on historical and future trends impacting the property and its competitiveness relative to comparable properties. The appraisal provides market income and expense data including historical and budgeted operating statements, income and expense comparables, rent estimates, tenant improvement allowances and leasing commissions. Duff & Phelps looks to comparable sales data in selecting the appropriate capitalization rate and in determining value.” - Duff & Phelps Credit Rating Co.'s Approach to Rating Commercial Mortgage-Based Securities,

With the increase in securitization of commercial properties, the rating agencies play a key role in the process. When properties are pooled together, a rating agency places a rating on the collective package for potential investors. Investment grade CMBS are generally priced based on the rating assigned by the rating agency. Therefore, issuers and conduit lenders are putting packages together with the rating agency perspective in mind.

The rating agencies currently prefer a full appraisal because it provides are being sought.

II. CHARTING A COURSE

To meet the needs of this changing marketplace, the Wall Street team has developed policy recommendations for the Appraisal Institute in the following areas:

Standardisation

A common theme heard on Wall Street is the desire to seek products that add efficiency, transparency, and liquidity to the transaction. The need to develop a standardized report format that will allow the appraisal product to be viewed by multiple readers in an efficient manner is critical. In addition, standardization would help the review process and add value from an institutional perspective. To achieve the goal of standardization, the AI is to develop a standardised report format for commercial securitization that addresses the needs of Wall Street participants. This includes developing a standardized platform for the transfer of data.

A work group has been formed to develop a Standardized Appraisal Format for Wall Street and Investor reporting purposes. The development of the Appraisal Format is an extension of the standardized forms

January 1999.

Because pools of loans are typically scattered across the country, many Wall Street users select appraisal firms and consultants that can provide multiple services and offer a network of coverage. Many firms are offering more than appraisals and single asset valuation services. Products and services such as underwriting, environmental assessment, engineering, site inspections, servicer reviews, tax appeals, due diligence, portfolio analysis, litigation, highest and best use studies, speciality properties, along with market and feasibility studies,

CSSA did was develop a list of 100 items that were to be included in the documents of loans to be securitized. Since that time the CSSA has worked diligently with real estate trade associations to correct any inconsistencies, and make revisions where necessary. The most recent standardized set of forms has been reviewed extensively by servicers, issuers, originators, rating agencies, accounting firms, and investors.

The objective of the AI is to create and add a “front piece” to the CSSA 100 format for detailing mortgage loans. The Standardized Appraisal Format will enable the AI to have a place in the securitization pipeline of transactions and establish the platform from which everyone could draw information.

Ultimately, the idea is for the data on a loan to be entered only once into a database that could be used, not only for appraisers, but by underwriters, servicers, rating agencies, accounting firms and investors without the current duplication of effort and triple levels of due diligence and verification.

Regulatory Relief and Enforcement

US Principles of Appraisal Practice (USPAP) and the Financial Institutions

and definitions already approved by the Commercial Real Estate Secondary Market and Securitization Association (CSSA), Urban Land Institute, Mortgage Bankers Association of America, and the National Association of Realtors.

Nearly four years ago CSSA realized that in order for an efficient secondary market to trade Commercial Mortgage Backed Securities (CMBS), standardized forms for reporting income and expenses for each property type had to be established. The first thing that the Many members of the AI feel that USPAP are too restrictive and subsequently place members of the AI at a competitive disadvantage with accountants, real estate consultants, and non-affiliated state licensed and certified appraisers. Several users of appraisal services on Wall Street confirmed that appraisers cite USPAP as a reason why they were unable to perform non-traditional assignments.

The AI is to work to change the perception of appraisers, since USPAP may not be as restrictive as many perceive, and work to modify USPAP to recognize that the market may be effectively serviced by a broader role for appraisers.

FIRREA was passed in 1989 as a reaction to the Savings & Loans crisis and subsequent federal bailout that occurred in the late 1980's. The main effect on the appraisal community was the development of a state licensing and certification system based on minimal qualifications. The AI is to pursue public policy initiatives that refine the scope of FIRREA - for e.g. improving access o temporary practice and redefining “federally related transactions” to clarify when an appraisal is required.

Education, Training, and Admissions

Reform, Recovery and Enforcement Act (FIRREA) need to allow the members of the Appraisal Institute to provide the products and services the marketplace is looking for in an ethical and competent manner.

Because Wall Street often wants non-traditional appraisal products, such as a portfolio analysis, specific market analysis, and comparative studies, appraisers believe that they are forced to either find a way to perform the assignment within the scope of USPAP or refuse the work.

Commercial database

The Appraisal Institute is to pursue a viable commercial database strategy that leverages its members and maximises their ability to provide knowledge and experience.

As public capital continues to expand, evidenced by the growth of REIT's and the CMBS market, more information becomes available to the public. With such public equity and debt instruments, communications like SEC filings, equity issuances, annual reports, and investor road shows all put more information in the public domain. So while some are concerned that a commercial database would give away the appraisers' information, much of that information is already available. The AI believes that the professional who can add value to that information with specialised market knowledge, and organise and present it in a way that has value for a multitude of users, is the one who will succeed as relevant to the transaction.

Similar initiatives are already underway by many providers, including Wall Street firms themselves. The members of the AI have the best knowledge and can provide the human factor to property information.

The Center for Advanced Real Estate Analysis is an independent corporation affiliated with the Appraisal Institute designed to deliver education and training beyond current levels, an integral part of putting AI members in the position to meet the dynamic and ever-changing needs of Wall Street. The Center gives the Appraisal Institute the ability to deliver targeted Wall Street training for members and tailored programs for a wider audience.

primarily complements AI members existing valuation products and services. For example, a commercial database could tailor products specifically to the rating agencies for surveillance. Following the rating process, the agencies are involved in a surveillance function, whereby properties are periodically visited to ensure that an appropriate rating is attached to the bonds. In addition, there is a commercial property insurance component and loan servicer component that could find value in such a product.

Madison Avenue – A Public Relations Campaign

The AI is to embark on a campaign to promote the designations and the AI to Wall Street, policymakers and the general public, delivering the message to clients, consumers and policymakers that AI members can provide a variety of services to meet the needs of the market in an ethical and competent fashion.

International Perspective: The Globalisation of Capital

Wall Street is enthused with the potential volume of foreign sources of assets and capital. Foreign capital associated with real

On the equity side, a commercial database offers an opportunity to open the door. Because of the structure of REIT's, value conclusions are essentially determined by stock price. Stock price is often correlated to the potential for growth and the perceived strength of the REIT management team. Large institutional investors, and potentially REIT management teams, would find value in quality real estate information available on line.

On the debt side, a commercial database

estate needs a common standard. The same efficiencies, transparency and liquidity that US markets currently seek are the same characteristics that international investors will need. The AI is seeking to lead in the development of international standards.

MEETING OF MINDS FOR VALUATION AND WALL STREET CAPITAL MARKETS

Today's evolving commercial real estate market is changing the way Wall Street investors and real estate appraisers do business. In real estate, commercial mortgage securitization is rapidly replacing the traditional private equity. The first symposium to bring the valuation experts together with Wall Street financiers will be held on 5-6 October, 1999, in Naples, Fla.

Speakers at the 1999 Symposium "Valuation and the Evolution of the Real Estate Capital Markets", are: Anthony Downs, Ph.D., a senior fellow of the Brookings Institution; Michael Lewis, the author of Liar's Poker; Joe Franzetti, of Solomon Smith Barney and formerly of Duff & Phelps; Tom Wratten, the father of the Commercial Mortgage Backed Securities (CMBS) market; and Ken Patton, Ph.D., from New York University's Center for the Study of REITs. This seminal event is sponsored by the Appraisal Institute, the National Council Real Estate Investment Fiduciaries (NCREIF) and the Center for

Advanced Real Estate Analysis in cooperation with Commercial Real Estates Secondary Market and Securitization Association (CSSA) and American Real Estate Society (ARES).

"Participants will gain an understanding of a significant emerging market". Said Brian Glanville, MAI, current chair of the Center for Advanced Real Estate Analysis and 1999 vice president of the Appraisal Institute. "If you're valuing commercial real estate and want to move into secondary markets, here's your first opportunity to learn from the key players."

The dialog between real estate appraisers and top investors will focus on these key issues:

- ?? What type of commercial property analysis should the valuation profession provide from the investors' perspective?
- ?? What information is most valuable and in what form do investors want it reported?

?? What other roles can appraisers play in valuation beyond traditional appraisal services?

“The real estate profession isn’t just private equity anymore,” said Mary K. Ludgin, 1999 NCREIF president. “Real estate needs to be placed in a capital markets context.”

The Symposium aligns with the Appraisal Institute’s recent efforts to evaluate how appraisers can work most effectively with Wall Street investors. “We are developing

relationships with Wall Street to show our members how to diversity their business practices,” said Bert Thornton, MAI, 1999 president of the Appraisal Institute.

CSSA became involved with the Symposium because the organisation wants to share information with others involved in the industry about CMBS products. “Part of our mission is to foster the growth of the secondary market for commercial mortgages,” said Dottie Cunningham, executive director of the CSSA.

INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE - AN UPDATE

INVESTMENT PROPERTIES

The IASC has published proposals for changes to its rules on accounting for investment property with the publication of Exposure Draft E64, *Investment Property*.

E64 proposes that an enterprise should:

- ?? Measure all investment property at fair value; and
- ?? Recognise all changes in the fair value of investment property in the income statement.

Explaining the Exposure Draft, Sir Bryan Carsberg, Secretary-General of IASC, said:

“The accounting proposed by E64 is a significant change from our current rules in IAS 25, Accounting for Investments. E64 requires a single accounting treatment, unlike IAS 25, which permits a choice of several different accounting treatments. Our Board believes that the proposed accounting will give a clearer picture of

the activities and performance of enterprises that hold investment properties.”

IVSC issued its own press release following publication of E64.

‘INTERNATIONAL VALUERS ASSOCIATION ACHIEVES MAJOR BREAKTHROUGH’

Consistent global financial reporting standards in accounting and valuation moved a step closer with the publication of Draft International Accounting Standard, Investment Property, by the International Accounting Standards Committee (IASC).

The International Valuation Standards Committee (IVSC) was represented on the IASC Steering Committee by John Edge, UK representative to IVSC.

The Draft recommends that all investment property should be

measured at fair value. The IVSC has expressed concern previously at increasing evidence of confusion as to the relationship between the accounting term 'fair value' and the valuation term 'market value'. The guidance on the fair value of investment property included in the Draft reflects the market value guidance contained in International Valuation Standard 1.

The Draft recommends that an enterprise should be encouraged, but not required, to measure all investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional quality and who has recent experience in the location and category of the investment property being valued.

The Draft directs those who wish to comment to consider the International Valuation Standards of the IVSC and other material produced by the IVSC.

"The pressure now to measure to fair value/market value, rather than holding assets at cost, is very widespread, even in those economies where markets are relatively thin or untested," commented John Edge. "It is how the USA reacts, where fair value of assets in the balance sheet is not yet a requirement, that will be most interesting, especially in the context of the call for a common set of core accounting standards world-wide."

Philippe Malaquin, IVSC Chairman commented "It is an objective of IVSC that International Valuation Standards be recognised within international amounting standards. The release of this Exposure Draft by IASC

represents a major breakthrough for IVSC. It is evidence of the value that IASC attaches to the contribution that IVSC can make to effective financial reporting."

The Dow Jones News Service carried the following release on ED 64:

WARSAW (Nikkei) – "The IASC adopted a draft global accounting standard urging companies to assess real estate acquired for investment purposes at market prices in their balance sheets, the Nihon Keizai Shimbun reported.

The real estate affected would include land, buildings, parking lots and all other types of idle property, but not factories and other sites actually used for business activities.

The rule could have a dramatic impact on earnings if Japanese real-estate prices tumble. Japanese companies, still reeling from the artificially high property prices paid during the bubble economy, could be among the worst hit. Enforcement of the rules would finally expose the "negative legacy" of their bubble economy activities, according to quoted sources."

IASC PROPOSES FAIR VALUE ACCOUNTING FOR AGRICULTURE

IASC published in August an Exposure Draft of proposed standards of accounting for agricultural activity, a matter not covered in a prior International Accounting Standard. Agricultural activity is the management of the transformation of living animals and plants ('biological assets') into agricultural produce awaiting further processing, sale, or consumption or into additional biological assets. The

proposed effective date is financial years beginning on or after 1 January 2001.

Exposure Draft E65, Agriculture, proposes that:

- ?? All biological assets be measured at fair value;
- ?? All agricultural produce at the point of harvest be measured at its fair value;
- ?? The change in fair value of biological assets be reported in net profit or loss.

IASC Secretary-General, Sir Bryan Carsberg, explained that: “in the Board’s judgement, the change in fair value of biological assets is a more relevant indicator of the performance of an enterprise engaged in agricultural activities than is profit or loss measured on the traditional historical-cost basis, which recognises no profit until a sale takes place. In the case of livestock and timber that could involve many years. Reliable measures of the fair values of biological assets and agricultural produce at the point of harvest are available. Moreover, because of the allocations that would be required in an agricultural context, our Board concluded that cost-based measures are often of questionable reliability and usefulness.”

E65 does not deal with further processing of agricultural produce after harvest – processing grapes into wine, wool into yarn, ageing of cut tobacco or meat, and so on. Those are regarded as “manufacturing” activities to which accounting standards for inventories would apply.

The IASC proposal would not establish any special accounting standards for agricultural land. Rather, it would require

that IAS 16, Property, Plant and Equipment, be followed.

IAS 16 allows agricultural land to be carried at (a) cost subject to a write-down for impairment and (b) fair value. The Exposure Draft proposes, further, that biological assets that are physically attached to agricultural land (for example, crops and trees) be recognised and measured at fair value separately from the land. The Draft asks: Do you believe that:

- (a) IAS 16 should apply to agricultural land;
- (b) all agricultural land should be measured at fair value, either separately or as part of a combined group that includes the land and related bearer biological assets;
- (c) only agricultural land that is part of a combined group that includes the land and related bearer biological assets should be measured at fair value;
- (d) enterprises should be permitted or encouraged to measure agricultural land at fair value, but not required; or
- (e) all agricultural land should always be carried at cost, that is, the revaluation alternative of IAS 16 should be prohibited?

The deadline for comments on the Exposure Draft is 31 January 2000.

REPORTING OF FINANCIAL PERFORMANCE

IASC has issued a discussion paper that invites comments on certain proposals for Reporting Financial Performance that were developed by the G4+1 Group of

Accounting Standards Setters. G4+1 comprises representatives of national standard setting bodies from Australia, Canada, New Zealand, the UK and the US, together with IASC.

The main G4+1 proposals are:

- ?? financial performance should be presented in one financial statement rather than two or more statements;
- ?? the single statement of financial performance should be divided into three components:
 - (a) the results of operating (or trading) activities;
 - (b) the results of financing and other treasury activities; and
 - (c) other gains and losses.
- ?? Recycling should not generally be permitted (recycling is reporting the same item of income, expense, gain, or loss in two different periods in two different types of performance measures, for example, first in “other gains and losses” and subsequently in the results of operating activities);
- ?? The category of extraordinary items should be abolished, and abnormal or exceptional items should not be reported as a separate category of revenue or expenses;
- ?? Results of continuing and discontinued operations should be segregated.

Sir Bryan Carsberg, Secretary-General of IASC, said: “Traditionally, the income statement has been the main vehicle a company uses to report its financial performance for a period. However, today some gains and losses are reported directly in equity outside the income statement – for example, revaluations of land and buildings. In our current projects on investment properties and agriculture,

our Board is wrestling with the question of how best to report changes in values of real estate held for investment and agricultural assets.”

Sir Bryan continued: “The challenge is to bring greater consistency to reporting practice without destroying the usefulness of existing practice.”

Practice varies among the G4+1 member standard-setters. All of them are publishing the same proposals for comment.

To obtain IASC publications, please contact Publications Dept, International Accounting Standards Committee, 166 Fleet Street, London EC4A 2DY, UK. Tel: +44 (171) 427-5927, Fax: +44 (171) 353-0562, <http://www.iasc.co.uk>

GROWING INFLUENCE OF IAS

International accounting standards are growing in influence, with important repercussions for both national and international valuation standards.

Russia – the Russian Ministry of Finance has announced the introduction of IAS for the first quarter of 2000.

US – Over 87% of US fund managers in a recent survey believe there should be an immediate and concerted move to develop IAS and that the IASC is the appropriate body to develop a global accounting system. The firms surveyed represent over \$1.7 trillion of assets.

UK – a government group reviewing company law has issued a consultation document asking whether UK companies should, like their French, German and Italian counterparts, have the right to use IAS for consolidated accounts rather than UK principles.

Romania - Regulations adopted in June require companies to follow IAS in the absence of national accounting standards

and begin a programme to develop national standards based on IAS.

Europe - The European Commission has drawn back from making the use of IAS mandatory for all European listed financial statements. It is likely to down the less contentious route of allowing listed companies the option of using IASs rather than accounting directives incorporated into local law. Some see this as an interim measure, being the only politically acceptable route at the moment.

BASEL COMMITTEE ON BANKING SUPERVISION

Consultative Paper on a New Capital Adequacy Framework

The Basel Committee recently issued a proposal for a new capital adequacy framework to replace the previous Capital Accord issued in 1988. The proposals are designed to align capital requirements more closely with a bank's risk profile and to address financial innovations, such as asset securitization, whilst at least maintaining the current level of capital in the system.

Claes Norgren, Director General at Finansinsektionen, Sweden, and Chairman of the Task Force on the Future of Capital Regulation, said, "The 1988 Accord has been a cornerstone of the current international financial architecture. It has helped to strengthen the soundness and stability of the international banking system and enhanced competitive equality among internationally-active banks." Mr Norgren

added, "that the financial marketplace has developed dramatically during the past ten years, to the point where the Accord's capital ratio is sometimes not a good indicator of a bank's financial condition. The world financial system has also recently witnessed considerable economic turbulence. The new framework is designed to better align regulatory capital requirements to underlying risks, and to recognise the improvements in risk measurement and control."

The Basle Capital Accord prescribes how much capital internationally active banks must set aside against their loans. Under the Accord, a number of asset classes are given different weights based on their perceived credit risk. Broadly, the risk weighting is as follows: zero weight to government securities; 50% weight to residential real estate loans; 100% weight to most other loans including commercial real estate loans.

Proposed revisions to the Accord were held up by a wrangle between Germany and America (with the support of other countries).

The two areas of conflict were:

(i) The treatment of commercial property lending. Germany wants its banks to continue to put aside against commercial mortgages an amount of capital that most other regulators think inappropriately meagre - 4% capital as against the full 8% that other regulators require. That is, Germany applies a 50% not 100% risk weighting to commercial mortgages. German regulators remain convinced that, historically, such lending has been relatively risk free in their country.

(ii) The second conflict was over bonds issued by Germany's mortgage banks, known as Pfandbriefe. German lending for real estate is predominantly funded through the Pfandbriefe, which is regulated by the Mortgage Banking Law. It is backed by mortgage loans of no more than 60% loan-to-value ratio with property value 'conservatively appraised' using a prudential banking concept of sustainable long-term value. Germany insists that banks which buy Pfandbriefe bonds should continue to set aside only a minimal amount of capital. This gives Germany's mortgage banks a huge funding advantage. The UK journal 'Estates Gazette', 28 August 1999, carried a report on commercial mortgage-backed securities. "Many investment bankers, doubt whether they can make enough money from securitising property debt" the report claimed and continued "one of the problems is that they have to compete with the German mortgage banks which dominate the UK lending market and offer aggressive rates".

The new framework rests on three pillars: minimum capital requirements, supervisory review of a bank's capital adequacy, and market discipline. The revised minimum capital requirements, as the centrepiece of the new framework, build on the existing "standard approach," but would increase the number of risk buckets and allow the selective use of external credit assessments and banks' internal ratings.

The main issues of relevance to the IVSC are:

Minimum capital requirements

The Committee proposes that lending fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented should continue to be weighted at 50%.

In view of the experience in numerous countries that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades, the Committee holds to the view that mortgages on commercial real estate do not, in principle, justify other than a 100% weighting of the loans secured. The appropriate capital treatment of various types of assets, including those secured by commercial real estate, will continue to be reviewed by the Committee during the consultative periods and after the Committee has received comments.

Risk assessment

A new risk weighting scheme to address asset securitisation is proposed. The Committee recognises that asset securitisation can serve as an efficient way

to redistribute credit risks of a bank to other banks or non-bank investors. In this respect, securitisation is providing better risk diversification and is enhancing financial stability. Nevertheless, the Committee has become increasingly concerned with some banks' use of structured financing or asset securitisation to avoid maintaining capital commensurate with their risk exposures. Furthermore, the current Accord lacks consistency in that the same economic risk may result in substantially different capital requirements depending on the type of transactions that a bank employs. Thus, through such techniques, a bank may be able to achieve an overall risk-based capital ratio that is nominally high but which may obfuscate capital weakness in relation to the actual economic risks inherent in the bank's portfolio. To address these concerns, the Committee is now proposing a revision to the Accord that makes use of ratings by eligible external credit assessment institutions for setting capital charges for asset securitisations.

Accounting and valuation practices

With respect to both regulatory capital and measures of risk exposure, the Committee stresses the importance of sound accounting and valuation principles that produce realistic and prudent measures of assets and liabilities and related profits and losses in the determination of capital reserves. Weak or inadequate accounting policies undermine the usefulness of capital requirements by causing overstated or unreliable capital ratios.

The Committee recommends that a bank should disclose information in its accounting policies, including policies for valuation of assets. This information is

crucial to enable financial statement users to assess and compare the quality of an institution's capital.

Credit Risk in Banking Activities

The Basel Committee issued in July three other papers providing guidance to banks and banking supervisors on various aspects of credit risk in banking activities. These papers form part of an ongoing effort by the Committee to strengthen procedures for risk management in banks

Sound Practices for Loan Accounting and Disclosure

The paper – Sound Practices for Loan Accounting and Disclosure - addresses a range of issues facing banks and bank supervisors in the accounting for loans and loan losses. "Sound and prudent loan accounting practices are critical not only to adequate management and control of credit risks in banks. Sound practices are also important to ensure accurate and transparent financial reporting and prudent calculation of bank capital," noted Prof. Dr Arnold Schilder, Executive Director of the Netherlands Bank and Chairman of the Basel Committee's Task Force on Accounting Issues, the group in charge of developing the guidance.

This paper is a revised version of a consultative paper issued in October 1998, on which the IVSC commented.

A key paragraph for valuers is paragraph 45 which states:

"Management should establish a programme to periodically monitor and analyse collateral, which should be valued

on a prudent basis. For example, for significant commercial real estate loans, banks should obtain sound appraisals of the current fair value of the collateral from a qualified professional either internal or external to the bank. Management should review each appraisal's assumptions and conclusions to ensure timeliness and reasonableness. Typically, appraisal assumptions are based on the current performance of the collateral or similar properties. Many supervisors also expect appraisals to take into account, on a discounted basis, the ability of the real estate to generate income over time based on reasonable and supportable assumptions."

Management of Credit Risk

The consultative paper - Principles for the Management of Credit Risk - encourages banking supervisors globally to promote sound practices for managing credit risk. The paper emphasizes that banks must manage the credit risk in all their activities, both in the banking book and in the trading book, and on and off the balance sheet.

Mr Roger Cole, Associate Director at the Board of Governors of the Federal Reserve System and Co-chair of the Committee's Risk Management Group, noted that "exposure to credit risk continues to be the leading source of problems in banks in both the G10 and non-G10 countries. Recent events demonstrate the importance of sound credit infrastructures at banks to the stability of global financial systems. The practices set out in this document should be applied in conjunction with the other sound practice papers being issued today."

Among the recommendations and statements in the paper are the following:

?? Banks must develop a clear understanding of the credit risks involved in more complex credit-granting activities (for example, loans to certain industry sectors, asset securitisation)

?? Banks should have policies covering the acceptability of various forms of collateral, procedures for the ongoing valuation of collateral, and a process to ensure that collateral is, and continues to be, enforceable and realisable.

?? Credit concentration problems – Concentrations arise because banks identify hot and rapidly growing industries and use overly optimistic assumption about an industry's future prospects, especially asset appreciation. Banks seem most susceptible to overlooking the dangers in such situations when they are focused on asset growth or market share.

?? A common and very important problem among troubled banks in the early 1990s was their failure to monitor borrowers or collateral values. Many banks neglected to obtain periodic financial information from borrowers of real estate appraisals in order to evaluate the quality of loans on their books and the adequacy of collateral. As a result, many banks failed to recognise early signs that asset quality was deteriorating and missed opportunities to work with borrowers to stem their financial deterioration and to protect

the bank's position. This lack of monitoring led to a costly process by senior management to determine the dimension and severity of the problem loans and resulted in large losses.

?? Many banks' credit activities involve lending against real collateral. In lending against real assets, many banks have field to make an adequate assessment of the correlation between the financial condition of the borrower and the price changes and liquidity of the market for the collateral assets.

?? A related problem is that many banks do not take sufficient account of business cycle effects in lending. Industries such as commercial real estate often experience strong cyclical effects. Effective stress testing which takes account of business cycle effects is one approach to incorporating into credit decisions a fuller understanding of a borrowers credit risk.

Credit Risk Disclosure

The consultative paper -Best Practices for Credit Risk Disclosure - identifies the types of credit risk information market participants and supervisors need in order to make a meaningful assessment of a bank, and encourages banks in all countries to provide such information to the public. "Informed investors, counterparties, and other market participants are an important element in a stable, healthy banking environment," said Ms Susan Kruse, Senior Deputy Comptroller for International Affairs at the Office of the Comptroller of the Currency of the United States and Chair of the Basel Committee's Transparency group, which developed the paper.

Again, key recommendations and statements of interest to the IVSC are:

?? It is important that banks use comparable terminology, e.g. for impaired, non-performing and past-due assets

?? A bank should disclose information about the accounting policies, practices and methods it uses to account for its credit risk exposures covering, inter alia, the basis of measurement for assets at initial recognition and subsequent periods, e.g. fair value or historical cost

?? A bank should disclose quantitative and qualitative information about its securitisation activities

?? A bank should disclose total credit exposure by major asset category showing impaired and past due amounts relating to each category.

The IVSC has initiated a dialogue with the Basel Committee on a number of issues – greater consistency and understanding of terms as they relate to valuation for mortgage lending; and developing guidance in new and emerging areas, particularly risk assessment on both individual transactions, but perhaps more with property lending where it is the subject of securitisation.

The IVSC Management Board would be interested to hear from valuers with a particular expertise in these areas who would be interested in helping develop an IVSC response.

Note: The Basel Committee on Banking Supervision is a Committee of banking supervisory

authorities established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United

States. Its current chairman is William J. McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York. The Committee usually meets at the Bank for International Settlements (BIS) Basel, where its permanent Secretariat is located.

PUBLIC SECTOR FINANCIAL REPORTING

Governments often prepare financial information for three purposes: the compilation of general governmental financial statements; national accounts as per the United Nations System of National Accounts (SNA); and Government Finance Statistics (GFS) using the framework developed by the International Monetary Fund (IMF).

Ideally, government reporting entities would be able to establish financial information systems which can be used to compile all three sets of information and minimize duplication of information and time spent making adjustments to data. However, the extent to which this is possible may be constrained by the basis of accounting used for financial reporting purposes. Governments may use cash, modified cash, modified accrual or accrual accounting when preparing financial reports. The SNA is an accrual-based system. GFS is currently cash-based but is being revised to be accrual based.

Historically, accounting for governments and government agencies has been on a cash basis. It was not until the early 1980s that it was considered appropriate for government business enterprises to move closer to commercial accounting principles practised in the private sector either on a full accrual or a modified accrual basis. Since then the pace of change in government has accelerated, with governments being asked to do more with less and to be fully accountable to the community for resources entrusted to them. This pressure has encouraged an increasing number of government to consider adopting accrual accounting. At

this stage, only New Zealand and Iceland actually conduct fiscal policy on an accrual basis. A number of countries, including the US and UK, are either introducing an accrual framework, or examining the possibility. Australia is in the final stages of a phased shift from cash to full accrual budgeting. The 1999-2000 Budget will complete the transition.

Public Sector Committee (PSC) of the International Federation of Accountants

Moves to harmonise reporting for the private sector are being mirrored by moves to harmonise public sector financial reporting across jurisdictions and to improve comparability of information both within and between jurisdictions and, where appropriate, between the public and private sectors.

In 1996, the PSC initiated a multi-year project to develop recommended accounting standards and guidelines for the public sector worldwide. The project, entitled the "Standards Project" is a central element of the PSC's strategy aimed at contributing to better decision making, financial management and accountability by governments. The Standards project is to be completed in two separate projects. The first involved the development of a guideline, to provide descriptive guidance on the application of the four bases of accounting. The second project will develop a core set of recommended accounting standards for governments. The development of these accounting standards will be based on existing International Accounting Standards (IASs) in an effort to determine

the application of IASs to public sector accounting.

The PSC is proposing a change in approach to the development of International Public Sector Accounting Standards (IPSASs). The Development of International Public Sector Accounting Standards: Which Basis of Accounting? was released for comment in June 1999. Specifically, the PSC is proposing to:

- ?? develop standards for the cash basis and accrual basis of accounting only
- ?? publish Standards separately for each of the cash and accrual bases, in the form of a single, comprehensive Standard for the cash basis and a series of Standards for the accrual basis
- ?? develop guidance to assist entities in making the transition from cash accounting to accrual accounting, recognising that there will be a variety of different transition paths, depending on the circumstances of each individual jurisdiction
- ?? introduce transitional provision into its individual accrual Standards, as a means of providing entities with time to fully implement the Standards. The transitional provisions would address areas likely to cause difficulties for public sector entities, such as property, plant and equipment, provisions and contingencies and pension liabilities.

The IVSC has provided commentary to the PSC to assist in the drafting of Exposure Draft International Public Sector Accounting Standard, *Property, Plant and Equipment*, due to be released early next year.

Government Finance System

The IMF is currently revising the Manual on Government Finance Statistics. The new version will be closely aligned with the 'System of National Accounts (SNA)' which sets out the guidelines for national economic accounting in general. The Manual will be, in effect, an adaptation of the general government sector of the SNA for the purpose of providing general government statistics for fiscal and general economic analysis. The revised Manual will follow the SNA in adopting accrual accounting and the compilation of full balance sheets with fixed assets, as well as all other assets and liabilities, valued at current market prices.

Chapter 7, which is concerned with transactions in fixed assets, and Chapter 10, which is concerned with balance sheets, are still in preparation. Even when completed, however, they will be more statements of general principles than detailed guidance. The IMF has expressed interest in working with the IVSC in the production of a 'Compilation Guide' which is intended to provide more practical guidance for compilers of government financial statistics on the valuation of fixed assets.

The IVSC Management Board would be interested to hear from valuers with experience in the adoption of accrual based reporting by the public sector who could participate in the debate.

THE CASE FOR INTERNATIONAL ACCOUNTING STANDARDS IN CANADA

For member institutes currently debating the relationship between national and international standards, the following publication may be of interest. The document was published by the Certified General Accountants Association of Canada – CGA.

There has been a debate for some time in Canada as to whether to move away from “Made in Canada” accounting standards. No consensus has arisen, however, as to which standards should be adopted in place of Canadian generally accepted accounting principles.

The publication ‘The Case for International Accounting Standards in Canada’ was written by Alan Richardson and Ian Hutchinson. Based on the conclusions in the report, the CGA adopted a policy statement supporting the adoption of IAS for financial reporting by profit entities in Canada.

This is not completely at harmony with the position taken by the Canadian Institute of Chartered Accountants. The CICA recommends the harmonization of Canadian accounting standards with FASB standards, but that Canadian standard setters maintain a continuing presence within the International Federation of Accountants and the International Accounting Standards Committee.

In arriving at its conclusion, the CGA paid attention, inter alia, to the following which is reproduced from the report:

Quality of standards

The standards promulgated by the US Financial Accounting Standards Board (FASB) and International Accounting Standards Committee (IASC) are broadly similar and converging. The two main conceptual differences between them are that (1) FASB has emphasized setting standards for measurement while the IASC has been mostly concerned with disclosure (and hence allowing alternative measurement systems) and (2) the IASC retained the requirement that financial statements be “true and fair” rather than simply in accordance with generally accepted accounting principles (GAAP) as in the United States. US standards are more prescriptive and rule-orientated than IAS, reflecting the relatively more litigious environment surrounding financial information in the US. The more descriptive IAS provide greater room for the application of professional judgement. Both the “true and fair” override and the use of dual standards (benchmarks and alternatives) are examples of the flexibility inherent in IASC standards. Curiously though, as IASC shifts to more prescriptive standards, a shift in the conceptual foundation underlying US standards is emerging as well. The upshot of that conceptual shift is that, although historical costs remains as the primary accounting convention in the US, more and more FASB standards have come to embrace the “fair value” approach currently favored by the IASC. In summary, IAS standards have begun to embody a scale

of prescription approaching that found in existing US standards, and US standards are moving toward the “fair value” convention that underlies many IAS.

Size of the Community

Canada is economically dependent on the US for trade and capital, which suggests the appropriateness of FASB standards for Canada, IAS, however, are more widely adopted around the globe as national standards and FASB recognizes that the “made-in-America” label limits the acceptability of their standards (the assumption FASB seems to make is that their standards are technically superior but politically unacceptable). That conclusion has led the SEC and FASB to work with the IASC to attempt to restructure the IASC along US lines and to work co-operatively to harmonize FASB and IASC standards.

It is apparent that IAS have been adopted more widely by stock exchanges and in national filing requirements. It is notable that only 10 countries have accepted financial statements based on FASB standards for filings from foreign

companies and of these, eight also allow IAS based statements.

There are reports that US stock exchanges are concerned that they are losing listings to foreign exchanges because of the costs of compliance with FASB standards. US exchanges have relatively few international companies listed. The New York Stock Exchange the standards of choice. Canada thus faces a dilemma in its choice of a standard-setting regime between the immediate community of its dominant economic partner and the long-run community of global trading partners.

The CGA is concerned that what might be gained in supporting the near-term position taken by the CICA would be more than offset by the losses sustained by not immediately adopting a longer-run approach to the standard-setting process. It concludes that in the long run IASC will become the global standard setter and that Canadian standard setters might be better served by further consolidating their role in IASC and IFAC by immediately committing to IASC standards and avoiding any endorsement of FASB standards.