IVSC: COMMENTS ON THE EXPOSURE DRAFT OF TIP 1
The DCF Method – Real Property and Business Valuations

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26 April 2011

This personal response to the exposure draft is in three parts, being:

A - Responses to the six questions
B - Comments on the wording of the draft TIP
C - Additional considerations

A: Question responses

1. Yes, the DCF method can be used to assess market value. The wording of the introduction to question 1 is acceptable.

2. Yes, the **underlying DCF method,** that is the discounting of cash flows, is the same for real property and businesses. It may be helpful to be careful with the use of the three terms "approaches", "methods" and "techniques", which are hierarchical. In my opinion "methodology" is correct here as the method does not change, but the models or techniques employed will differ.

3. The TIP correctly states that the discount rate used when assessing **market value** should be market derived and that the discount rate to assess **investment value** may be influenced by the requirements of the investor. Consequently, I think it is incorrect to state that the discount rate is "based on the risks associated with the cash flows" for **investment value**. Also this is referenced in para 11 not in para 10. I would suggest that the first (generic) sentence of para 11 state: "The discount rate should take account of the risk associated with the cash flows."

4. The TIP refers to the calculation of the terminal value (para 17). It is noted that para 17 discusses first the calculation of the terminal value for business valuations and only provides generic guidance on the terminal value calculation for real property in the final sentence. The positioning of this paragraph is unfortunate as it appears as an extension of the business subheading and the emphasis on the terminal value for business valuations is unbalanced.
   I do not agree that, in Australia and New Zealand, the most commonly adopted terminal value calculation is the constant growth model. To assist areas of the world where the constant growth model may mean many things (such as increasing a property cost at a constant growth factor), I think that the constant growth statement should not be used unless it is further clarified.
   I suggest that the initial two sentences of para 17 are correct. Thereafter the explanation could be expanded by saying that, "for the determination

of market value of property investment assets, the estimation of the terminal value should be appropriate for the particular investment property market", and continue (from para 17) "the terminal value can be based on the capitalisation of the anticipated net income for the year following the last year of the cash flow period". The additional clauses on "appropriate rate" and "void periods" could be included or excluded. This would comply with market practice in Australia.

5. I consider that this is a complex question and that the statement part and question part could be answered in many ways. Three refinements/considerations of the model are mentioned – inflation, specific investor financing and investor taxation.
   No, I suggest that you cannot make an overriding statement that the valuation report should be the same when explicitly or implicitly considering individual financing or taxation. There is varying risk related to different individuals' financing and taxation. I also do not recommend that you make an overriding statement about equivalency of growth implicit or explicit models, although the generic statement for forecast inflation is correct, because of the confusion with finance and tax arrangements and that the marketplace is currently not sufficiently sophisticated on evaluate these elements in their selection of the discount rate.

6. While it is true that it is unwise to be too specific, I believe there is merit in providing guidance on elements of the cash flow model and related techniques.
   For instance, reference has been made, correctly, to the need to use effective rates. There should be comment on other important inputs and techniques within the studies. Common errors, through lack of understanding, include the positioning of actual cash flow items within the time intervals and whether or not to discount the initial period – this is a crucial variable decision, i.e. the beginning or end period?
   This is a draft TIP, not a standard, and I feel more guidance should be provided for information/instruction purposes. There appears to be more detail on the valuation of businesses than on the valuation of real property, and this is unbalanced. Refer to the additional considerations below.

B: Wording of Draft TIP

Para 6, line 3 – could replace method with "methodology"**.** Rationale – refer to Q1
Para 7, first bullet point – suggest add "net" before income on both lines. Rationale – refers to all income, costs and expenditure.
Para 10, line 3 – add "greater" before vigilance. Rationale – always need vigilance for assumptions.
Para 11, line 6 – replace "an investor" with "a probable purchaser". Rationale – purchaser is broader than investor.

Para 16, subsection b) – the final sentence is too broad in stating that all net income is discounted. Income and expenses in the initial period should not be discounted. Suggest the statement needs qualification.
Para 16, subsection d) – I suggest that the wording of the second sentence could be more specific. Recommend - "Inflows and outflows should be placed in the appropriate time intervals and reasonably supported".
Para 16, subsection e) – recommend that the third sentence starting "Expenses . . ." be deleted. I find this concept confusing; this is a cash flow so why accrue expenses when all other items are on a cash basis?
Para 19, line 2 – typo – remove "will".
Para 22, lines 2 and 10 – typos "1" and "is"
Para 24, line 2 – typo – add "it" before "is".
Para 24, sixth bullet point – commentary on the discount rate is repetitive (see second last bullet point), delete sixth bullet point.

C: Other Considerations

As mentioned above, I believe that the draft TIP would benefit from expansion in certain areas, especially the key assumptions and techniques within a DCF.

In particular I would recommend further commentary on:

1. No discounting of the initial period (interval) of the cash flow – this is the present time.
2. The placement of income or expenses in the appropriate time periods. This means that income and expenses will be included in the initial period if received or paid in that time interval.
3. The appropriate positioning of the terminal value figure in the correct time interval, depending on date of assumed sale.
4. More explicit proposals on the calculation of the terminal value when assessing the market value of real property – eg could provide some guidance on the determination of the terminal capitalisation rate.
5. Further encouragement to undertake risk analysis on the key input variables of the DCF and specify a range of probable values.

Finally, may I add that I think that the comprehensive list of disclosure items, mentioned in para 24, is highly commendable.

TPB