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Our Ref: RMS11/01937

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Dear Mr Rélolle

EXPOSURE DRAFT TECHNICAL INFORMATION PAPER 1: THE DISCOUNTED CASH FLOW METHOD – REAL PROPERTY AND BUSINESS VALUATIONS

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to provide comments to the International Valuation Professional Board (IVPB) Exposure Draft Technical Information Paper 1: The Discounted Cash Flow Method – Real Property and Business Valuations (‘the ED’).

HoTARAC is an intergovernmental committee that advises Australian Heads of Treasuries on accounting and reporting issues. The Committee is comprised of the senior accounting policy representatives from all Australian States, Territories and the Australian Government.

International Valuation Standards are adopted as national standards in Australia.

HoTARAC is providing comments in its capacity as a preparer of financial statements, rather than as a valuer.

HoTARAC strongly supports the development by the IVPB of guidance regarding the application of the Discounted Cash Flow (DCF) Method. The project potentially provides useful information to both valuers and accountants.
HoTARAC acknowledges that valuations are undertaken for many purposes, and that financial reporting is just one of those purposes. However, HoTARAC is concerned that attempting to develop generic guidance for differing purposes could potentially lead to 'rules' rather than principle based guidance and give rise to greater potential for confusion and inconsistencies.

Consistent with previous HoTARAC comments on the ED Proposed New International Valuation Standards, HoTARAC believes that any IVPB guidance should clearly acknowledge the respective authority of Accounting Standards and cross reference the relevant requirements. In this regard, HoTARAC notes that the IVPB has omitted the subsection on the ‘relationship with Accounting Standards’ from the current Guidance Note 9. HoTARAC does not support this change of approach.

In contrast, HoTARAC recommends that it is important to reconcile any valuation guidance to relevant Accounting Standards and to make transparent any differences, where they exist, including clarifying where there are restrictions on valuers imposed by Accounting Standards.

In particular, the following issues need to be considered from a financial reporting perspective:

- Paragraph 16(e) refers to "Expenses may be placed at the accounting point in time rather than the point of time at which they are incurred". From an accounting professional's point of view, the imprecise use of accounting terminology creates uncertainty when accounting professionals liaise with valuation professionals. HoTARAC is of the opinion it is preferable for the IVPB to clearly define the terms in use to avoid confusion.
- HoTARAC specifically draws the attention of the IVPB to an inference in Paragraph 16(j). The Technical Information Paper assertion that pension deficits are contingent liabilities does not align with the International Financial Reporting Standards (IFRSs), as they qualify for balance sheet recognition.

HoTARAC also makes the following general comments:

- HoTARAC notes that businesses are inherently more risky than real property and this may impact the equal application of the DCF method. This is particularly pertinent where risk is elevated for businesses in the start-up phase where cash flows may be negative. Consequently, HoTARAC believes caution should be exercised in making the statement of paragraph 3 of the ED “DCF method may be more applicable than other methods if the asset or business is experiencing significant growth, has yet to reach a mature level of operations”. HoTARAC considers the DCF methodology could be equally or more validly applied to businesses with stable or predictably growing/declining income where comparable company data is not readily available, such as government controlled businesses.
- The ED states (paragraph 16j) that the DCF should be adjusted for contingent liabilities not reflected on the balance sheet. HoTARAC recommends the ED also discuss the treatment of contingent assets. A majority of HoTARAC
members view the omission of contingent assets as overly conservative. A minority of HoTARAC members opposes the inclusion of contingent assets.

In relation to the specific matters for comment in the consultation paper, and certain other matters, Attachment A sets out HoTARAC’s views. HoTARAC has also provided additional commentary on the application of valuation techniques to the specific requirements of relevant Accounting Standards in Attachment B.

If you have any queries regarding HoTARAC’s comments, please contact Peter Gibson from the Australian Department of Finance and Deregulation on 612 6215 3551.

Yours sincerely

[Signature]

Grant Hehir
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE
25 April 2011
1 Do you agree that the DCF method, if properly applied, can be used as a method to arrive at market value?

HoTARAC recognises that the DCF method, when consistently applied, is a robust methodology for arriving at market value. It may be worth considering a cross reference to the Depreciated Replacement Cost TIP to reinforce the applicability of DCF for specialised assets.

2 Do you agree that the underlying DCF method described in this paper applies equally to the valuation of real property and businesses? If not, please explain the differences that you believe exist?

HoTARAC notes that businesses are inherently more risky than real property and this may impact the equal application of the DCF method. This is particularly pertinent where risk is elevated for businesses in the start-up phase where cash flows may be negative.

3 Do you agree, or do you consider that other matters should be taken into account in determining the appropriate discount rate?

HoTARAC notes differing types of risk, including expectations about the possible variations in the amount, timing of cash flows, and, the price for bearing such uncertainty (risk premium) impacts on the valuation result. HoTARAC recommends that IVBP includes an acknowledgement of alternative ways of incorporating risk in the DCF method; that is how risks are incorporated in the discount rate or in the cash flows (or combined) in both.

HoTARAC has provided additional commentary on the incorporation of risk in valuations provided for Accounting Standards in Attachment B.

4 Do you agree that the most commonly adopted terminal value calculation at the end of the explicit forecast period is the ‘constant growth’ model, cross-checked for sensibility to an implied capitalisation rate or exit multiple? If not please identify what other method you most commonly use?

HoTARAC notes that a constant growth model, cross-checked for sensibility, appears reasonable.

5 Do you agree that providing a discount rate is used that is consistent with the financial assumptions made in calculating the cash flows that the choice of using explicit or implicit financial assumptions in the cash flows should not affect the valuation result?

HoTARAC offers no comment on the resultant valuation result. However, the documentation of assumptions per Paragraph 23 for each valuation is a sensible requirement.
6 Do you agree that more detailed discussion and examples of the valuation inputs into a discounted cash flow model are inappropriate? If not how much additional information do you think should be included in best practice guidance?

HoTARAC is concerned that inclusion of guidance could potentially result in 'rules based', rather than 'principles based' application of the technique contained in the guidance paper. Therefore, HoTARAC recommends caution in the addition of guidance material.
Attachment B - HoTARAC ADDITIONAL COMMENTARY ON THE APPLICATION OF THE DCF METHOD TO VALUATIONS PROVIDED UNDER ACCOUNTING STANDARDS

HoTARAC recommends the following issues specific to requirements under Accounting Standards be considered when providing DCF valuations from a financial reporting perspective:

- Clarifying how and when contingent assets and liabilities are used in the valuation process. For example, IFRS 3 Business Combinations requires an acquirer to recognise contingent liabilities where the fair value can be reliably measured. International Accounting Standard (IAS) 37 Provisions, Contingent Liabilities and Contingent Assets applies different probability thresholds to the recognition of contingent assets.
- Distinguishing the use of DCF as ‘fair value’ valuation under IAS 16 Property, Plant and Equipment compared to a ‘value in use’ valuation under IAS 36 Impairment of Assets.
- Clarifying the discount rate required to be used under Accounting Standards; for example IAS 36, paragraph 55 requires the use of a pre-tax rate based on the time value of money and risks specific to the asset for which future cash flows have not been adjusted.
- Acknowledging alternative ways of incorporating risk in the DCF method; that is how risks are incorporated in the discount rate or in the cash flows or combined) in both (refer to the use of expected cash flows in Appendix A of IAS 36
- Identifying different types of risk; expectations about the possible variations in the amount and timing of cash flows; and the price for bearing such uncertainty (risk premium) (refer paragraph A1 of IAS 36)

N.B. HoTARAC notes that the alternative methods of incorporating risk and identification of different types of risk raised in the last two dot points are being considered for application to the estimation of fair value by IFRS in drafts of IFRS 13 Fair Value Measurement.