Fair Value Pro Pty Ltd
ABN 151 019 304

International Head Office
P +61 (0) 7 3221 3499
F +61 (0) 7 3221 8409
A Level 18, 344 Queen St
Brisbane QLD 4000, Australia
E Info@fairvaluepro.com
www.fairvaluepro.com.au

UK Office
P +44 (0) 20 7692 1845
F +44 (0) 20 7692 1846
A 78 York Street
London, W1H 1DP
www.fairvaluepro.co.uk

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IVSC
41 Morgate
LONDON EC2R 6PP
United Kingdom

Responses to IVSC Exposure Draft “Valuation of Specialised Public Service Assets”

The IVSC should be commended for their long standing commitment to providing guidance and consistency to the difficult and complex task of undertaking valuations. The proposed TIP will provide benefits to valuers involved with the valuation of specialised public service assets.

While generally in support of the TIP and its objectives I have however made a number of comments which I hope may lead to enhancements to the TIP. I have an extensive background both from a valuation as well as an audit perspective in relation to the valuation of these specialised assets. These comments have been grouped into the following areas -

- General Comments
- Specific Comments
- Responses to Questions

GENERAL COMMENTS

Context of purpose of valuation

While the TIP (paragraph 13) notes that valuations may be done for different purposes it does not clearly make the point that

- Valuations need to be done taking into account the context and purpose of the valuation as well as complying with any over-riding prescribed requirements
- Valuation undertaken for different purposes may result in different values. For example the insurance value will be different to the financial reporting value.

The TIP does not state how the methods proposed relate to the different valuation contexts. It would appear the TIP relates to a general valuation premise. However given that the majority of valuations for these types of assets are undertaken for financial reporting purposes I would suggest that greater focus needs to be given to the existing requirements as set out under the existing IFRS or IPSASB standards.

The TIP needs to clearly articulate the context for the valuation and recommended approaches for each different context. I would suggest suitable wording be included in paragraph 6 highlighting that financial statement valuations need to be undertaken in accordance with the appropriate accounting standard (IFRS or IPSASB) or other prescribed requirement and where there is inconsistency between the TIP and the prescribed requirements the prescribed requirements take precedence.

Lack of acknowledgement or reference to IFRS standards (Fair Value)

The Exposure Draft makes reference to the IPSAS and the proposed changes currently foreshadowed in the IPSASB Exposure Draft. However it fails to acknowledge that most public sector jurisdictions that already value these assets do so under the IFRS (or localised version of the IFRS) accounting standards at Fair Value rather than the IPSAS standards.

The proposed IPSASB approach to valuation is the Deprival Method which will result in significant variation to valuations under the IFRS (Fair Value). While some jurisdiction may adopt the proposed IPSASB approach (Deprival Value) many jurisdictions are already committed to IFRS (Fair Value) and are unlikely to change.

As the financial reporting valuations are undertaken in accordance with the relevant accounting standards the TIP needs to acknowledge that the accounting standards (either IFRS or IPSAS) take precedence over any guidance provided by the IVSC and that different approaches will be required depending which accounting standard is prescribed by legislation.

The TIP should also cover the requirements (including definitions) of the IFRS as the current TIP is inconsistent with the IFRS and existing IPSASB standards.

TIP terminology is not consistent with the accounting standards and is confusing

Much of the commentary, definitions and underlying assumptions appear to reflect views consistent with the accounting standards of 15 to 20 years past. However the accounting standards have undergone significant enhancement over this period and as a consequence the terminology, definitions, concepts and requirements have changed significantly.

For example Question 2 makes a statement that “Market value should give the same result as fair value as defined in IFRS13”. While Market Value is a term defined by the TIP and is relatively consistent with the old definition of Fair Value, the use of different terminology between the TIP (Market Value) and accounting standards (Fair Value) is very confusing and could lead to misunderstanding. Many may confuse Market Value with the Market Approach method to determine Fair Value.

The market approach (as defined in IFRS13) would generally be considered to be an inappropriate approach to use for specialised public sector assets. In fact IFRS13 clearly states that for these assets the cost approach is more likely to be used. For these assets there will be significant difference between the market value (determined using the market approach) and the fair value (using the cost approach). Likewise there is well documented inconsistency between the definition of “exit price” under the IVSC and the definition under IFRS13. It should be noted that some accounting standards result in significant changes in the reported value if the asset is required to be valued under an alternative standards due to changed circumstances. For example - the asset now being held for sale or needs to be adjusted for impairment.

If the TIP is to relate to the valuation for financial reporting purposes it is critical that the definitions and concepts are consistent with the over-riding prescribed requirements – the accounting standards. Currently the definitions and associated approaches are not entirely consistent with the accounting standards and it does not incorporate critical aspects of IFRS13 such a level of valuation input.

Entity Specific value contradictory to accounting standards

Despite the intention, the TIP is based around the concept of determining an entity specific value rather than determining the actual value of the asset to other market participants. It does so by explicitly excluding some of its service potential from the valuation process. For example Question 3 states that “…. is not correlated with the value of the owner’s interest in that asset”.

This is directly contrary to the requirements of the accounting standards (both IFRS and existing IPSASB) which require the value of the asset to reflect its full service potential based on the price market participants would pay to acquire such an asset. While an entity may use an asset for a specific operational purpose the asset may also incorporate some value which is not relevant or in excess of the needs for its existing use. However other market participants may be willing to pay a higher price for the asset in order to access those additional benefits.

It is critical that the value reflects the value of the service potential embodied in the asset rather than the value to a specific entity. This also challenges the assertion that the Market Value (for the TIP) will be consistent with Fair Value (per the accounting standards).

TIP does not highlight that specific situations are covered by specific accounting standards nor does it highlight the inter-relationship between the various technical accounting standards

The TIP provides some broad guidance. However certain circumstances require specific approaches under specific accounting standards – for example different approaches to leased assets or different models for PPPs.

This highlights the need for the TIP to reference back to the appropriate prescribed requirement. The following cross-reference of standards and Decision Trees are sourced from the CPA Australia "Guide to valuation and depreciation under the international accounting standards for the public sector". Further detailed decision trees are incorporated into the guide setting out the current accounting standard requirements.

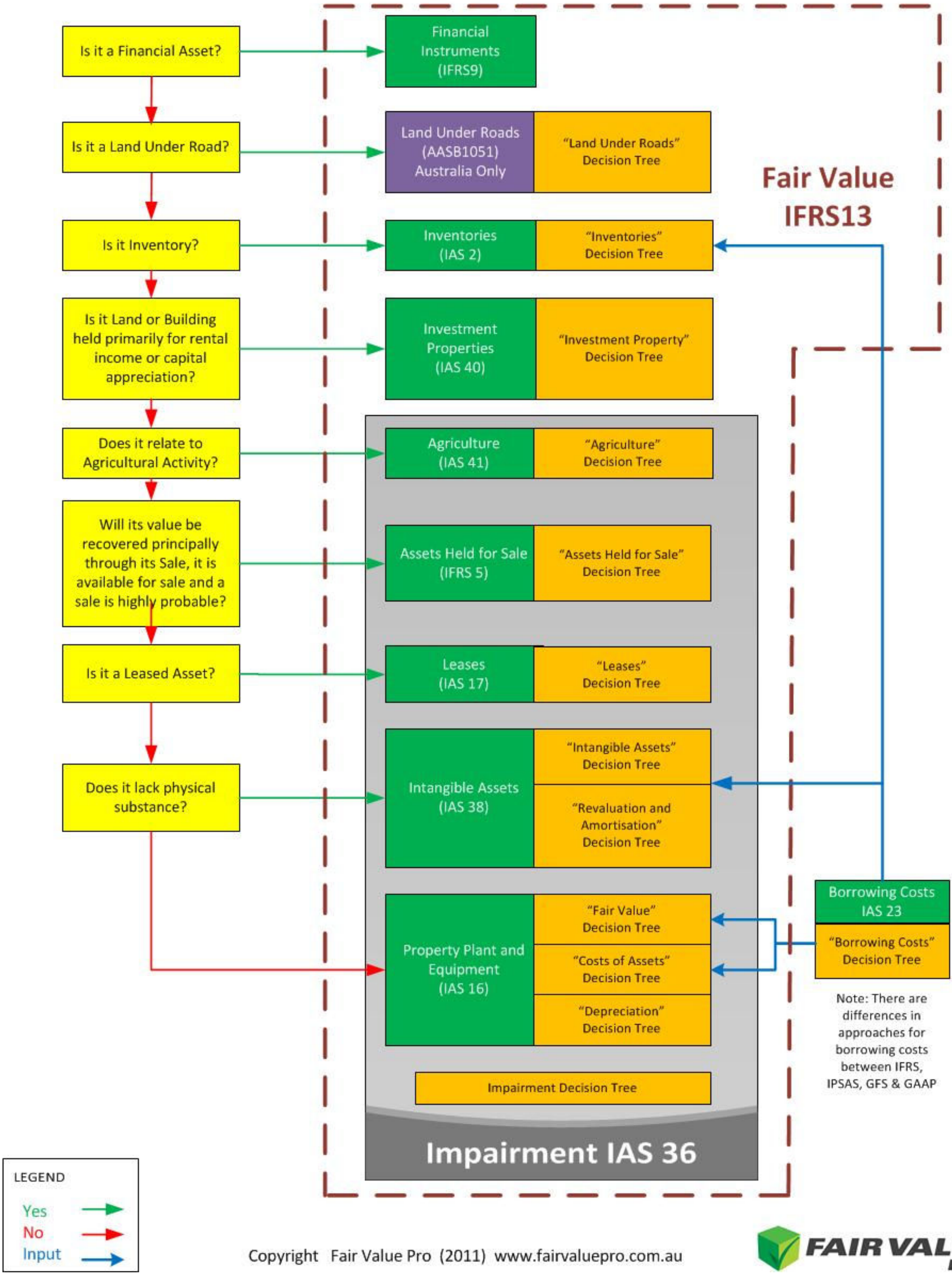
IFRS Standard	Name	IPSAS Equivalent	AASB equivalent
IAS 2	Inventories	IPSAS 12	AASB 102
IFRS 9	Financial Instruments	IPSAS 15 IPSAS 29	AASB 9
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations		AASB 5
IFRS 13	Fair value Measurement		AASB 13
IAS 16	Property, Plant and Equipment	IPSAS 17	AASB 116
IAS 17	Leases	IPSAS 13	AASB 117
IAS 23	Borrowing Costs	IPSAS 5	AASB 123
IAS 36	Impairment of Assets	IPSAS 21 IPSAS 26	AASB 136
IAS 38	Intangible Assets	IPSAS 31	AASB 138
IAS 40	Investment Property	IPSAS 16	AASB 140
IAS 41	Agriculture	IPSAS 27	AASB 141
	Land Under Roads		AASB 1051
	Whole of government and general government sector financial reporting		AASB 1049

[1]

[1] CPA Australia "Guide to Valuation and Depreciation under the international accounting standards for public sector assets" (2013)

Valuation of Assets Decision Tree

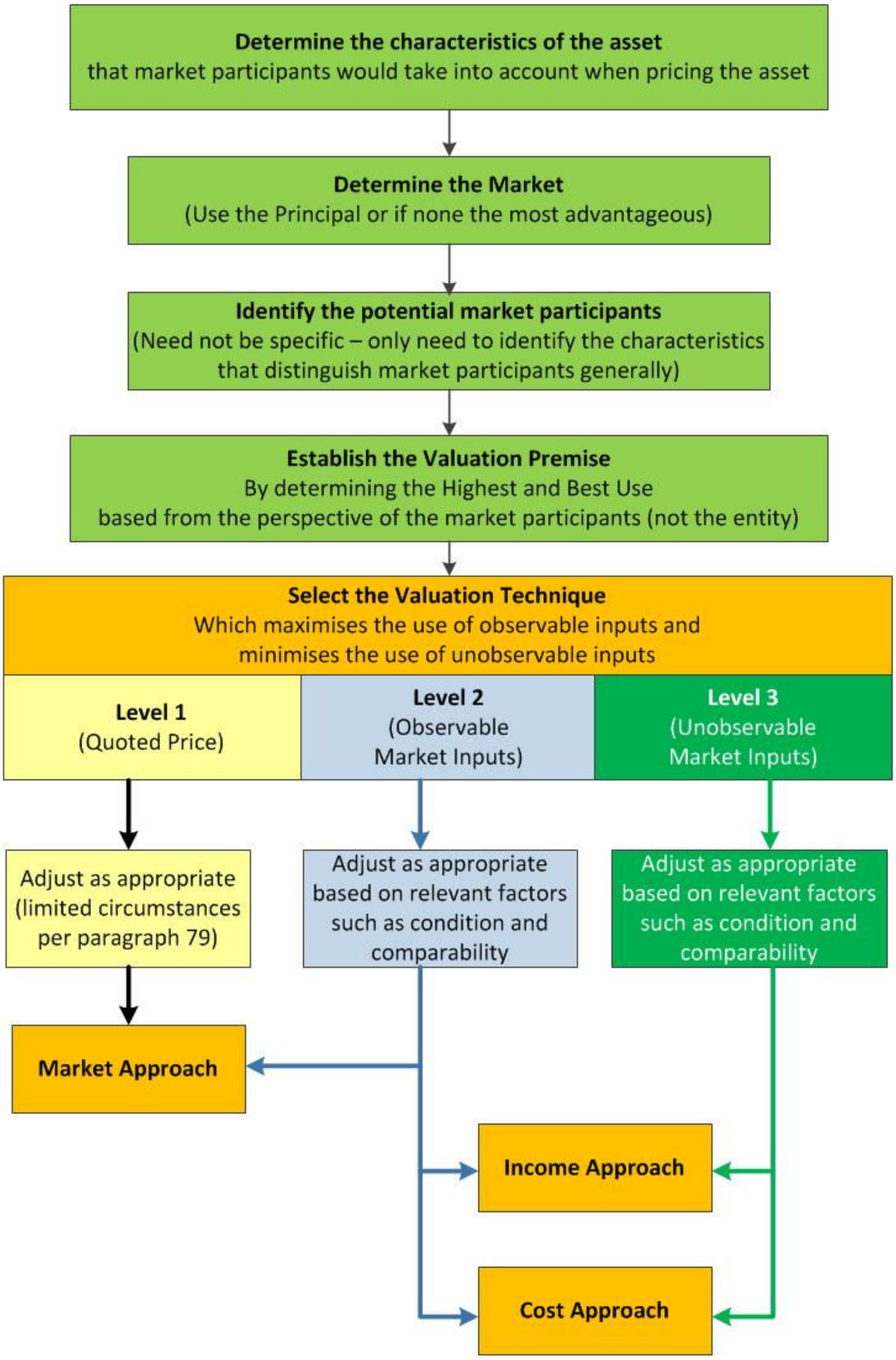
As at 31 Dec 2012



IFRS 13 Fair Value Measurement

Fair Value of Non-Financial Assets Decision Tree

As at 31 Dec 2012



TIP does not cover high level accounting concepts

This includes aspects such as the recognition criteria, control and materiality. In some cases assets are unable to be valued for financial reporting purposes. This might be for example due to the inability to reliably measure the asset or the asset, whilst being operated by an entity, being controlled by a different entity.

Before trying to attempt to value such assets it would be useful to include some discussion on these high level concepts.

SPECIFIC COMMENTS

Paragraph 4

The TIP states that "it is the characteristics of the asset and the service it provides that are relevant to its valuation". While I agree with this statement I also believe it is a little limiting and could easily be misinterpreted. In particular, taking into account remainder of the TIP, suggests that the value is limited to the services it currently provides for the existing operational use of the asset.

This is incorrect. The value is determined by "its characteristics, services that it provides and potential alternative uses to market participants".

These types of assets are typically held for long periods of time and as such the nature and demand for the specific services provided may vary or even become obsolete. However this does not necessarily mean that the asset loses value. It may be that the asset now has an alternative use with greater value than the current operational use. For example a school may have been built 100 years ago on the edge of town but with increasing populations and expansion on the town is now located in a prime CBD position. While the operational use of the asset as a school may suggest the school would now be built on land outside of the CBD (cheaper and more available) the reality is that the CBD location of the land provides it with a much higher alternative use value which other market participants would be willing to pay.

If the land were to be made available for sale the price generated would be significantly higher than what the entity would be prepared to pay to establish the same operational asset. This example demonstrates that the value of the asset needs to take into account much more than the services it currently provides. Consideration does of course need to be given to highest and best use and consideration of what is feasible, legally permissible, etc.

Definitions inconsistent with accounting standards

While the definitions are based on IVSC definitions some of these are inconsistent or too narrowly defined as with the definitions provided under the accounting standards. Where the purpose of the valuation is for financial reporting purposes the definitions (and associated interpretations) provided by the accounting standards must be used.

For example the definition of *future economic benefit* and its reference throughout the TIP (in particular paragraph 47) seems to be confused with the accounting standard definition of income generating units. Under the accounting standards all assets deliver future economic benefit (otherwise they don't satisfy the recognition criteria) but only those where the value is primarily driven by it income/profit generating capability are to be valued using the income approach. Paragraph 47 and the definition of future economic benefit in the TIP has confused these two distinct concepts.

The TIP definition of *Future Economic Benefit* is "a measure of the capacity of an asset to provide monetary benefits to those that hold or own that asset". This definition is limited to cash flows and takes an extremely narrow view of how assets are used by the public sector to deliver services.

The IFRS framework defines an asset as: *"*the future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.*"*[2]

The IFRS framework provide some additional comment:

> *The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.*[3]

In general accounting literature the terms future economic benefit and service potential are used as interchangeable terms. For example the IPWEA Australian Infrastructure Financial Management Guidelines *state "future economic benefits" is synonymous with "service potential"*[4]

As a consequence the accounting literature and various international guides define the terms for future economic benefit and service potential as the same and more broadly as "the potential to contribute, directly or indirectly, to the delivery of goods and services in accordance with the entity's objectives of a particular volume, quantity or quality to its beneficiaries."

This definition recognises that the future economic benefits are much more than just cash. It includes cash equivalents and the ability to deliver services.

The TIP also provides a definition for Market Value. It should be noted that the existing accounting standards do not value assets at Market Value. Instead they require valuation at Fair Value which may include either the market, income or cost approach. The definition of Market Value per the TIP is relatively consistent with the old definition of Fair Value as per IAS16. However with recent changes to the IFRS (IFRS13 Fair Value) and some of guidance provided by the TIP I don't believe the Market Value will be the same as Fair Value in all circumstances. I would suggest the definition per the TIP should be amended to be consistent with the accounting standards to ensure consistency.

[2] IFRS Framework Paragraph 53

[3] IFRS Framework Paragraph 53

[4] IPWEA NAMS AIFMG page 12.6

Paragraph 32

This states that the" historic cost of acquisition has no relevance to the value of land once it is part of the public service asset". This is not entirely correct.

I agree that the current replacement cost (Fair Value) is much more relevant than the historical cost. However IFRS13 specifically states that the Fair Value is to initially be calibrated to the transaction price. Therefore the historical cost does have relevance …. but only to the initial point of recognition and to the extent that it is used as evidence of future estimates of current cost.

Paragraph 35

Consideration of alternative uses should be performed for every valuation…. Not just when there are indicators that the service may no longer be needed.

The purpose of financial statements is to provide the general purpose users with information which enables them to make informed decisions. A critical part of this information is the value of the assets controlled by the entity. This should report the value as would be determined in an open market by market participants and therefore should always take into account alternative uses (providing they are possible, feasible, etc).

Paragraphs 46 & 47

These paragraphs are not consistent with the accounting standards and seem to confuse the term future economic benefit with income/profit generating capability. Likewise they are basing the valuation approach on the source of funding rather than maximising the valuation input.

For example – a hospital may be completely funded by public funds. Paragraph 47 suggests the appropriate valuation basis is the cost approach. However if the specific asset in question is a residential property the appropriate basis would be the market approach.

This highlights that the approach needs to be based on the characteristics of the asset rather than the nature of the entity which controls (as opposed to owns) the asset or the source of funding.

Paragraph 52 & Appendix 1

Reference should also be made to the fact that many jurisdictions around the world (such as Australia, New Zealand and UK) have previously adopted the IFRS standard (some with some public sector adjustments) and as a consequence public sector assets may need to be valued at Fair Value under the IFRS standards rather than under IPSASB.

This paragraph and the associate Appendix are misleading in that it suggests the IPSAS standards are the appropriate standards for public service assets. While these standards are relevant they are not the only relevant standards. Most existing public service assets that are valued for financial reporting purposes are valued under IFRS and this is unlikely to change.

As Australia has successfully adopted the Fair Value basis to the valuation of all public service assets (with some jurisdictions implementing over 20 years ago) and the Whole of Government accounts including a mix of entities mandated to report under IFRS requirements I would suggest it is unlikely countries such as Australia will abandon IFRS and Fair Value to adopt IPSASB and Deprival Value. Deprival was initially trialled in Australia in 1993 but was quickly replaced by Fair Value. Deprival is extremely complex and expensive to undertake given the extra steps involved and high level of theoretical scenarios to be created. Due to the mix of commercial entities involved in whole of government accounts it is unlikely whole of government accounts will be able to valued on any other basis other than Fair Value.

I suggest a separate appendix should be included to provide an overview of the IFRS requirements. It must be noted that the IFRS and IPSASB standards differ in a number of respects and the proposed IPSASB approach will result in significant variation to IFRS Fair Value valuations.

Given that this TIP is being developed for global use it is critical that it include appropriate recognition of the different approaches and discussion of IFRS requirements in addition to the IPSASB standards.

<u>Paragraph 55</u>

Given the previous comments about inconsistency with IFRS standards this paragraph is incorrect. Even in its most simplistic form the requirements of the IFRS require the valuation to be at "Fair Value". This is not the same as Market Value as defined by the TIP and the TIP does not cover the range of specific requirements covered by IFRS13 and the relevant specific standards (such as IAS16).

Some of the guidance in the TIP is contrary to that required by IAS16 and IFRS13.

RESPONSES TO QUESTIONS

QUESTION 1: WHAT IS RELEVANT TO THE VALUATION

I agree that the value of the asset should not be determined by reference to the status of the owner. However I disagree with the IVSC's position that it is "the characteristics of the asset and the service it provides".

This is too limiting and takes on an entity specific value rather than a market value. The market value should incorporate the perceived value to all market participants (rather than just the current owner and the service it is currently delivering). It therefore needs to take into account the characteristics of the asset, the service it provides and potential alternative uses to market participants".

This ensures that the value reflects the service potential embodied within the asset as a market value rather than an entity specific value. i.e. Not limited the value to the services it currently provides for the existing owner.

QUESTION 2: DISTINCTION BETWEEN MARKET VALUE AND INVESTMENT VALUE

I disagree that there has been sufficient distinction made between the two concepts.

As noted in my response to Question 1 the current approach to Market Value can be interpreted as limited to the services it currently provides. This might exclude alternative uses and therefore can result in an entity specific (Investment Value) for the existing owner.

The term Market Value could also be very easily confused with the market approach as defined in IVS300 Valuations for Financial Reporting, IVS 220 Property, Plant and Equipment and IFRS13 Fair Value.

As most specialised public service assets are valued for financial reporting purposes, and the intent per the TIP is that Market Value should be the same as Fair Value as defined by IFRS13, I believe it would more beneficial to adopt the accounting standards approach of valuing at Fair Value and specify the three approaches – market, income and cost approach.

QUESTION 3: EXCLUSION OF SOCIAL VALUE

The TIP is somewhat contradictory within its definitions and commentary. While I agree with the intent of paragraphs 27 and 28 to limit the valuation to the asset and exclude trying to place a value on the impact of other external flow-on impacts. However the definition for social value in the TIP is the “financial and non-financial benefit to the wider community provided by an asset”.

There is a fundamental problem with the definition as we are trying to value specialised public service assets which by definition are “established to provide financial and non-financial benefits to the wider community”. If we exclude these social benefits (as defined) we are essentially saying the asset is worth nothing.

Public sector entities such as local governments invest in specialised public service assets (such as community assets) to provide a range of social benefits to the community. By definition the value of these benefits is intrinsic to the value of the asset. If there is no benefit to be obtained the entity would not logically invest in such assets.

I believe the TIP should reflect that the social value is implicit in the Fair Value of the asset (either at market, income or cost approach) but that the valuation should exclude any adjustment for external flow-on effects such as potential employment savings, economic development estimates, etc. From a pure financial reporting valuation perspective those external flow-on impacts are probably not likely to meet the recognition criteria as they are not controlled by the entity nor are they able to be reliably measured.

(a) My experience with the impact of the asset on the wider community being used as a measure of the value of the asset.

In a previous role (Department of State Development) I was the Manager of the Commercial Advisory Group. This section was responsible for undertaking due diligence and economic analysis of potential investments in Queensland. This involved calculating the net benefit to be obtained across the wider community (employment, economic growth, etc) using a range of economic models.

The valuations were not valuations of a specific asset but rather the economic impact of specific projects.

(b) Purpose of the valuation

The purpose of these valuations was primarily to determining the level of support the government would provide to assist in such proposed projects. Essentially it enabled the government to determine whether to assist and if so the level of support they would provide to companies wishing to establish projects in the state of Queensland.

QUESTION 4: CAPABILITY OF RELIABLE MEASURMENT FOR PUBLIC SECTOR SEPCIALISED ASSETS

(a) Do you consider that all specialised public sector assets are capable of reliable valuation, or that some such assets should be declared as incapable or unsuitable for valuation?

I disagree with the views that argue these types of assets cannot be reliably measured. The arguments put forward are typical and traditional arguments based around the concept of the asset having no observable value because they are not traded. However this view is focussed on how much you could sell an asset for as opposed to valuing what it would cost to acquire the asset. This is reflected under the accounting standards as the Fair Value (Exit Price) and in the case of specialised public service assets is most likely to be the determined using the cost approach.

Almost all specialised public service assets are capable of being reliably measured using the Fair Value approach. The Fair Value approach provides the users of the financial statements, especially when the gross disclosure method is adopted, with important information about the general level of service potential remaining within the portfolio. Such information is important to enable these users to make informed decisions about the performance of the entity over time. For example it allows users to determine whether the general level of remaining service potential is increasing or decreasing over time and therefore whether the community equity is increasing or decreasing. Essentially it measures the level of investment the community has in its assets which are controlled by the various public service agencies.

There are however some assets which due to their unique nature may not be able to be reliably measured. Typically these include some heritage or cultural assets which are incapable of being replaced or renewed. It should however be noted that sometimes for these types of assets a market price may be observable if they are of a type where similar assets are openly traded. These assets though tend to be insignificant in relation to the value of the overall asset portfolio of public sector entities.

(b) If you have previous experience of valuing assets as those identified in this question, please describe the type of asset valued and briefly describe the method or methods used.

I have extensive, over 25 years, experience both valuing and auditing the valuation of these assets. This includes the valuation for financial reporting under both Fair Value and Deprival Value as well as valuation for insurance and alternative uses.

Prior to 2006 I spent 22 years with the Queensland Audit Office. This include responsibility for the audit of a range of asset valuation including all public sector housing, main roads, state government buildings, and all assets of the 125 local government and 155 water sector entities. This included –

- Land (freehold, reserves and restricted)
- Buildings (general, residential and specialised)
- Roads infrastructure (roads, bridges, kerb and channel, storm water, traffic signals, tunnels, etc)
- Water and Sewerage infrastructure (pipes, pits, manholes, treatment plants, filtration plants, etc)
- Civil assets (dams, weirs, ports, etc)
- Parks and reserves
- Community and recreational assets (sporting and cultural complexes, aquatic centres, etc)

While at the Queensland Audit Office I also chaired the Asset Valuation and Audit Advisory Group. This gave me responsibility to review and provide guidance on any asset valuation or depreciation related issue subject to audit by the Auditor-General.

In 1993-94 we implemented the Deprival method of valuation across the local government sector but this was replaced in 1995 with the Fair Value. The Deprival method was not continued as it was found to be extremely complex, time consuming and overly subjective due to the need to develop and rely of on a complex range of theoretical scenarios. The Fair Value method has proved to be much more objective, simpler, easier to understand and less costly to undertake.

The Fair Value method has now been used in Australia for specialised public service assets for approximately 20 years (some jurisdictions) and has proven to be very robust. Typically the valuations are performed using the cost approach (with gross disclosure method) with residential and non-specialised buildings valued using either the market or income approach. On occasion we have also used the income approach to determine the valuation of a range of assets of commercial entities.

Since 2006 I have worked in the private sector for a firm (APV Valuers and Asset Management) which specialises in the valuation and depreciation of public sector assets. This includes over 300 clients spread across all Australian states and involves the valuation of land, buildings and all infrastructure assets. Our client base includes local governments, large state government departments and right through to very large commercial entities such as the Port of Brisbane.

I also am a Director of Fair Value Pro which is a cloud based application which enables entities to undertake their own Fair Value valuations in full compliance with the requirements of the accounting standards. As part of my duties with Fair Value Pro I have provided a range of presentations throughout the UK for organisations such as the IAM and CIEAW and liaised with various Treasuries, valuation agencies and Audit offices.

I also represent CPA Australia on the Australian Asset Management Collaboration Group which is comprised of the various peak bodies concerned with asset management in Australia.

Additionally I have been involved in various publications pertaining to the valuation of public sector assets including –

- Author of CPA Australia's Guide to valuation and depreciation under the international accounting standards for the public sector (2013)
- Contributing author of IPWEA Australia's "Australian Infrastructure Financial Management Guidelines" (2009).

QUESTION 5: IVS230 HISTORIC PROPERTY ANNEXURE

I agree with the proposal to incorporate IVS230 as an appendix to the TIP.

QUESTION 6: CATEGORISATION OF SPECIALISED PUBLIC SECTOR ASSETS

I am happy with categorisation as proposed for the purposes of undertaking the valuation but note that different categorisations will be required for disclosure under the accounting standards.

The accounting standards require disclosure by asset class with asset classes determined by their nature as well as by the level of valuation input.

David Edgerton
Director
Fair Value Pro