liQuid property consultants

15 August 2017

Mr Mark Zyla
Chairman
IVSC Standards Review Board

By email: aaronsohn@ivsc.org

Dear Mr Zyla

Re: IVS Agenda Consultation

Thank you for the opportunity to provide a response to this Agenda Consultation Paper.

As specialists in the provision of valuations for fixed assets, and mainly for financial reporting purposes, many of the topics covered in the *critical* section sit outside our expertise. However, we desire to make comment on some aspects of the Invitation to Comment (ITC) and wish to point out the comments made in our submission are done in the context of valuation for fixed assets and the Australian financial/legal environment.

In addition to the comments relating to specific Chapters in the ITC, we desire to relay some of our recent observations as valuation practitioners.

- It appears (at least to this author) the accounting profession has had a significant impact in the development of the valuation framework and the direction of the valuation industry. With reference to this ITC, it appears this will continue into the future. We perceive real and tangible issues with this progression and primarily because the two professions have a significant conflict of interest, valuers are independent and accountants are not.

- The IVSC has developed a range of value definitions for use by the industry. However, we consider some value definitions are not so well defined. Until recently, the Australian Accounting Standards Board had adopted the valuation industry's accepted definition of *market value* but with the introduction of IFRS replaced the definition with the international accounting definition. We have posed the question to a number of accounting and valuation professional bodies but none has yet been able to provide a sound explanation as to the operational and conceptual differences between the two types of values.

- In the Australian environment, asset management has become a significant focus for all Government tiers. The need to formalise budgets and create sinking funds for maintenance and asset renewal have become fundamental to the implementation of asset management plans and associated systems.

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The fall-out from the implementation of asset management is the need to define a value that works for the AM practitioner. As part of the AM process, AM personnel require a present value for future capital replacement (including the asset's components). Unfortunately, there is a strong tendency by entities to adopt fair value as derived for accounting purposes as the value base for AM purposes. The complexity arises when the AM professional tries to componentise the fair value to meet their needs. It simply doesn't work.

What we are now observing is AM professionals side-stepping the valuation profession and going direct to the engineering or building industries to derive replacement costs and physical remaining life estimates for asset management purposes. The AM profession is happy to calculate their own depreciation (using AM system software) and call these value outcomes fair values (IFRS). And, accountants/auditors do not appear to have any issues adopting these values for their own financial reporting requirements. This is occurring to the extent that AM professionals are now more often managing valuation projects whereas 10 years ago it would have been an entities finance department.

What happened to the valuation profession as a result of the accounting profession taking the lead on matters of valuation will also happen as a result of the AM profession taking the lead. There are AM professional bodies springing up everywhere and some are developing their own standards on valuation which make no reference to IVS or even our own local professional bodies. A prevalent Australian body is the Institute of Public Works Engineering Australasia (http://www.ipwea.org/).

It is our opinion, the IVSC needs to develop a standard on valuation for asset management purposes and define a new value which would be relevant to the needs of the AM professional and distinct from the fair value currently been adopted.

Chapter 4 - Biological Assets

The issues raised are framed in the context of valuations to meet financial reporting purposes (Fair Value). However, we would expect valuations of these assets do also occur for purposes other than financial reporting (i.e. financing, sale, investment, etc) for which a market value would be required and we expect the methodologies adopted for either purpose would be consistent in all instances

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Question 4.1: Should IVS provide a standard of Biological Assets? If yes, do you agree with the title of this standard and the distinction provided by the FASB and IASB between Biological Assets and Agricultural Produce, please explain why?

Should IVS provide a valuation standard for Biological Assets

Yes, we strongly recommend the IVS develop a standard for the valuation of Biological Assets. Not so much to elaborate on the approaches to valuation in respect of this asset category (as the approach remains the same for any asset valued to a market) but simply for the reason that if the IVS doesn't issue a standard, then the perceived expertise will remain with the accounting profession.

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We continually observe diverse asset values for fixed assets in financial statements. These often occur due to an inappropriate application (or absence) of valuation methodology and tend to be performed by non-valuation professionals. The concept of highest and best evades many non-valuers and it is not unusual for us to spend considerable time explaining to clients, auditors and other users of financial statements that an asset's economic value is not simply measured using straight line depreciation based on a physical life expectation and there can exist economic relationships between asset categories.

If yes, do you agree with the title of this standard and the distinction provided by the FASB and IASB between Biological Assets and Agricultural Produce, please explain why?

We consider it important, that if an IVS is intended to address a topic which is already encapsulated in another professions standards (i.e. IASB, AASB, etc), then it should adopt the same international reference. This has several advantages.

- Create a direct relationship between the standards
- Users of financial statements seeking measurement may approach valuation professionals to undertake valuations knowing the valuation profession has standards that address these specialised situations.
- Non-valuation professions, such as accountants, may feel compelled to seek valuation professionals knowing we have standards directly related to their own..

The distinction between a biological asset and agricultural produce is relevant to the extent it marries up with the accounting professions pre-defined categorisation. That the valuation industry has not previously addressed these broad asset categories in a standard format is hard to comprehend.

Question 4.2: Do you observe a significant variation in valuation practice for Biological Assets? For each type of Biological Asset, what methods do you most commonly see used? Which type of the Biological Asset you listed have the greatest diversity in practice?

Our experience in this asset category is limited but we have observed the following methodologies:

(A) Income approach - Yields and returns benchmarked against similar enterprises and industry expectations.

(B) Direct comparison – Comparison with sales of improved land and residual value analysis utilising improved and unimproved parcels

Direct comparison has been the predominant application observed.

Question 4.3: Do you observe a significant variation in valuation practice for Agricultural produce? For each type of Agricultural Produce, what methods do you most commonly see used? Which type of the Agricultural Produce you listed have the greatest diversity in practice?

Refer 4.2 above

Question 4.4 Is the valuation of Biological Assets a critical area that should be addressed by the IVSC? Please explain why.

Please refer to comments made at 4.1 above

Question 4.5: Does the separation of value between the agricultural produce and its bearer plants cause issues within your market? Please explain why.

No comment

Question 4.6: Do you feel that there is conceptual Issue in allocating components of Fair Value? Please explain why together with your recommendations for resolving these issues.

We can see no more conceptual issue with allocating component values to biological assets than allocating values to land and buildings on the same site. The latter is undertaken every day and in significant volume on behalf of banks and other finance lending institutions.

However, as the question relates to the concept of asset componentisation, then there are conceptual issues surrounding this process and not just for Biological assets but for all asset categories.

The primary issue arises when assets are valued to market but component items have no specific market reference. It is then a requirement to derive a fair value of the component items which when summed match the total economic value of the asset being valued. This inherently involves combining two valuation approaches, market related approaches (direct comparison/income approach) and the cost approach (component items) to address a singular economic value.

One workaround is to synthesize a depreciated replacement cost for each component that then marries up with the total market value of the asset. Each component value being weighted with consideration to its contribution to the overall economic obsolescence of the asset.

Unfortunately, some practitioners prefer to adopt a cost approach from the outset to avoid the issue, which then has potential to provide diverse market (fair value) outcomes.

The statement that land supporting an existing biological asset is inherently more valuable than land primed to accommodate a biological asset remains a conceptual one unless there is market evidence to substantiate the claim and that market evidence is measurable. Even if such evidence happened to exist, it could only be considered at the sub-market level and not be representative of broader market behaviour.

Question 4.7: Do you think that potential alternative uses should be considered when valuing land as part of a Biological Asset valuation? Please explain why.

Absolutely, this is one of the formative concepts of value and articulated in the definition of highest and best use. Why should this change due to the type of asset being valued?

Land that is suitable for a specific purpose may attract a value premium if such land is in demand. However, these circumstances are more often than not regulated by authorities and like any other land-use are subject to land-use controls which in turn impact supply and demand.

If land is zoned for a certain use, then it holds any direct comparison with transactions should reflect identical if not similar land-use controls.

These are fundamental valuation principles and it is concerning they are been called into question.

Question 4.8: Do you think that there are four basic sampling and measurement techniques for the valuation of Biological Assets? If not, please explain what sampling techniques have seen used in practice.

We consider, if the IVSC needs to ask this question, then possibly there is a need to issue a standard on sampling for valuation purposes. Sampling component of many valuation assignments for large and voluminous portfolios and an over-arching standard would standardise the approach for professionals engaging in these assignments

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Question 4.9: Do you think that there are four basic sampling and measurement techniques for the valuation of Biological Assets? Do you think that the inclusion of information on generally accepted sampling and measurement techniques would substantially reduce diversity of valuation practice and if so, how?

Refer 4.8 above

Chapter 6 – Inventory

The issues raised are framed in the context of valuations to meet financial reporting purposes (Fair Value). However, we would expect valuations of these assets do also occur for purposes other than financial reporting (i.e. financing, investment, etc) for which a market value would be required and we expect the methodologies adopted for either purpose would be consistent in all instances

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Question 6.1: Should IVS provide separate standards for valuing inventory? Please explain why.

In line with our reasoning at 4.1 above, we strongly recommend the IVS develop a standard for the valuation of Inventory. Not so much to elaborate on the approaches to valuation in respect of this asset category (as the approach remains the same for any asset valued to a market) but simply for the reason that if the IVS doesn't issue a standard, then the perceived expertise will remain with the accounting profession.

Question 6.2: What methods for the valuation of inventory do you most commonly see used in practice?

Many of our clients value their own inventory and usually in terms of a replacement cost. The Australian Accounting Standards Board has its own standard (AASB 102) in relation to inventories which states;

Inventories shall be measured at the lower of cost and net realisable value.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See AASB 13 Fair Value Measurement.)

Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date.

The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.

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Question 6.3: Do you agree with the decision to focus on the application of the Comparative Sales Method? If not, please discuss the other methods that should be included in the performance framework.

Unfortunately, this chapter only talks about selling prices, costs and profit margins and does not put into context the value being sought (i.e. market value, fair value or other), making it difficult to answer the question. The chapter does refer to replacement cost or comparative sales method both of which have a basis in determining market value and fair value (IFRS).

As the question is made in the context of accounting standards, then we would restate the underlying principle of Fair Value as defined in our local AASB 13.

Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same—to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions

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Again, thank you for providing us the opportunity to respond to this invitation and we will continue to monitor the development of professional standards.

Yours faithfully

Martin Burns

Director: Liquid Pacific
Chartered Valuation Surveyor, RICS,
Certified Practicing Valuer, AAPI