ILLUSTRATIVE EXAMPLES OF VALUATION PRINCIPLES AND CONCEPTS

The International Valuation Standards Council (IVSC) is an independent, not-for-profit, private sector organisation that has a remit to serve the public interest. The IVSC's objective is to build confidence and public trust in the valuation process by creating a framework for the delivery of credible valuation opinions by suitably trained valuation professionals acting in an ethical manner.

The IVSC achieves this objective by:

(a) creating and maintaining the International Valuation Standards (IVS);

(b) issuing technical guidance for professional valuers; and

(c) promoting the development of the valuation profession and ethical practices globally.

The IVSC Professional Board has resolved to undertake a project to develop examples which would illustrate the practical application of valuation concepts discussed in the new IVS Framework. This will include, but will not be limited to, elements of the Conceptual Framework for Market Value in paras 31 – 36 as well as illustrations of concepts such as special purchasers and the identification of entity specific factors. This paper describes the background to the project and identifies some matters that Board believes need to be addressed.

The IVSC wishes to form a working group to progress the project. This will ideally include individuals with a range of valuation experience across different business and asset types, including financial instruments, who can draw on their experience to help create simplified hypothetical examples to illustrate various valuation principles and concepts.

Nominations for membership of the working group are invited no later than 19 August 2011. An application form and further details can be obtained from the IVSC Technical Director, Chris Thorne by email cthorne@ivsc.org.

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The IVSC Professional Board has agreed to undertake a project to develop a series of examples which would illustrate how some of the valuation principles and concepts identified and discussed in the IVS Framework are applied to different situations in practice. The examples are to cover a range of different valuation purposes, measurement bases and types of assets, including financial assets.

BACKGROUND

Although historically IVSC has frequently been asked to provide further explanation of some of the concepts in the International Valuation Standards (IVS), the IVSC has not seen the development of examples or material that could be classed as "educational" as being within the remit of a standard setter. However, following the 2008 restructuring of the organisation, the Professional Board was created with a specific remit to promote education and training in relation to the IVS. The demand for educational material is mainly, although not exclusively, from emerging markets where there is not a strong tradition of professional valuation.

Further, specifically in the area of financial reporting, the adoption of International Financial Reporting Standards (IFRSs) by many countries is exposing a significant number of people to valuation for the first time due to the need to use fair value measurements in financial statements. Discussions with the IASB indicate that it too has received many such requests for additional educational material around its recently introduced IFRS 13 Fair Value Measurement. As a result, the IFRS Foundation is proposing to produce educational material on valuation, specifically aimed at preparers of financial statements in emerging markets. The IVSC and IASB have agreed that while each will need to produce its own material to suit its own requirements, it is important that there is consistency in the guidance given around key concepts, including those that are common to the IVS Market Value and IFRS 13 Fair Value definitions. It has been agreed that the two organisations will cooperate in the development of their respective guidance.

THE IVSC PROJECT

The IVS Framework published in July 2011 includes discussion and explanations of a number of valuation bases and concepts. These include:

- The definition of Market Value together with a "conceptual framework" that discusses and explains each element of the definition and related principles including highest and best use (HABU).
- Identification of the market in which the hypothetical transaction takes place
- The nature of market participants
- Bases other than market value, eg special value, entity specific value, non IFRS fair value, and others.

The project should produce material to supplement that in the IVS Framework. While some additional commentary may be appropriate, care must be taken not to modify or alter the IVS principles. It is therefore recommended that guidance should reference the principles and concepts in the Framework and then focus on illustrating them with hypothetical examples.

The expectation is that the examples would be mainly in a narrative form, setting out a scenario, discussing the options and indicating the appropriate solution and the reasoning. However, where necessary to illustrate the concept or principle quantitatively, simplified quantitative examples would be used.

Relationship with IFRS

As it is proposed that the IVSC collaborates with the IFRS Foundation there needs to be clarity as to the areas of commonality and the areas of distinction between our respective objectives.

IVS 300 *Valuations for Financial Reporting* consists of a short valuation standard that sets out matters that must be included or considered in a valuation assignment for financial reporting generally. This is followed by guidance on the valuation assumptions that are normally appropriate to meet various valuation requirements under IFRS. This guidance is clearly labelled as being non mandatory.

Meanwhile, the new IFRS 13 also states in the Introduction:

"The IFRS explains how to measure fair value for financial reporting. It does not require fair value measurements in addition to those already required or permitted by other IFRSs, and is not intended to establish valuation standards or affect valuation practices outside of financial reporting."

IVS is therefore neither a subset of IFRS nor produced solely for valuations under IFRS.

Consequently, although it is proposed that the IVSC liaise with the IFRS Foundation in the production of this guidance, this is to ensure that the principles are consistent and to avoid confusion. It is anticipated that the IVSC project will have a wider focus as it will be concerned with concepts and principles that apply to all valuation, including addressing various different bases of value, whereas the IFRS project will relate specifically to fair value as defined in IFRS 13.

Market Value and IFRS Fair Value

The similarities and differences between IFRS Fair Value and IVS Market Value were much debated during the IVS improvement project and have been discussed between IVSC and IASB staff at length.

For historic reasons IFRS uses the term Fair Value and IVS the term Market Value to describe the estimate of a price obtainable in a hypothetical market transaction between willing parties. The actual definitions and detailed narratives supporting them in both IVS and IFRS indicate that these are essentially similar concepts; however, some differences do exist because of specific assumptions that are required to be made in applying fair value to certain types of asset and liability under IFRS.

Principles and Concepts to be Discussed

The Board considers that the principles and concepts addressed by the project should include, but would not be limited to:

Aggregation: Illustration of the effect of different aggregation assumptions on value.

Highest and Best Use: Discussion of this concept as a natural consequence of an efficient market. Effect of aggregation on HABU and its applicability to financial instruments.

Market: Identifying the market in which the exchange takes place.

Market Activity: Considering the impact of market activity on whether a transaction price is evidence of value.

Market Evidence: Factors that should be considered in evaluating transaction and other market evidence.

Market Participants, including an illustration of:

- the motivation of parties, what is meant by “willing”, “knowledgeable” and “without compulsion.”
- a “forced seller”
- a “special purchaser”

Marketing Period: The meaning of a proper (customary) marketing period relative to the valuation date.

Transaction Costs: Clarifying the difference between agreed price, net receipts and gross costs.

Special Value: Examples of special value and distinguishing from market value

Ends