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International Public Sector Accounting Standards Board

By email

26 September 2019

Dear Sirs

Consultation Paper – Measurement

We have pleasure in attaching our comments on the above Consultation Paper.

By way of background, Valuology is a business formed by Marianne Tissier and Chris Thorne, two former directors of the International Valuation Standards Council. It provides support and advice to valuation firms, government agencies and professional organisations on valuation standards, compliance with best practice and risk management.

We have a particular interest in the work of the IPSASB on this subject given our experience of trying to develop an international consensus on best practice guidance for public sector valuations while at the IVSC. We discovered then that there was insufficient commonality between different countries on what public assets could or should be measured at all, let alone valued, for there to be any useful guidance that would be applicable internationally. Hopefully the Conceptual Framework and the proposed measurement standard will assist in harmonisation.

Chris Thorne also had considerable dialogue with both the FASB and IASB during the development of their respective Fair Value standards, including being a member of the FASB's Valuation Resource Group and providing "Education Sessions" to the IASB on valuation issues.

The attached response is in two parts. Part 1 provides our response to the specific questions asked in the Consultation Paper. Part 2 provides detail to support some of the responses in Part 1 and our comments on other matters. Please do not hesitate to contact us if you would like to discuss any aspect of our response.

Yours faithfully,

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Responses to IPSASB Measurement Consultation Paper

Part 1: Responses to Questions in Consultation Paper

1 The IPSASB's Preliminary View is that the fair value, fulfilment value, historical cost and replacement cost measurement bases require application guidance.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons, stating clearly which measurement bases should be excluded from, or added to, the list, and why.

Response:

We agree with the Board's Preliminary View. Measurement bases and the concepts upon which they are based need to be clearly explained if consistent application is to be achieved. This is especially the case with public sector assets where the economic concepts underpinning many measurement concepts used in the private sector cannot be readily applied.

2 The IPSASB's Preliminary View is that the application guidance for the most commonly used measurement bases should be generic in nature in order to be applied across the IPSAS suite of standards. Transaction specific measurement guidance will be included in the individual standards providing accounting requirements and guidance for assets and liabilities.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons, and state what guidance should be included, and why.

Response:

We agree with the Board's Preliminary View. The proposed standard should set the required principles at a sufficiently high level to ensure they can be applied across the widest range of public assets and liabilities.

3 The IPSASB's Preliminary View is that guidance on historical cost should be derived from existing text in IPSAS. The IPSASB has incorporated all existing text and considers Appendix C: Historical Cost– Application Guidance for Assets, to be complete.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons, stating clearly what you consider needs to be changed.

Response

We have no comment on the historic cost bases of measurement.

4 The IPSASB's Preliminary View is that fair value guidance should be aligned with IFRS 13, taking into account public sector financial reporting needs and the special characteristics of the public sector. The IPSASB considers Appendix A: Fair Value–Application Guidance, to be complete.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons, stating clearly what you consider needs to be changed.

Response:

We agree that the Fair Value guidance in the proposed standard should be aligned as far as possible with that in IFRS 13. We do, however, have some detailed observations on the supposed differences between Fair Value and Market Value in 2.19 – 2.24, which we address in Part 2 of this response.

5 The IPSASB's Preliminary View is that fulfilment value guidance should be based on the concepts developed in the Conceptual Framework, expanded for application in IPSAS. The IPSASB considers Appendix B: Fulfilment Value–Application Guidance, to be complete.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons, stating clearly what you consider needs to be changed.

Response:

We agree with the Board's Preliminary View.

6 The IPSASB's Preliminary View is that replacement cost guidance should be based on the concepts developed in the Conceptual Framework, expanded for application in IPSAS. The IPSASB considers Appendix D: Replacement Cost–Application Guidance, to be complete.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons, stating clearly what you consider needs to be changed.

Response:

We agree that the guidance on replacement cost should be based on concepts in the Conceptual Framework but have some detailed comments on the detail of Appendix D which we address in Part 2 of this response.

7 The IPSASB's Preliminary View is that all borrowing costs should be expensed rather than capitalized, with no exception for borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset.

Do you agree with the IPSASB's Preliminary View?

If not, please state which option you support and provide your reasons for supporting that option.

Response:

We have no comment on the Board's Preliminary View.

8 The IPSASB's Preliminary View is that transaction costs in the public sector should be defined as follows:

> Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of an asset or liability and would not have been incurred if the entity had not acquired, issued or disposed of the asset or liability.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons, and provide an alternative definition for the IPSASB to consider.

Response:

We agree with the Board's Preliminary View.

9 The IPSASB's Preliminary View is that transaction costs should be addressed in the IPSAS Measurement Standard for all IPSAS.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons and state how you would address the treatment of transaction costs in IPSAS, together with your reasons for supporting that treatment.

Response:

We agree with the Board's Preliminary View.

10 The IPSASB's Preliminary View is that transaction costs incurred when entering a transaction should be:

- Excluded in the valuation of liabilities measured at fulfilment value;
- Excluded from the valuation of assets and liabilities measured at fair value; and
- Included in the valuation of assets measured at historical cost and replacement cost.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons and state how you would treat transaction costs in the valuation of assets and liabilities, giving your rationale for your proposed treatment.

Response:

We disagree with the Board's Preliminary View. The main reason we disagree is that there is apparent confusion between the question of the extent to which a market participant would reflect transaction costs in calculating the price they would be prepared to pay or accept and the question as to whether transaction costs should be reflected in the measurement for financial reporting purposes. The Preliminary View also incorrectly identifies historical cost as a type of valuation, rather than as a type of measurement. We expand on our concerns in Part 2 of this response.

11 The IPSASB's Preliminary View is that transaction costs incurred when exiting a transaction should be:

- Included in the valuation of liabilities measured at fulfilment value;
- Excluded from the valuation of assets and liabilities measured at fair value; and
- Excluded in the valuation of assets measured at historical cost and replacement cost.

Do you agree with the IPSASB's Preliminary View?

If not, please provide your reasons and state how you would treat transaction costs in the valuation of assets and liabilities, giving your rationale for your proposed treatment.

Response:

We disagree with the Board's Preliminary view for the same reasons as stated for 10 above.

Specific Matter for Comment 1 - Chapter 2 (following paragraph 2.29)

Definitions relating to measurement have been consolidated in the core text of the Illustrative ED.

Do you agree that the list of definitions is exhaustive?

If not, please provide a listing of any other definitions that you consider should be included in the list and the reasons for your proposals.

Response:

We agree that the list of definitions is exhaustive. We do not agree with all definitions and highlight those which we feel need reconsideration in Part 2 of this response.

Specific Matter for Comment 2—Chapter 3 (following paragraph 3.5)

Guidance in International Valuation Standards (IVS) and Government Financial Statistics (GFS) has been considered as part of the Measurement project with the aim of reducing differences where possible; apparent similarities between IPSAS, IVS and GFS have been noted. Do you have any views on whether the IPSASB's conclusions on the apparent similarities are correct?

Do you agree that, in developing an Exposure Draft, the IPSASB should consider whether the concepts of Equitable Value and Synergistic Value should be reviewed for relevance to measuring public sector assets (see Addendum B)?

Response:

We agree it is important that the Board aims to maximise consistency between relevant concepts in other standards and the IPSAS in order to ensure the widest comprehension of those concepts among preparers, advisors and users of public sector financial statements.

We do not consider that the concepts of Equitable Value and Synergistic Value as defined by the IVSC have any relevance or application to financial reporting whether in the public or private sector. We explain these concepts and explain why we do not believe they are applicable to the measurement objective in the Conceptual Framework in Part 2 of this response.

Specific Matter for Comment 3—Chapter 4 (following paragraph 4.21)

Do you agree that the measurement flow charts (Diagrams 4.1 and 4.2) provide a helpful starting point for the IPSASB to review measurement requirements in existing IPSAS, and to develop new IPSAS, acknowledging that other matters need to be considered, including:

- The Conceptual Framework Measurement Objective;
- Reducing unnecessary differences with GFS;
- Reducing unnecessary differences with IFRS Standards; and
- Improving consistency across IPSAS.

If you do not agree, should the IPSASB consider other factors when reviewing measurement requirements in existing IPSAS and developing new IPSAS? If so, what other factors? Please provide your reasons.

Response:

We agree that some may find them helpful as starting points although they need supporting with some detailed explanations of the decision criteria for each stage.

Part 2: Detailed Comments

Fair Value and Market Value

Consultation Paper 2.19 – 2.24
We encourage the Board not to present the difference between market value and fair value as being simply that Market Value can be both an "entry value" and an "exit value" whereas Fair Value can only be an "exit value".

This is a matter that was the subject of considerable debate to which the writer was party between the IASB and IVSC during the development of IFRS 13. We understand that the reason IASB specifically identified Fair Value as being an exit value is to emphasise that the reporting entity is deemed to be willing to dispose of the asset (or settle the liability) in question on the reporting date regardless of their actual intention. At conferences with preparers in the period between 2006 and 2012 when first the FASB and then the IASB were developing their Fair Value standards, a surprising number were asserting that Fair Value was not a valid measure if they had no intention of selling. The "exit value" provision was felt necessary to make the point that the measure required the assumption of a sale even if the entity intended to hold the asset for the foreseeable future. Rather than describe the type of value required it is being used as shorthand for "you are assumed to be selling even if you are not".

From a valuation perspective the exit v entry debate has always caused confusion when discussing any basis of value that involves a transaction. If the basis requires the assumption of a transaction, there must be two parties to that transaction, and they strike a price at which one is exiting and one is entering. The price under such an assumption is therefore simultaneously an entry and an exit price. Assertions that a transaction price will differ depending on which side of the transaction it is viewed from contradicts most of the other assumptions required to estimate that price.

Because financial reporting standards are written from the perspective of the reporting entity, we accept the term "exit price" makes sense in explaining the required approach to an existing owner of an asset or liability. However, valuation bases in valuation standards are written from a neutral perspective and in this context the expressions entry and exit are unhelpful. The assumed motivation of both the seller and buyer is dealt with in the IVSC definition of Market Value by describing both as being "willing", with supporting detail in the Conceptual Framework in IVS 105.

Before IFRS 13 was finalised there was considerable discussion between IASB staff and the IVSC as to the similarities and any differences between Fair Value and Market Value, which resulted in the statement in IVS 2013[1] that for most practical purposes Market Value under IVS would meet the Fair Value measurement requirement under IFRS 13. The only significant difference identified was the requirement in IFRS 13 to ignore "blockage factors".[2]

The Board states in 3.5 that *"it is important that the preparers of financial statements and the valuators (sic) have a clear understanding of each other's requirements and for the preparers of financial statements to have a basic understanding of the approach the relevant expert might adopt in providing a valuation."* Distinguishing between definitions or bases of value by referring to them as exit or entry values does not help achieve this objective.

Equitable Value and Synergistic Value

Specific Matter 2 - Para 3.5 of Consultation Paper and Comparison Table at Addendum B

Equitable Value is used to describe a price that would be agreed between two specific entities having regard to their specific interests. Examples of where Equitable Value will be an appropriate measure of value include:

- A minority shareholder selling its holding to another minority shareholder which would give the buyer a controlling majority interest.
- A lessor acquiring the interest of a lessee.
- An owner of a strip of land required for access selling to the owner of the land to which it provides access.

In each example the price in the transaction will differ from that which the seller could command in the open market because of the relationship between the parties or between the assets. Equitable Value is a price that a) assumes the parties are willing or obliged to transact and, b) is equitable having regard to the parties' respective interests.

Synergistic Value is the amount of additional value that arises when two interests are combined. It differs from Equitable Value as it represents the whole of increase in value arising from the combination of two interests, not the price that would be paid between two specific parties to achieve that increase in value. Often the Equitable Value is one that apportions Synergistic Value between the specified parties. Synergistic Value also differs from Equitable Value in that it is not confined to a transaction between two specific parties. It can also arise from the combination of the subject interest with more than one other complementary interest, for example where there would be more than one prospective buyer for a business, each of whom could create Synergistic Value from efficiencies achieved from combining the subject business with their own.

The concepts of Equitable Value and Synergistic Value may be useful to an entity contemplating an actual transaction but have very little relevance where there is no intention or obligation to enter into a transaction with a specific party. Value measurements in financial reporting are based on what the reporting entity would either receive or pay in a hypothetical transaction in the market.

[1] IVS 2013 IVS Valuations for Financial Reporting 300 G2
[2] IFRS 13 Fair Value Measurements para 69

Even if the reporting entity was under a contractual obligation to sell an asset to a specific party on the reporting date the appropriate measurement is not what it would receive under that contract but the current benefit of that contract. For example, an entity with a holding of land may have granted an option for another party to buy that land at a future date. The price at which that option can be exercised may represent Equitable Value. Exercise of the option may also create Synergistic Value. However, the current benefit to the reporting entity is not the sum it would expect to receive if the option were exercised but the value it could obtain from transferring its interest now subject to the option, which would take into account the risk and uncertainties of if and when the option would be exercised. It would therefore be the Fair Value of that option.

Transaction Costs

Paras 3.29-3.54 and Illustrative ED 24-28
We have no view on the question as to whether transaction costs should be capitalised or not. However, from a valuation perspective it is important that they are clearly distinguished from the estimated price that would be paid in a transaction. They are not a characteristic of the asset or liability. This is the reason for the statement in IVS 104 210.1[3] quoted in para 3.47 of the Consultation. A similar position is taken in IFRS 13 25:

> *The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs shall be accounted for in accordance with other IFRSs. Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.*

The discussion and the Preliminary Views expressed in the Consultation Paper fail to recognise that regardless of whether the reporting entity has historically acquired an asset or whether it is deemed to either be acquiring or disposing of an asset on the reporting date, the costs involved in those transactions are not an intrinsic characteristic of those assets. The suggestion that this could change depending on whether the entity is "exiting" or "entering" is, therefore, flawed.

That virtually all transactions will incur costs for either or both parties is not a point of contention. However, the treatment of those costs in financial statements will depend on the accounting objective. For example, if the accounting objective is to measure the "net selling price" then the estimated proceeds of a sale will involve deducting the estimated transaction costs from the estimated selling price. To allow for such adjustments, transaction costs should be clearly stated as separate items from the measurement of the asset itself.

There is also danger of confusing the treatment of transaction costs that would be incurred in a hypothetical disposal or acquisition by the reporting entity with how such costs are treated in different valuation techniques. This is evident in the two extracts from the IVS in para 3.47. The first extract from IVS 105 210.1 concerns the reported value, emphasising that this is the price that is agreed between the hypothetical parties without adjustment for the costs or taxes that either may occur. The second extract, from IVS 105 70.10, is a reference to inputs required when using the cost approach, when the any costs that would be incurred by a market participant in creating an equivalent asset are reflected, which includes transaction costs. These extracts are not advocating

[3] Incomplete reference in Consultation Paper

alternative approaches depending on whether a particular entity is entering or exiting, but describing very different things, one the reported value and the other one of the techniques that can be used to estimate that value.

All recognised valuation techniques either explicitly or implicitly reflect transaction costs because these costs influence the price that market participants are prepared to agree. However, the reported figure is that price. Confusion between the technique and the result is not uncommon. We are aware of misstated values for investment property by entities purporting to use the Fair Value model under IAS 40 who mistakenly believe that the requirement in IFRS 13 not to adjust the price for transaction costs means that they must strip out all such adjustments from the technique used to estimate Fair Value, normally a form of discounted cash flow. In countries where there are high taxes on property transfers this makes a significant difference. This is, of course, not reflecting how market participants would calculate the price they would be prepared to pay in an actual transaction and, therefore, is contrary to the definition of Fair Value and specifically to IFRS 13 22:

> *An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest*

For similar reasons to those given in our earlier comments on the problems caused by categorizing bases of value as either "entry "or "exit" values, we believe the proposal that differentiates the treatment of transaction costs depending on the chosen measurement method is unhelpful. Instead we recommend that the proposed Exposure Draft should focus on the need to:

a) Distinguish the measurement of the asset or liability (whether that be historic cost or one of the permitted valuation bases) from any transaction costs incurred in a past transaction or that would be incurred in a hypothetical transaction on the reporting date. This provides transparency to users of the financial statements and allows for different treatment of the items under other IPSASs.

b) Avoid causing confusion between the exclusion of transaction costs from the reported value of an asset or liability and the proper reflection of such costs in any valuation technique used to estimate that reported value.

Illustrative ED - Definitions

Cost Approach: While this definition is the same as in IFRS 13 we believe that words in parentheses at the end are unnecessary and unhelpful. The cost approach is a valuation technique. "Current replacement cost" is an input into the Cost Approach rather than the result of using that approach. An additional risk that does not arise in IFRS is of confusion with "Replacement Cost" as an alternative measurement option under the Board's proposals. The Cost Approach can be used as a valuation technique to estimate both Fair Value and Replacement Cost. The words add nothing but potential for confusion and could usefully be removed.

Entry Price / Exit Price: If these definitions are considered essential, for the reasons explained above we recommend that they are amended so it is clear that these terms are explaining the assumed transaction from the perspective of the reporting entity, e.g. "… is the price paid <u>by the entity</u> to acquire…." and "… the price received <u>by the entity</u> to sell…"

Market value for assets / Market value for liabilities: We do not agree that it helps to bifurcate this definition. Further, it is unclear why Market Value needs defining at all as it is not listed in the Illustrative ED as a measurement option. We understand from 2.20 that a combination of these definitions is currently used in IPSAS 29, but the Basis for Conclusions indicates that the Board intends that IFRS Fair Value be used as the measurement basis for financial instruments. If, for any reason, it is decided that a Market Value definition is necessary, then we encourage to use the IVSC Definition which is widely understood and applied and which has a Conceptual Framework for its application developed over the past 25 years.

Illustrative ED - Appendix D: Replacement Cost – Application Guidance

D5 Location Factors: We believe that this does not adequately explain the approach to be adopted where public services need to be situated in expensive city centre locations and where the value of land, at least superficially, for alternative uses is much higher. When it is stated that the replacement cost of the land is based on the *current value* of the existing site, does this mean its value for the current use or the current value for an alternative use that would be permitted if the hospital, school etc was not required in this location?

Other factors that need exploration in application guidance is the role of any legislation controlling land use, which may have designated city centre land specially for public service uses. This would mean that the highest and best use would be for the designated public service use, not for any alternative higher value uses that may surround it. In other cases, a public service use may not be on a site which has specific legal limitation to that use, perhaps because the use is historic. What assumptions should be made about the cost of acquiring a site for the public service use in that locality under these circumstances?

We would submit that, while information about the potential for higher value uses may be material to a public entity for planning and efficient location of future projects, for measuring the value of an existing asset for financial reporting it has little relevance, especially if it means that the value of the land is incompatible with the continuing provision of the public service. An entity needing to replace the remaining service potential would not rationally buy land that had a value for an alternative use in excess of that that could be supported for the existing use.

Overall Comment on Appendix D

We understand and support the use of the concept of “Replacement Cost” where Fair Value or Historic Cost do not best meet the measurement objective. However, the term “Replacement Cost” fails to convey that this is a current value measure and is too easily confused with an actual cost or the cost of replacing or reinstating if the asset were lost by fire or another hazard.

In the UK, the government and other public sector bodies have adopted accounting principles largely based on IFRS but for property owned and occupied for service delivery do not use IFRS Fair Value but an alternative, “Existing Use Value”. This was originally developed in the 1990s by the RICS working in conjunction with the former UK Accounting Standards Board for application to owner occupied property in the private sector, although this did not survive the requirement for all listed private entities to adopt IFRS in 2005. However, the public sector clearly considered it was a useful alternative taking into account the problems of applying Fair Value to many types of land and buildings held to deliver a service.

Existing Use Value (EUV) meets the broad criteria of Replacement Cost as defined in the Illustrative ED but is more precisely defined as:

"The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction, after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion, *assuming that the buyer is granted vacant possession of all parts of the property required by the business and disregarding potential alternative uses and any other characteristics of the property that would cause its Market Value to differ from that needed to replace the remaining service potential at least cost."*

It will be noted that the first half of this EUV definition is the same as the IVSC definition of market value, but there are four additional conditions in the italicised section. Examination of these help to understand how EUV differs from Market Value:

" … *assuming that the buyer is granted vacant possession* …". This means that in the hypothetical exchange physical and legal possession passes to the buyer of all parts of the property required to provide the service. In the case of property this does not mean that any building is assumed to be disused or empty with all that could imply in terms of additional costs for either party. If any part of a property is occupied by a third party, the valuation will reflect the benefit or encumbrance of those occupations.

"...*of all parts of the property required by the business*…". This reinforces the objective for the value to reflect the potential for the asset to provide the service required of it by the reporting entity. The reference to "the business" reflects the definition's origins but has been accepted by the UK Government and public sector as also meaning *"… of all parts of the property required for delivery of the service.."*. If parts of a property are surplus to the operational requirements and if they are capable of separate occupation then they should be categorised as surplus, and separately valued. Any surplus parts incapable of separate occupation would be expected to have no more than a nominal EUV, as they would contribute nothing to the service potential of the property and would not feature in a replacement at least cost.

"…*disregarding potential alternative uses…*". Unlike market value, which is unconcerned with the needs of a specific entity, EUV requires the valuer to disregard uses that would drive the value above that needed to replace the service potential of the property to the reporting entity. A public sector entity will often have a statutory duty to provide a service in a particular locality and, therefore, potentially higher value uses are of no relevance unless and until the property becomes surplus. Notwithstanding, it would be appropriate to take into account the potential for additional development of a property providing this was for the existing use, would be required by the entity and that such construction could be undertaken without major interruption to the current operation.

"…*disregarding any other characteristics of the property that would cause the market value to differ from that needed to replace the remaining service potential at least cost."*. This is a "catch all" instruction to ignore any factor that would be reflected in the market value but that is irrelevant to the continued provision of the service. Examples include restrictive user covenants, planning conditions or remedial costs that would be incurred if the existing use ceased. Another would be where a property is in an unusual location or is oversized for its location which would restrict its market value below the cost of replacing the service potential.

Like other bases of value, EUV can be estimated using any of the main valuation techniques, i.e. the market approach, the cost approach and the income approach.

We are also aware that EUV is being considered as a suitable alternative to Fair Value in other jurisdictions where an objective measure of the cost of replacing the service potential is considered more relevant and capable of estimation than the amount that could be obtained on disposal. Given that EUV has had the benefit of some twenty five years' use, over which time it has been refined and a body of guidance developed around it, we believe that it is worth the Board considering this as an alternative to "Replacement Cost".

This would also have the advantage of avoiding confusion with historic cost which is available as a measurement option but for which the techniques used for any of the three valuation options have no relevance.

Valuology: September 2019