Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through email CommentLetters@ivsc.org

29 April 2011

International Valuation Professional Board
41 Moorgate
London EC2R 6PP
United Kingdom

Dear Sirs,

IVSC Exposure Draft of Technical Information Paper 1 The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations

The Hong Kong Institute of Certified Public Accountants ("the Institute") is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

We generally agree with the principles-based approach adopted in the proposed guidance. In our view, the purpose of valuation guidance is to provide the underlying principles that should be considered in undertaking a valuation, rather than to stipulate a specific technique. Prescriptive technical information paper at an international level would not take account of differences in legal frameworks and market mechanisms between countries where should be left to the local valuation standard setters. We therefore support the view that it is not the role of the IVSC guidance to expressly identify particular approaches that would be acceptable or unacceptable.

From a financial reporting perspective, we consider that the underlying DCF method described in the Technical Information Paper (TIP) is generally consistent with that in IFRS, except for that relating to investment value which is not consistent with the IFRS fair value concept of an exit price from the market participants' perspective. We consider that it is conceptually not appropriate for the TIP to state that the cash flows for future periods are constructed using "actual" income and "actual" expenditure in paragraph 8 as the concept of the cash flow model is developed based on forecast information. It is recommended that the word "actual" should be replaced with "contractual/estimated expected" if the Board means to refer to cash flows that are known or are reasonably predictable at the time the valuation is performed.

We support that the TIP provides examples of key components that should normally be provided for the DCF model in the valuation report. We believe that it is important for the valuation report to provide clear guidance in relation to its reliability stating the inputs and assumptions adopted and the reasonableness thereof including an indication of the availability of data or the possible range of such data in the context of the current market conditions.

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

Finally, we would like to highlight that although we believe valuation standards need to be principles-based in order that they can be applied globally, we are aware that more practical implementation guidance would be welcomed by emerging economies in Asia as entities in those economies might find it difficult to apply the principles in practice due to the immaturity of the market. We encourage the IVSC to work closely with local valuation standard setters such as The Royal Institution of Certified Surveyors (RICS) in the UK and the Hong Kong Institute of Surveyors (HKIS) in Hong Kong in developing local practical guidance on real property and business valuations so as to ensure it is consistent with the underlying principles in the TIP when addressing specific legal and market conditions of different jurisdictions.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/jn

Encl.

Hong Kong Institute of CPAs

Comments on the IVSC Exposure Draft of Technical Information Paper 1 The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations

Question 1

This Exposure Draft states that the DCF method should not be judged on the basis of whether or not the explicit cash flow assumptions are ultimately realized but rather on the degree of market support for the assumptions at the time they were made.

Do you agree that the DCF method, if properly applied, can be used as a method to arrive at market value?

Yes, we agree that the DCF method, if properly applied, is one of the methods that can be used in conjunction with other methods to arrive at market value.

Question 2

The IVPB has concluded that although there may be distinct terms and types of analyses that apply respectively to real property valuations and business valuations, the underlying DCF method is identical in each case.

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?

We agree that the underlying principle and the methodology of the DCF method apply to real property valuations and business valuations should be the same. However, the actual application of the assumptions and the inputs used for the valuation should depend on the specific facts and circumstances.

Question 3

This Exposure Draft states that the discount rate should be determined based on the risk associated with the cash flows (para 10), whether the DCF model is being used to determine a market value or investment value.

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

We agree that the discount rate used to determine both a market value and investment value should be determined based on the risk associated with the cash flows which could include interest, credit, liquidity and other risk components. We further agree that entity specific criteria, e.g. a target rate of return, an opportunity cost or the entity's WACC rate should also be considered when determining the discount rate for an investment value as mentioned in paragraph 19 of the ED.

Question 4

A number of different methods are identified which can be applied to the calculation of the terminal value at the end of the cash flow period (growth, fading growth, net asset value, salvage value, etc). For long-life real property assets or going concern businesses the Board believes a constant growth model is the most commonly used method, coupled with a cross check for the reasonableness of the figure, eg by reference to the implied exit multiple.

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?

We do not disagree that the constant growth model is the most commonly adopted terminal value calculation but we do not believe that it is appropriate for all valuations. We consider that other factors such as the ability of obtaining accurate cash flow projections and variation in market mechanism between countries and types of valuation are also important. For example, the long term sustainable growth rate may not be applicable in emerging economies where the growth of particular industries may to a large extent be driven by government policies in which case more subjective judgment would need to be made outside of market parameters.

Question 5

The Exposure Draft explains that cash flows can be developed on the basis of alternative financial assumptions, eg inclusive or exclusive of anticipated inflation, inclusive or exclusive of tax etc. Providing the discount rate used is consistent with the financial assumptions in the cash flows the valuation result should not be affected by the alternative used.

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?

We agree that a discount rate used should be consistent with the financial assumptions made in calculating the cash flows which is in turn driven by the specific purpose of the valuation. We support this requirement be highlighted in the TIP as it is an important factor in arriving an accurate information as long as the assumptions are transparent to the users.

Question 6

This Exposure Draft is intended to identify best practice in the creation and application of discounted cash flow models. The Board has made the decision not to explain in detail the types of inputs that may be used in different situations or the investigations that may be appropriate. Neither are illustrative examples provided. The preliminary view of the Board is that detailed discussion of inputs or a limited range of examples is inappropriate because it could be misleading if it led readers to believe that these models were endorsed by IVSC or conversely, variations of these models in different situations were not appropriate. There are many industry specific sources for those who require training in the development and use of relevant DCF models.

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?

We agree with the principles-based approach adopt in the proposed guidance. In our view, the purpose of valuation guidance is to provide the underlying principles that should be considered in undertaking a valuation, rather than to stipulate a specific technique. We support the view that it is not the role of the IVSC guidance to expressly identify particular approaches that would be acceptable or unacceptable. However, we are aware that more practical implementation guidance would be welcomed by emerging economies in Asia as entities in those economies might find it difficult to apply the principles in practice due to the immaturity of the market. We encourage the IVSC to work closely with local valuation standard setters such as The Royal Institution of Certified Surveyors (RICS) in the UK and the Hong Kong Institute of Surveyors (HKIS) in Hong Kong in developing local practical guidance on real property and business valuations so as to ensure it is consistent with the underlying principles in the TIP when addressing specific legal and market conditions of different jurisdictions.

~ End ~