

Supplement 1

to

“An Australian Standard for Valuing Commercial Forests”

Version 1, May 2004

The Association of Consulting Foresters of Australia standard “An Australian Standard for Valuing Commercial Forests” was the outcome of a lengthy drafting process. The Association has long recognised that amendments will be required from time to time and has always planned to release revised versions as appropriate.

However when a subject changes rapidly it may not be sensible to release a complete revision in a timely manner, and in these circumstances it is believed that a supplement is a more appropriate update mechanism. This is the first such Supplement.

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Comments are invited, preferably as marked amendments to paper copies, rather than as electronic revisions. They should be sent to The Secretary, Association of Consulting Foresters of Australia, PO Box 4263, Kingston, ACT, 2604.

Association of Consulting Foresters of Australia

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INTRODUCTION

In May 2004 the Association of Consulting Foresters of Australia (ACFA) released Version 1 of “An Australian Standard for Valuing Commercial Forests (abbreviated to “May 2004 ACFA standard” in subsequent references). This was made available on the web site:

<http://www.australianconsultingforesters.org>

This standard had been widely discussed with interested parties and especially with staff of the Australian Accounting Standards Board (AASB). With this first publicly released forest valuation standard it was anticipated that changes would be necessary within a relatively short period.

In July 2004 the Australian accounting standard AASB 141 “Agriculture” was released based on International Standard IAS 41. This is applicable to annual reporting periods beginning on or after 1 January 2005. The timing suggests that organisations may need to consider the effects of this standard in the preceding accounting period in order to be able to determine any changes in forest valuation by creating an opening balance sheet at the date of transition to Australian equivalents to International Financial Reporting Standards (IFRSs). AASB 1 “First-time Adoption of Australian Equivalents to International Financial Reporting Standards” defines this as “*the beginning or the earliest annual reporting period for which an entity presents full information under Australian equivalents to IFRSs as comparative information in its first Australian equivalents to IFRSs financial report.*” AASB 1047 “Disclosing the Impacts of Adopting Australian Equivalents to International Financial Reporting Standards”, which is applicable for interim and annual reporting periods ending on or after 30 June 2004, requires entities to disclose a narrative explanation of the key differences in accounting policies that are expected to arise from adopting Australian equivalents to IFRSs (for 30 June 2004 and later financial reports) or any known or reliably estimable information (if available) about the impacts on the financial report had it been prepared using the Australian equivalents to IFRSs (for 30 June 2005 and later financial reports).

Consideration of IAS 41 and AASB 141 has led to some interpretational difficulties. These issues are currently under review by IFRIC (the International Financial Reporting Interpretations Committee) who are understood to be considering proposing amendments to IAS 41. Any changes to that standard would only be incorporated into AASB 141 after due process has been undertaken. Therefore AASB staff were unable to suggest appropriate changes to the ACFA standard with any certainty that they would not be superseded within a relatively short space of time.

Due to the timing urgency, the Forest Valuation Committee of ACFA decided to recommend to the Association and its Executive that a Supplement be issued to the standard with clauses to override or add to the existing standard. These clauses are to be considered part of the standard and to be considered the Association’s interpretation as at the date of issue.

The release of the May 2004 version also led to some clarifications of other subjects that were considered desirable.

This document includes four supplemental clauses that are to be considered together with Version 1 of “An Australian Standard for Valuing Commercial Forests” dated May 2004. They are extensions and interpretations of the ACFA standard. No clauses in the May 2004 ACFA standard are to be deleted or modified. Then a section follows discussing aspects of the interpretation of AASB 141.

ACFA is especially grateful for the assistance of AASB staff in the preparation of this Supplement.

SUPPLEMENTAL CLAUSES

Four supplemental clauses have been approved by the Association of Consulting Foresters of Australia.

S1.1 AASB 141 “Agriculture”

The Australian Accounting Standards Board has decided to adopt the International Accounting Standards as the basis for Australian accounting standards. The new standard AASB 141 “Agriculture” adopts international standard IAS 41 “Agriculture” with some paragraphs added that specifically relate to Australian circumstances. Other standards have also been released that affect financial reporting under the Australian accounting standards. AASB 141 has a number of provisions that specifically relate to forestry and forest valuation.

The Association of Consulting Foresters of Australia notes that entities that do not have to report under the Corporations Act may not be required to adhere to AASB standards although they may choose to do so as a matter of good practice.

The ACFA Forest Valuation Committee noted that the new standard is to become mandatory for reporting periods after 1 January 2005. It supersedes AASB 1037 (and AAS 35) that was the basis for the May 2004 ACFA standard.

ACFA holds that the primary objective of a forest valuation is to determine fair value or Net Market Value (NMV), in essence the value of the forest in the market place. This was the basis for the May 2004 ACFA standard. AASB 141 holds the same primary objective but is restricted to valuing the tree component.

AASB 141 and other relevant standards were carefully considered in mid 2004. ACFA is mindful of the discussions believed to be ongoing internationally, but believes that there are at present no cogent reasons to recommend changes to underlying forest valuation methodologies.

Until a more definitive interpretation can be made of the AASB 141 standard and other AASB standards it is recommended that the methodologies detailed in the May 2004 ACFA standard be accepted as an appropriate interpretation of AASB 141.

It is recognised that other interpretations may be possible.

S1.2 Pre-post tax issues

AASB 141 is quite specific in requiring that a “*current market-determined pre-tax rate be used*” in determining the present value in an expected cash flow analysis (paragraph AASB 141.20).

The ACFA forest valuation standard states in clause 6.3.8 “After-tax basis” that although some practitioners use a pre-tax basis an after-tax rate will provide a better indicator of Net Market Value (NMV). AASB 1037 was not definitive in this area. If the appropriate pre-and post-tax discount rates are used then the two valuations should, in general, be equivalent. However if a linear programming run is used to optimise wood flows at a particular discount rate, for example, then the position becomes more equivocal.

ACFA notes that some organisations are believed to determine the discount rate to be applied, calculate the forest valuation, and to then adjust for the taxation effects. The selected rate may really be a post-tax rather than a pre-tax rate.

This matter has been discussed with AASB staff who are of the view that AASB 141 should be consistent with other accounting standards by referring to an ‘appropriate’ taxation rate rather than be so definitive. ACFA concurs with this view.

In essence the taxation considerations should match those used to determine the value in the market, or fair value.

The Association of Consulting Foresters of Australia recommends that any forest valuation report explicitly address this issue, explaining what has been done, and gives reasons why.

S1.3 Carbon credits

Clause 6.2.5 “Carbon Credits” of the May 2004 ACFA standard states that Carbon Credits have not yet become established market commodities and notes that they are not specifically identified in the AASB 1037 standard. In the section in AASB 141 on incompatibilities between AASB 1037 and AASB141 it is noted that AASB 141 is narrower in focus and specifically excludes an *“investment in a forest as a carbon sink which gives rise to carbon credits that can either be sold or used to offset pollution caused by the entity”*.

The Association of Consulting Foresters of Australia believes that forests will generally not be established solely as a vehicle for carbon credits, and that it is therefore necessary to separate out the carbon credit component and treat it separately in the financial reports. Presumably, carbon credits could be valued by the market and can be accounted for as a financial instrument.

Until a more definitive interpretation can be made it is recommended that the forest be valued as though there is no Carbon Credit value in order to determine the change in gross value of the biological asset, and that this be adjusted by the change in value of the Carbon Credits for the entity over the same period.

S1.4 Planning horizon

A specific consideration of clause 6.3.5 “Planning horizon for NPV determination” in the ACFA forest valuation standard was raised and an interpretation requested. If land is leased for say 25 years and the silviculture planned is two crops of 10-12 years with the second rotation likely to be re-established via coppice not planting, then what should the planning horizon be?

As coppice can be considered natural regeneration, the SGARA can be considered as the first planted crop plus the second coppice crop. The analysis could be for the two crops. When a valuation occurs during the first 12 years the valuation takes into account the best estimate at that time as to how the crop for the second half of the lease will be re-established. Given that the lease is for 25 years the accepted planning horizon for the whole forest investment is 25 years not 12, and this would seem the more appropriate planning horizon.

Whether the second crop is established by planting or coppice the two standing forest crops are likely to be of similar value and comparative valuations should be consistent and use consistent planning horizons.

ACFA believes that the primary objective of the forest valuation is to determine fair value less estimated point-of-sale costs (AASB 141) or Net Market Value (NMV) (AASB 1037). In this case ACFA interpret the accounting standards as allowing the planning horizon to be 25 years regardless of how the second crop is to be established. This would correspond to the most likely determination of fair value of the entity in the market place.

AASB staff are of the view that this interim interpretation appears reasonable, noting it would then be necessary to separate land and other non-biological assets from biological assets.

DISCUSSION AND INTERPRETATION OF AASB 141

This section discusses AASB 141 and how the Association of Consulting Foresters of Australia currently interpret its provisions. Because changes are expected to the international standard on which AASB 141 is based it is not possible for ACFA to be too definitive in interpreting the standard at this time.

In mid 2004 the implementation of AASB 141 appeared to the ACFA to raise some issues that were difficult to resolve.

AASB 141 is directly based on the international standard IAS 41 and includes additional Australian requirements as "Aus" paragraphs. A section on the differences between AASB 141 and AASB 1037 (and effectively AAS 35) is contained in AASB 141. The section notes the incompatibilities between the two standards, areas where AASB 1037 (and effectively AAS 35) is more detailed or restrictive, and areas where AASB 141 disclosures are more extensive.

Discussions were commenced with AASB staff in order to determine how various issues might be interpreted. AASB staff noted that the International Financial Reporting Interpretations Committee (IFRIC) was considering proposing amendments to IAS 41 and that any changes to that standard could be incorporated into AASB 141 only after due process has been undertaken. The comments in this section must therefore be considered an interim interpretation only. Other interpretations are believed possible.

The section in AASB 141 noting the inconsistencies between AASB 141 and AASB 1037 (and effectively AAS 35) does not identify the following paragraphs in AASB 141 (directly taken from IAS 41) as being inconsistent. It should be noted that the analysis of differences in the Standard should not be taken as necessarily providing an exhaustive list of differences. The bolding has been added to assist the discussion, it does not appear in the AASB standard.

21. *The objective of a calculation of the present value of expected net cash flows is to determine the fair value of a biological asset in its **present location and condition**. An entity considers this in determining an appropriate discount rate to be used and in estimating expected net cash flows. The present condition of a biological asset **excludes any increases in value from additional biological transformation and future activities of the entity, such as those related to enhancing the future biological transformation, harvesting, and selling.***
22. *An entity does not include any cash flows for financing the assets, taxation, or **re-establishing the biological assets** after harvest (for example, the cost of replanting trees in a plantation forest after harvest).*
23. *In agreeing an arm's length transaction price, knowledgeable, willing buyers and sellers consider the possibility of variations in cash flows. It follows that fair value reflects the possibility of such variations. Accordingly, an entity incorporates expectations about possible variations in cash flows into either the expected cash flows, or the discount rate, or some combination of the two. In determining a discount rate, an entity uses assumptions consistent with those used in estimating the expected cash flows, to avoid the effect of some assumptions being double-counted or ignored."*

In 5. Agriculture-Related Definitions:

"Biological transformation comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset."

For more detail about other paragraphs consult Standard AASB141 or IAS 41.

Future growth

On first glance it appears that AASB 141 is incompatible with AASB 1037 and AAS 35 in that AASB 141 appears not to permit the value from future biological transformation (ie growth) to be reflected in determining the fair market value of a biological asset.

The wording in paragraph AASB 141.21 appears to be quite clear and unequivocal. Any discounted cash flow is to exclude any increases resulting from **additional** transformation and future activities such as those related to enhancing the future biological transformation. The paragraph seems though to make a distinction between what can be thought of as 'growth' and the 'potential for future growth'. Ignoring future silvicultural practices such as pruning or fertiliser application which affect future harvested yields would mean that the valuation does not match practice, does not match the methodologies used in the market place, and certainly makes little practical sense.

The issue of whether to include or exclude future growth, or the potential for future growth, in the valuation of a biological asset was brought to the attention of IFRIC. In December 2003 they started considering this issue. AASB staff have indicated that they believe that IFRIC intends clarifying the meaning of fair value in the context of the required exclusion in IAS 41 of 'any increases in value from additional biological transformation'.

IFRIC is reported to have considered these issues in May 2004 and to have agreed to recommend to the IASB that the IASB should take action as follows.

- Amend IAS 41 to clarify which value in which market would be relevant to establish fair value, emphasising that the asset held must be the focal point.
- Establish a fair value hierarchy in IAS 41 that is consistent with other standards.
- Clarify that when fair value is determined by using valuation techniques an entity should incorporate assumptions that market participants would use on the basis of facts or information known or knowable at the measurement date unless impracticable.
- Retain the requirements that a recognised value of a biological asset should reflect the assets present condition and location, that is the asset should be measured at its fair value less transport costs and other costs of getting the asset to market and less other costs to sell.
- Conform the terminology in IAS 41 to other Standards.

It is expected that IFRIC (and the IASB) will further consider the issue and will release an Exposure Draft for comment. It is likely that the AASB will also then release an Exposure Draft and report back to the IASB and the IFRIC on the issues.

In the meantime, an arguable interpretation of paragraph 21 is that although it excludes future growth (because that is a future event) it does not exclude the potential for future growth (because that is currently controlled by the entity). AASB staff have expressed the view that this interpretation is reasonable.

Discounted cash flows

Paragraph AASB 141.22 could be interpreted as not allowing cash flows related to re-establishment to be used in any valuation model. However, as noted in section 6.3.5 "Planning horizon for NPV determination" of the May 2004 ACFA standard, if valuing trees and land as a composite asset in perpetuity, the cost of replanting would be taken into account. Paragraph AASB 141.25 allows the fair value of biological assets to be determined by deducting the value of land from the composite asset.

When deriving biological assets separately from land, it is the present biological asset that is being valued. Whether re-establishment is 'home grown from existing biological assets' (for example coppice or natural regeneration) or 'acquired' (for example planted from externally raised stock) could affect the measurement of the biological asset separately from the non-biological assets. The value from 'home grown from existing biological assets' is a value attributable to existing biological assets. The value from 'acquired' is a value attributable to future biological assets. To comply with AASB 141 it would be necessary to ensure that the latter is reflected in the land value, not the biological value.

If land is at its highest and best use as a forest, then it is expected that adjacent vacant land would be valued consistently with the discounted cash flow that the land can generate in perpetuity from establishment as a forest. Therefore the value of land at highest and best use implies that the management style adopted in a forest would be used as a basis for valuing the vacant land (or at least it should be implicit in that value). In practice the use of market value is appropriate and it is reasonable to assume that it reflects highest and best use.

IFRIC Agriculture project

At mid 2004, the IFRIC was believed to be considering how to account for an obligation to replant or re-establish a biological asset after harvest. To date IFRIC have tentatively concluded that when an entity has an obligation to re-establish a biological asset after harvest, that obligation is attached to the land and thus does not affect the fair value of the biological assets currently growing on the land. This treatment is consistent with IAS 16 (AASB 116 "Property, Plant and Equipment") which requires restoration costs to be included in the value of property, plant and equipment to the extent that it has been recorded as a liability in accordance with IAS 37 (AASB 137 "Provisions, Contingent Liabilities and Contingent Assets"). The recognition of the obligation to replant or re-establish a biological asset as part of the fair value of land is also consistent with the concept of including the value of future growth in the land value when deriving the value of the biological asset as part of a composite asset. IFRIC has also tentatively concluded to date that the harvest is the triggering event, that is if an entity does not harvest there is no present liability. Therefore, an entity should recognise a liability to replant at harvest only.

At that stage too the IFRIC observed that, in some instances, an entity may have an obligation to replant a biological asset but the entity will not always have ownership of the new biological asset created by replanting (and therefore not be able to benefit from the replanting). This could, for example, be the case in some leases of land. IFRIC noted that such an obligation would be similar to other hand-back obligations included in leasing agreements, the accounting for which should be determined by the leasing standard and general requirements for liabilities. IFRIC therefore agreed not to consider this issue as part of its agriculture project.

ACFA has been informally advised of a forest valuation that included the cost to make the site good for agriculture at the end of one rotation even though there was a legal requirement to replant the forest. This would seem to be illogical and ACFA would suggest that the situation needs to be clarified.

The various observations by the IFRIC would seem to ACFA to be more simply resolved by valuing trees and land as a composite asset in perpetuity as noted in section 6.3.5 "Planning horizon for NPV determination" of the May 2004 ACFA standard, and then accounting for changes in the land value. Paragraph AASB 141.25 suggests this composite approach.

25. *Biological assets are often physically attached to land (for example, trees in a plantation forest). There may be no separate market for biological assets*

that are attached to the land but an active market may exist for the combined assets, that is, for the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to determine fair value for the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

The Association of Consulting Foresters of Australia suggests that an organisation may need to consider whether it has an 'obligation' to replant in the sense that IFRIC seem to imply and whether the 'obligation' to replant in order to meet long term wood supply contracts is, or is not, equivalent.

Fair value presumption

Paragraph AASB 141.30 states that *"there is a presumption that fair value can be measured reliably for a biological asset"* (see also the summary quoted earlier for IAS 41) but allows that to be rebutted if *"market determined prices or values are not available"*. The interpretation of paragraphs 30 and 31 implies that if the presumption can be rebutted then a cost based methodology should be used.

AASB staff noted that the requirements in AASB 1 "First-time Adoption of Australian Equivalents to International Financial Reporting Standards" should be carefully considered as they specifically affect the application of Paragraph AASB 141.30. AASB 1 contains Implementation Guidance (Paragraph AIG 62.2) to the effect that an entity recognising a SGARA in full under AASB 1037 / AAS 35 must continue to recognise the asset at fair value less estimated point-of-sale costs under AASB 141 (that is, the rebuttable presumption in AASB 141.30 cannot be applied). AASB 1037.5.1 / AAS 35.5.1 requires a SGARA to be recognised when, and only when;

- it is probable that the future economic benefits embodied in the SGARA will eventuate, and,
- the SGARA possesses a value that can be measured reliably.

Accordingly, the only circumstances in which the rebuttable presumption would seem to be able to be applied are as follows;

- when an entity did not previously recognise a SGARA under AASB 1037 / AAS 35 because it did not possess a relevant and reliable value, and,
- when newly-acquired biological assets have not previously been accounted for under AASB 1037 / AAS 35.

However, this could only be justified when the newly acquired biological assets are of a different type from other biological assets measured at fair value less estimated point-of-sale costs. This is because, before an entity rebuts the reliable measurement presumption, it must determine whether other entities with the same type of biological asset can establish a reliable measurement and therefore should recognise the asset at its fair value less estimated point of sale costs.

Paragraph AASB 141.32 notes that:

"in all cases, an entity measures agricultural produce at the point of harvest at its fair value less estimated point-of-sale costs. This Standard reflects the view that fair value of agricultural produce at the point of harvest can always be measured reliably".

ACFA suggests that volumes and unit values in 20-50 years time cannot be 'measured' let alone measured reliably. Future expected volumes are estimated as precisely as possible, but the longer the projection, the poorer the reliability of the predictions. Past trends in, for example, export sawlog prices are difficult enough to model and future trends are, at best, estimates, although sensible assumptions about price trends can be made and can be justified. It is suggested that a net present value approach will

commonly provide estimates of forest value that are more closely akin to fair value, or value in the market place, than a cost based approach.

It is relevant to summarise the discussion in terms of the five bases of forest valuation as described in the May 2004 ACFA standard.

The obvious thread through all the accounting standards and almost all aspects of forest valuation is the desire to measure fair value or Net Market Value (NMV), in essence the value that willing buyers and willing sellers would place on a forest entity.

Transaction based approach

This is the preferred approach. However it tends to fail in practice for forest valuation in the Australian market for a number of reasons including the following.

- The market is illiquid.
- Forests are heterogeneous and two forests are almost never directly comparable.
- Taxation implications affect NMV, and different organisations may have different taxation implications leading to different valuations, although most organisations reporting under AASB 141 should be somewhat similar in this regard.

A major difficulty with the transaction based approach is that there is generally a lack of publicly available information to assess any transaction, even if the transfer price is disclosed, so that all the various component effects can rarely be ascertained.

In essence this highly desirable approach is generally impractical for forest valuation. Known transactions should be taken into consideration in determining forest value, but transactions alone can never be used in the valuation of large forest entities in practice.

Members of the Australian Property Institute would seem to rely almost solely on a transaction based approach. However they are rarely involved with the sale of a large forest entity and then generally only in terms of the land base not the forest.

This would all seem to be sufficient argument to reject a pure transaction based approach, and to consider other approaches.

However fair value is really the expected transaction value and if transaction information is available then it will generally provide useful bounds that a forest valuer can justify and use.

Cost based approach

Costs may provide a base for determining value for example for insurance purposes, or for very young forests, but they do not provide a valid base for determining a possible transaction price.

A high cost forest does not necessarily imply a high value forest and a low cost forest does not imply a low value forest, in fact commonly the opposite is true. Establishment costs are a function of soil physical characteristics, terrain, location relative to base, current vegetation, and the necessity for silvicultural treatments such as weedicide. Value is a function of site productivity, soil nutrient levels, location relative to markets, and growth rates. Inflating costs does not necessarily inflate value. Cost and value are only loosely related.

A cost based approach would rarely, if ever, provide the expected transaction value in a liquid market.

The argument against the use of a pure cost based approach to determine NMV is compelling.

The earlier discussion on AASB 1 and AASB 141 should also be considered.

Liquidation based value

Immediate liquidation value assumes that all the forest can be liquidated or sold at the point of valuation. It provides a useful value if the forest estate is mature and if it can be harvested and it is used in those circumstances. The approach fails for a large forest because the size of the forest estate generally means that it cannot reasonably be expected to be immediately harvested without severely affecting unit prices. Also, the approach generally ascribes young plantation stands a zero value when they are further advanced and closer to harvest than any younger plantation that has just been established, and thus are more valuable to a potential purchaser.

Liquidation value would seem to meet the point of paragraph AASB 141.32 in that the price at the valuation point can be measured reliably, but in fact cannot be considered appropriate for anything other than reasonably small areas of forest and only then when they are approaching maturity. It would seem to be inappropriate for any entity reporting under the Corporations Act and using AASB 141.

Net Present Value approach

Historically, net present value methods have been used in forest valuation to determine the price that a seller may deem a minimum price or a buyer a maximum price. In valuing forests as ongoing entities the most common approaches have almost always been based on variants of Faustmann's 1849 methodology.

For a single stand it is sensible to discount the expected costs and returns to provide a value. For an ongoing forest entity it makes sense to value the land and trees combined in perpetuity and then to deduct the land (or any other non-biological asset) component to derive a value attributable to the trees. Wood flow considerations mean that stands cannot be considered separately but have to be considered together as a forest.

The May 2004 ACFA standard paragraph 6.3.5 "Planning horizon for NPV determination" was prepared after discussions with AASB staff. The phrasing recognises the concern that optimising a forest is not the same as optimising each stand in that forest. It therefore makes sense in valuing large ongoing forest estates to set one planning horizon for the whole forest rather than vary it for each stand. It is suggested that for these forests the fair value or NMV of the SGARA restricted by definition to the current rotation, may best be valued using NPV over an infinite planning horizon and adjusting for land effects.

NPV remains the most commonly used, and seemingly most appropriate, methodology for determining fair value. NPV does provide estimates of expected transaction value, in essence of fair value.

Option based approach

The option based approach has not been widely used in forestry, is not mentioned in any of the accounting standards, and is an extension of the NPV approach.

Moving forward

In the recent past AASB 1037 (and AAS 35) were interpreted as implying that if all current stands were discounted for the current crop, a NPV would be obtained that was considered an appropriate proxy for NMV or fair value.

The May 2004 ACFA standard allows this as an option while suggesting that the NMV may also be approximated by calculating NPV over infinite rotations and adjusting for land effects. At that time this was considered a reasonable approach by AASB staff.

AASB 141 is more difficult to interpret.

It is hoped that a practical interpretation of AASB 141 can be achieved, perhaps based on the generalised comment taken from AASB 141.20.

“In some circumstances, market-determined prices or values may not be available for a biological asset in its present condition. In these circumstances, an entity uses the present value of expected net cash flows from the asset discounted at a current market determined pre-tax rate in determining fair value.”

This would seem to fit with the methodology defined in the May 2004 ACFA standard, and would enable the forest value as used to determine the annual change to be accounted for in the financial reports to closely approximate fair value or Net Market Value as considered likely to pertain in the market place.