ALL PRICE NO VALUE?

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New valuation standard under development within the IASB - how can this affect the real estate appraisal process?

The International Accounting Standards Board (IASB) published its draft new valuation standard - Exposure Draft Fair Value Measurement, below referred to as ED, shortly before summer 2009. The idea is that this standard should be applied across all the IFRS accounting rules that require or permit assets or liabilities to be measured at fair value (market value). In the article below, Bo Nordlund from KPMG develops the ideas from an asset-/property valuation perspective.

The ED, which is expected to be a new standard in the third quarter of 2010, contains proposals for new rules likely to affect real estate appraisers in different ways. It may also be noted that this standard over time will become law if adopted. Other valuation standards as real estate appraisers often refer to, for example, RICS Red Book or the International Valuation Standards are to be seen as recommendations without 'enforcement power' which gives a certain difference in significance between the coming IFRS and the other measurement standards.

The definition of fair value

The ED now shows that the fair value is an '*exit price*', i.e. what you could sell the asset for on the market. It also clarifies that there is a conceptual distinction

EPRA Comment:

The fact that the IASB is venturing further into the valuation arena, gives rise to some interesting questions around what happens when the work of the professional valuation community meets the accounting regulators. Valuation standards like those developed by the IVSC, provide generally accepted principles and concepts to guide the work of the valuer whereas IFRS provides the principal driver for valuation. However, where the IFRS requirements stop and the valuer starts is a difficult and perhaps controversial discussion.

This is further complicated by the obvious differences in various region's familiarity with the valuation concepts and the maturity of the valuation profession. In countries such as UK and Australia, where there is a long tradition of valuation in financial statements (and appraiser's liaising with national accounting standard setters), there is naturally some concern that the IFRS are moving too far into the valuer's domain.

between what a company buys an asset for, the '*entry price*', and what you can sell the asset for, the 'exit price'. Certainly in many situations the 'exit price' and 'entry price' are likely to be quite similar to the amount, but it is quite clear that the standard focuses on the fair value to be seen as an 'exit price'. This also leads to the conclusion that it is likely to be more difficult to argue that what is paid for an asset, such as a building, will also serve well as an approximation of the asset's fair value after the time when the asset is initially recognised in the purchasing company's accounts. Especially in inactive markets with hardly any observable market prices this issue could be highly significant.

The fair value in accordance with the ED is also to be assessed on the basis of an assumption on the asset's "highest and best use". In other words, if there would be a real option associated with the property, such as a construction right, and it is likely that this option has value to the market, the value of this option shall be included in the estimated fair value.

As with IAS 40, the fair value is assessed based on how hypothetical actors behave when pricing an asset on the market. That is, the current holder of a particular property may well argue that the property is worth more than what is possible to get paid on the market in a given situation. In such a situation what the current owner thinks the value should be is ignored. The exit price is primarily not from the seller point-of-view. Furthermore, the fair value shall not be adjusted for transaction costs.

Valuation methods

The ED states that different types of valuation methods can be applied. Those are based on 'market approach' (such as comparable sales method), 'income approach' (such as discounted cash flow method) or the 'cost approach' to assess the fair value. So far, nothing is new. A novelty in relation to *IAS 40 - Investment property*, however, is that the *ED does not give preference for any particular valuation method*, but instead focuses on the type of inputs you have access to as inputs in the selected valuation model.

Inputs in the valuation models and the fair value hierarchy

IAS 40 contains a fair value hierarchy which, in brief, indicates that the comparable sales method is the best way to assess the fair value of an investment property. The proposal in the ED, however, is that the sections of IAS 40 containing guidance on how the property valuation should be done, are now deleted from IAS 40 and instead, a reference to the new standard - *Fair Value Measurement* is added in IAS 40.

Regarding the fair value hierarchy, the ED turns to the basis of the inputs you have access to in the valuation models. These inputs will be divided into different levels which are dependent on the quality of inputs. In other words, the ED gives no preference for certain methods over others. It also clarifies that the inputs can be divided into observable and unobservable inputs; and that a company is to *maximise the relevant observable inputs* in the valuation and *minimise unobservable inputs*.

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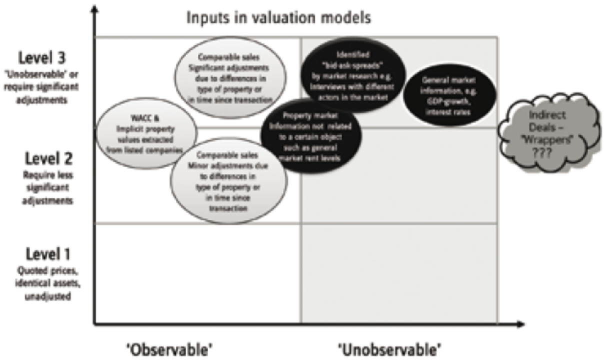
The new hierarchy is summarised below:

Level 1 = Inputs require no adjustments (for example, if the valuation object is a share in the listed company, it can be monitored on the stock exchange. It can be observed what exactly the same instrument is worth on the market).

Level 2 = Inputs which are directly or indirectly observable from the market and require different degrees of adjustments (e.g. comparable objects sold in the property market, close in time in relation to the value date and sold objects whose other characteristics[1] are not significantly different from the valuation object).

Level 3 = Unobservable inputs. This group may also include input from the market that requires significant adjustments. Examples of the latter might be comparable

1 For instance, site, rental income level, vacancy level, technical condition etc.



'Fair value hierachy' in a property valuation context. Example of principle-based reasoning (may be different from time-to-time

objects sold on the property market which occurred further back in time or when the sold objects' other characteristics differ significantly from the valuation object.

Level 2 and level 3 should be the dominant levels from which to retrieve input in a property valuation context under normal market conditions. In high liquidity property market conditions, level 2 may be the dominant source of information. In the market conditions today, likely level 3 inputs will be dominant. In this context it is interesting to note that the ED under the heading "Level 2 inputs" for example addresses that inputs in this hierarchy-level can be information derived in different ways from observable market data. For instance, maybe a relationship can be demonstrated by a correlation.

In the past year, it has been discussed whether, in real estate valuation, one may (or even should) draw conclusions on the underlying real estate values from the fact that the share prices of listed property companies had fallen considerably in the last two years. As many studies show a sizeable positive correlation[2] between the value of listed property shares and underlying real estate assets in the longer term, this indicates that one cannot just ignore such observable inputs for the benefit of unobservable input in property valuation. If this is done, it may have to be justified. Such unobservable inputs (level 3) may include the negotiated price levels in transactions that never happened. Of course, important in this context, the valuer also needs to estimate the time lag between pricing listed real estate shares on the stock exchange and pricing regarding the underlying assets in the direct real estate market.

The graphic above contains an attempt to illustrate various possible sources of information that can provide input in a valuation model for properties based on the above reasoning, where it can also be found that the so-called Level 1 inputs are normally lacking in these types of valuations:

As illustrated above, an interesting question is where to place indirect deals ('wrappers') in this fair value hierarchy. Maybe some of these deals could be classified as observable in level 2, if publicly known. Otherwise, those transactions should probably be classified as level 3 inputs. To be classified a level 2 input, the seller and buyer will probably need to be willing to allow transparency connected to the transaction, such as underlying real estate values, net rental income levels, estimated deferred tax value in the traded company holding the real estate etc.

Disclosure requirements on the valuation in the financial statements

The ED states (like IAS 40) that the company preparing the financial statements should, for instance, provide information on the valuation methods and inputs used in the assessment of fair values. Further, the ED also states that the company should disclose the information used to develop these inputs.

In my opinion, it is not sufficient to write, for instance, that "for some time there have been few real estate transactions; buyers and sellers are often far apart in negotiations", and then round off with the assessment that the yield-demand in the market increased by 0.5%. What is interesting here is to finalise the discussion and inform on how, despite the scant information on the transaction market for real estate, the company came to the conclusion of 0.5%.

From where was the information gathered leading to this percentage level? For instance, the valuer may have performed extended market research e.g. interviews including bankers, sellers, buyers and transaction firms to find a bid-ask-spread. In turn a hypothetical transaction may have been judged to take place within such a spread. If this is the case, it may be necessary to disclose information connected to such research.

Companies must also disclose where in the valuation hierarchy inputs - levels 1, 2 and 3 - to the valuations have been taken. The supplement to the ED with 'illustrative examples' also gives the impression that you should detail how amounts of assessed values are based on Level 2 inputs and amounts based on level 3 inputs. For the items valued with Level 3 inputs, extra disclosures are required such as a sensitivity analysis.

Another interesting observation from the review of the ED indicates that companies should disclose information on the situation when the "highest and best use" differs from the current use of an asset. In such cases, the requirement is to disclose the value generated by the current use and the amount that distinguishes this value from the value resulting from a "highest and best use". It is also proposed that the company, in such cases, should disclose the reasons why they use the asset in a different way than "highest and best use".

The supplement with an 'illustrative example' attached to the ED also gives the impression that real estate appraisers are expected to split the total fair value of a property between land and buildings.

Concluding remarks

The discussion above suggests that the proposed new accounting rules relating to fair value may very well affect the real estate appraiser's work in different ways. Examples of impacts are the balance between observable and unobservable inputs in valuation models, and also the proposal on disclosure requirements. In the case of disclosure requirements, I am among other things, referring to the disclosure requirement on how different inputs to valuation models are gathered; also to the division of fair values between buildings and land, and if there are differences between the fair value of the "highest and best use" and the value generated in current use.

The ED is now under re-deliberation and it cannot be excluded that there will be changes from the current wording in a final version, which will then be adopted as a standard. However, one should keep in mind that the US has already adopted a standard, SFAS 157 - Fair Value Measurement, which largely contains the same basic approach that appears in this ED. A not too daring guess is that one should not expect too many revolutionary changes in the final standard relating to Fair Value Measurement adopted by the IASB.

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2: See for instance Morgan Stanley research presented in EPRA News - March 2009 and Deutsche Bank report RREEF Research - Global Real Estate Securities - January 2007, Cohen&Steers research presented in EPRA Press release April 20 2009. Furthermore, an EPRA study by Schätz, A and Sebastian, S, presented in IPE Magazine - December 2009, concludes that the real estate equity markets are predominantly driven by the progress of the underlying properties.

EPRA Comment:

EPRA supports the Board's effort in trying to establish a framework for measuring and disclosing fair value on a consistent basis to all assets, liabilities and equity instruments. The ED establishes a single definition for fair value as well as a single source of generic guidance for fair value measurement which we believe should form the basis for fair value guidance throughout IFRS and will shine light on some of the issues that have been troubling valuers and auditors. However, we have some concerns with moving to a single source of generic guidance as being proposed by the ED.

Our primary concern is that the fair value measurement framework should not necessarily eliminate fair value guidance currently within IAS 40 that may continue to be relevant and useful while remaining consistent with the principles of the framework. In the decade since IAS 40 has been put in place, preparers, valuers, auditors and users have found that the guidance in IAS 40, combined with IVS guidance (followed by the vast majority of valuation professionals) has worked well. Removing this in favour of the more generic guidance contained in the ED could create further uncertainty.