TEGoVA
THE EUROPEAN GROUP OF VALUERS' ASSOCIATIONS

Information Paper 2/13

FAIR VALUE MEASUREMENT UNDER IFRS 13

FAIR VALUE HIERARCHY

1. Introduction –IFRS standards and Fair Value

Since 2005 consolidated accounts of listed companies domiciled in EU states must be prepared in conformity with IFRS financial reporting standards.

Fair value is relevant for the measurement and reporting of the value of property assets in accordance with the following two standards:

.

- IFRS 16 –Property, Plant and Equipment (particularly owner-occupied property used for the purposes of providing goods or services), and
- IFRS 40 – Investment Property.

Fair value is one of the two allowable accounting bases for real estate assets (along with cost accounting). Fair value is the preferred basis for investment properties. Even if reporting entities account for IFRS 16 properties on a cost basis, they are required to provide Fair Values in the annexes to their accounts and are required to review these values when they are considered to have changed significantly.

All EU listed companies therefore have to measure the Fair Value of their properties at various times for their consolidated accounts.

Fair Value was originally defined in IFRS 40, but questions of its measurement were dealt with in a number of the IFRS standards. A new standard, IFRS 13 "Fair Value Measurement", was introduced in May 2011 and is applicable for all accounts concerning periods starting 1st January 2013 or later. IFRS 13 introduces a number of new criteria for Fair Value measurement and reporting that are important to real estate valuers and will have an impact on the way they prepare their valuations and their valuation reports.

This subject has already been treated in some detail in EVS 2012 in EVS2, section 4 and in EVA1, section 6 and readers are referred to EVA1 for its treatment of it. The present paper is intended to discuss the more practical aspects of the valuer's role in Fair Value measurement and his reporting of the information that his client will require in order to comply with the standard's requirements.

At the time this paper was prepared (Q2 2013) few if any valuers had had practical experience of applying these new rules, as for many European companies the first accounts to which they applied would be those for the period ending 30th June 2013. As companies, their auditors and their valuers gain more experience in handling these new rules it is hoped that firmer recommendations can be given to valuers dealing with such valuations.

2 Scope

This Information Paper only applies to valuations in connection with the determination of Fair Value for IFRS financial reporting (for example, annual valuations for listed property companies). It has no application for the determination of Fair Value in the sense of the price to be set for a transaction between two known parties, nor for the assessment of Market Value.

3 Definition of Fair Value in IFRS 13

As stated in EVS 2, section 4 and EVA 1, section 6.5, IFRS 13 defines Fair Value as:

"The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".

EVS 2 and EVA 1 already compare Fair Value for IFRS accounting purposes with Market Value and it is not considered necessary to repeat that discussion here. In most cases Market Value

and Fair Value are interchangeable, although there may be cases, particularly involving properties with future development potential or hope value, where the two values are not the same.

It should be noted that, under the new definition, Fair Value is intended to be a sale price (or "exit price") in the open market. The standard makes it clear that Fair Value must be assessed from the point of view of actors in the market. If the reporting entity considers that the asset has an additional value to it for its particular needs, that additional value should not be included if actors in the market would not include it in their purchase price.

It should be noted that we are not concerned here with Fair Value in the second sense identified in EVS 2 (section 4.1. (i)), i.e. the value of a property in the case of a transaction between two particular identified parties.

4 Highest and best use

The concept of highest and best use is covered in section 5.4.6 and onwards of EVS 1 and readers are referred to that text for a more detailed discussion of the concept.

In essence, highest and best use is the use that is at the same time legally permissible, physically possible and economically feasible and that gives the best value for the property.

IFRS 13 requires the reporting entity (the valuer's client) to confirm that the property has been valued on the basis of its highest and best use. For the reporting entity to be able to make this statement, it will be necessary for the valuer to have stated in his report that he has valued the property on the basis of its highest and best use.

In most cases this is unlikely to pose any difficulties for the valuer, as many properties are already clearly in their highest and best use, particularly investment properties. In other cases it may be possible to envisage uses that could give a higher value, but if those uses do not pass the triple economic, physical and legal test referred to above then the property can also be considered to be in its highest and best use.

If the valuer has not valued the property on the basis of its highest and best use he should state this and should give the reasons why he did not do so. The reporting entity will then in turn include this information in its report.

5 Fair Value Hierarchy, Levels 1, 2 & 3

IFRS 13 deals at length with the notion of Fair Value hierarchy. The purpose of this notion is to allow readers of financial reports to understand the extent to which the reported value is based on readily observable evidence or, on the other hand, derived from other methods.

IFRS 13 states that "valuation techniques" (valuers might prefer the word "methods") "shall maximise the use of relevant **observable** inputs and minimise the use of **unobservable** inputs". "Unobservable inputs shall be used to the extent that relevant observable inputs are not available". (See below for the definitions of "observable" and 'unobservable").

It is important to note that the concept of Fair Value hierarchy in IFRS 13 applies to the **inputs** used or adopted in valuations, not to valuation methods. This is a change from the previous situation, where IAS 40 defined a hierarchy based on valuation techniques. The inputs are categorised in one of levels 1, 2 or 3, as follows:

- **Level 1** inputs are unadjusted quoted prices in active markets for items identical to the asset being measured.

- **Level 2** inputs are inputs other than quoted prices in active markets included within Level 1that are directly or indirectly observable.

- **Level 3** inputs are unobservable inputs. A reporting entity develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data, taking into account all information about market participant assumptions that is reasonably available.

Once the inputs have been categorised, the Fair Value measurement (i.e. the valuation) will finally be classified as level 1, 2 or 3 according to the classification of the inputs adopted, not on the basis of the method used. It should not be thought that the use of one method or another automatically leads to the valuation being categorised as level 1, 2 or 3 – the final classification will depend on the nature of the inputs used in each case.

If inputs are of different levels, the whole Fair Value measurement will be categorised at the lowest level input that is significant (3 is lowest). Thus a valuation that contains a significant input that is at level 3 will be classified as level 3.

It is important to stress that the classification of a value measurement as Level 3, rather than Level 2, for example, is not intended to suggest that the valuation on which it is based is of a lower or poorer quality. The distinction between Level 2 and Level 3 is intended to inform

readers of financial reports about the nature of the inputs used, rather than being in some way a measure of the quality of the valuation.

In a similar way, classification of a fair value measurement in Level 3 does not in any way imply that the asset is less liquid than others. Indeed, one can imagine that the valuations of certain very liquid assets might be at Level 3 because of a lack of evidence due to the fact that, as these assets have a high scarcity value they are rarely traded - their owners choose to hold them on a long term basis, rather than sell them.

6 "Observable" and "Unobservable" inputs

IFRS 13 contains the definitions of "Observable" and "Unobservable" inputs:

Observable inputs are "Inputs that are developed using market data, such as publicly available information about actual transactions…, that reflect the assumptions that market participants would use…".

Unobservable inputs are "Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use".

7 Adjustments to observed inputs

The standard states that an adjustment to a significant Level 2 input might result in categorisation of that input as Level 3 if the adjustment uses significant unobservable inputs.

This concept is particularly relevant to the valuation of real property assets, as will be seen below. Valuers should therefore pay particular attention to the concept of adjustments to observable inputs in deciding on the hierarchy level to be ascribed to an input.

8 Implications of value hierarchy for financial reporting requirements

Regardless of the hierarchy of the value measurements, a company has to include in its report a description of the valuation techniques used and the inputs used, as well as information regarding the changes made in valuation techniques and the reasons for making those changes.

However, if a measurement is classified as level 3, the report must cover a number of additional points, including:

- Quantitative information about the significant unobservable inputs used in the fair value measurement if reasonably available,
- Description of valuation processes, policies and procedures,
- Narrative description of the sensitivity of the fair value measurement to significant changes in unobservable inputs.

The valuer may therefore be asked to provide the information needed to enable his client to comply with these requirements. Having said this, valuers may consider that much of this information is already given in their reports.

9 Real property valuation and Fair Value Hierarchy

IFRS 13 was drafted in the aftermath of the sub-primes crisis and the subsequent collapse of Lehman Brothers and the document is clearly aimed more at the valuation of complex financial instruments than at the valuation of real property. Indeed, very few of the many examples stated in the Standard refer to real property situations, thus confirming that real property valuations were not the principal target of this initiative.

This creates difficulties for property valuers in applying the standard to their daily work. In particular, the concepts of “observable” and “unobservable” inputs lack clarity – one is tempted to ask “observable to whom?” If the observer is a novice in the market, much information may be unobservable to him. In contrast, if the observer is an experienced valuer with access to a lot of confidential information, a great deal more information could be considered as “observable” for him.

IFRS allows the use of three main types of method, “the market approach”, “the income approach” and “the cost approach”.

The market approach is essentially valuation by reference to sale prices achieved for similar properties, as is used widely for residential owner-occupier properties. In many markets, comparisons will be made on a floor area basis, in which case the valuer’s principal input would be a value per unit of floor area. Another common example would be the price per hectare for agricultural land.

The two main variants of the income approach in property valuation are generally capitalisation methods on the one hand and the discounted cash flow (DCF) method, on the other. Both methods involve inputs such as estimated market rental values and yields, as well as various deductions and allowances for non-recoverable expenditure, void periods, capital expenditure, etc. In addition, the DCF approach, as it seeks to make any assumptions explicit, will contain assumptions about future growth in rental values and, in some markets, future indexation of rents.

The cost approach requires the valuer to estimate or determine construction costs and other ancillary expenditure in the first instance, then estimate the value of the land on which the property stands. A depreciation factor is often applied to the estimated construction cost, in which case the depreciation factor is an input that will often be significant in the determination of the final value.

Valuers therefore use a wide variety of inputs, depending on the valuation method they adopt. Most of these inputs will be based on evidence obtained from the market, whether it is evidence of price, yield, cost, void periods, or whatever.

The quality and reliability of this evidence will vary according to the type of property and also from country to country, from city to city and even from sub-market to sub-market within a town or city.

In addition, in most markets the quantity of such evidence is comparatively limited, as the number of properties that are let or sold each year often represents only a modest percentage of the total stock of such properties. There will nevertheless be exceptions, such as sales of new properties on a sizeable estate of very similar ones.

The quantity, quality and reliability of the evidence will also vary according to where the valuation date falls in the market cycle. For example, a downward phase of the cycle often starts with a period of much reduced market activity in which few transactions take place and thus little evidence is available to the valuer. In addition, at some stages in the market cycle participants may be more or less inclined to share information about prices or rents achieved and this can once again affect the quantity, quality and reliability of the evidence available.

Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset being measured. Real estate assets are rarely identical to each other not least because no two assets occupy exactly the same physical space, which means that even two very similar houses may have different views or orientations. Similarly an office suite on the top floor of a building will often have less natural light and a poorer view than a similar-sized suite on a lower floor.

In most markets, prices achieved on sales or lettings of properties are rarely quoted and available to the general public. For all these reasons it is therefore considered most unlikely that level 1 measurements will arise in property valuation.

The valuer's choice will therefore most likely be between levels 2 and 3.

10 The choice of Level 2 or Level 3 for property valuation inputs

In virtually all cases the valuer will therefore be deciding whether an input he has used is to be classified as level 2 or level 3.

Adjustments to inputs. This occurs in the choice of ERVs and yields for the great majority of investment valuations, which are those most frequently concerned by IFRS 13.

IFRS 13 states that if an adjustment to a level 2 input is "significant", the input should be considered as thereafter falling in level 3. The word "significant" is not defined in the standard. The valuer will therefore have to judge himself what is significant. It is not possible to indicate a range of percentage adjustment that might be considered significant.

The appreciation of what is significant will vary according to the type of property and the quality and transparency of the market information that is available. Valuers generally have an idea of the degree of accuracy of the information they have at their disposal, and hence of the degree of accuracy of any value they produce. It is suggested that valuers could measure the significance or otherwise of any adjustment against the level of accuracy that they believe is implied in their value.

Taking account of the inherently unique nature of property assets and the limitations on evidence discussed above, valuers are very often required to adjust significant inputs. Some would even say that if no significant adjustments were required there would be no need for valuers!

It is therefore considered that in many cases Level 3 is the most likely conclusion for the main inputs used in the valuation of investment property (particularly ERVs and yields).

For an input to be level 2, sufficient good evidence of the required input must be available from identical or near-identical properties. In particular, this evidence must be sufficiently recent for it to be applied directly without any significant adjustment for the passage of time between the dates of those transactions and the valuation date of the subject property.

Even if the evidence comes from very recent transactions, the valuer will still have to be satisfied that the supply and demand situation remains unchanged between the date of the evidence and the valuation date of his subject property.

Examples of cases where Level 2 might nevertheless be possible could include:

- Sale prices of identical or very similar residential units,
- Rents of identical or very similar light industrial units on the same estate,
- Rents for suites let off on similar floors of the same office building.

11 The role of the valuer in determining Fair Value Hierarchy

Who will be responsible for identifying the hierarchy of the inputs? The valuer is the closest to the "measurement" (i.e. the valuation) and is in our view the best able to categorise the various inputs.

Valuers undertaking Fair Value valuations for the consolidated accounts of EU listed companies can therefore be expected to be asked to comment on the hierarchy of the main inputs in their valuations. It remains to be seen how this will be put into practice, but two possibilities might be:

- Where similar valuation methods have been used for a whole portfolio, comments on a general portfolio level, highlighting the exceptions, if any, or
- Comments on a property-by-property basis.

It remains to be seen which of the valuer or his client will be expected to take the final decision on the level that will be applied to the value measurement (i.e. the valuation) as a whole. We would nevertheless suggest that this decision belongs to the reporting entity, not to the valuer – at the end of the day it is, after all, the reporting entity's responsibility to state whether the measurement is at level 1, 2 or 3.

The valuer's role is to give his client sufficient details about the various inputs for the client to be able to make the final decision of the level to be ascribed to the fair value measurement of each asset. In order to do this, the valuer may also have to state which inputs are considered to be significant.

12 Potential implications for the preparation of valuation reports

As stated above, valuers undertaking Fair Value valuations for the consolidated accounts of entities that have adopted IFRS accounting (and in particular for EU listed companies) can be expected to be asked to comment on the hierarchy of the main inputs in their valuations.

It is therefore suggested that valuers should identify the inputs that they consider to be "significant" and then state which of level 1, 2 or 3 they consider to be appropriate for each one, with brief explanations why. While it remains to be seen what level of detail will be required by clients and their auditors, it is suggested that it may be possible to deal with this in brief tabular format.

Nevertheless, it is highly recommended that valuers seek confirmation from their clients (and perhaps also their client's auditors) of their reporting requirements at an early stage in the instruction and preferably before confirming their terms of engagement.

Reporting requirements will clearly vary according to the nature of the properties valued, their tenure, their geographical locations, etc. The more varied the portfolio, the more detail is likely to be required.

13 Conclusions

We are at the start of the implementation of IFRS 13 and do not yet have any practical experience of the way that auditors, in particular, will interpret the requirements of this standard.

It is considered likely that in most market many of the significant valuation inputs will fall into Level 3. This means that valuers will have to provide the information about the significant inputs and their level 1, 2 or 3 hierarchy when they prepare valuation reports for properties valued for companies that are subject to Fair Value reporting. This will particularly concern investment property owned by companies listed on the stock exchange of an EU country.

Valuers of such properties will therefore have to learn a new vocabulary ("observable" and "unobservable") and will have to familiarise themselves with these and other new concepts, in order to meet the new requirements of their clients and their auditors.

TEGoVA's EVSB is keen to follow the development of this subject and would be pleased to receive any observations on this paper and to hear of any practical experience that valuers may have during the early stages of the application of this new standard.

June 2013