EPRA | REPORTING

European Public Real Estate Association

EPRA Position Paper on IFRS 13

Fair Value Measurement

& Illustrative Disclosures

(February 2013)

Introduction

The ownership and management of investment property has evolved over many years into a diverse and complex industry. Likewise, in developed markets, the valuation of investment property has evolved into a well established profession with sophisticated methods and techniques to refine the practice of property valuation. Real estate is a unique asset class - an observation evidenced by the fact that investment property is one of few asset classes with a dedicated International Accounting Standards (IAS 40).

IFRS 13 *Fair Value Measurement* is a generic valuation standard that has not been developed with investment property valuations specifically in mind. Terms such as 'observable' or 'significant' adjustments to an observable input, are often a matter of judgment and leave wide scope for different interpretation and inconsistency between property companies.

For the above reasons, EPRA formed an industry working group and consulted with property companies, valuers, accounting and audit advisors to develop a better understanding of the application of IFRS 13 in the context of investment property valuation and reporting and provide a base level of common level 2 and 3 disclosures that can be applied consistently. The following illustrative guidance has been developed with input from all of the Big 4 accounting firms. Members of the EPRA Working Group are listed on page 3.

EPRA believe it is important that the new IFRS 13 framework helps the users of the financial statements of listed property companies in obtaining useful information on property valuations. For many years, valuers have been working with companies and auditors within the existing framework and made progress in this area. It is important that the introduction of IFRS 13 builds on these improvements and assists the continued evolution of global valuation standards for investment property. Crucially, a classification of a property valuation as level 1, 2 or 3 should not become synonymous with the quality of the valuation, or the liquidity of the asset concerned.

Our objective with this paper is to assist preparers, auditors and valuers in implementing IFRS 13 with a consistent approach and to achieve disclosures that are ultimately useful to users of financial statements. The paper will also help to create a framework to assist users in understanding the reporting information relevant to property valuation.

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Background

The range of inputs used in a property valuation and the IFRS 13 rules regarding their classification as 'observable' inputs ('Level 2') or 'unobservable' ('Level 3') has been the subject of wide debate.

Our observation that IFRS 13 was not framed with just investment property in mind is based on the limited illustrative examples of inputs and disclosures that are less for relevant investment property. For example, we note that most of the examples of inputs (in paras B34-B36) are focused on financial instruments (e.g. swaps).

Estimating the fair value of an investment property inevitably requires a significant range of methodologies, inputs, and adjustments to reflect the wide range of factors which contribute towards the value of a property e.g. state and condition, location, in-place leases, development potential, infrastructure, etc. Consequently, even in the most transparent and liquid markets – and depending on the valuation technique - it is very likely that valuers will use one or more significant unobservable inputs or make at least one significant adjustment to an observable input. Accordingly, it is likely that the vast majority of property valuations will fall within the level 3 category.

Nevertheless, users of the financial statements of property companies may not understand how IFRS 13 determines the level of classification and associate this with 'liquidity' or 'transparency'. They could interpret a (re)classification to level 3 as an indication that a property valuation is unreliable; that market conditions have deteriorated or; even that the asset is of low quality. Investors could make crude assumptions about the quality of different companies' valuations on the basis of how much of the property is classified as level 2 or level 3. In fact, the (re)classification to level 3 may have more to do with the interpretation of the standard than whether there is any substantial change in the valuation technique, market conditions, etc.

To avoid such negative impacts on investor perception and promote useful and consistent disclosures, we have developed the following illustrative guidance in order to assist companies in adopting the new requirements in IFRS 13 and provide a common basis for discussion.

Furthermore, the level of disaggregation of quantitative information provided about the inputs does not necessarily need to be so detailed as to reveal sensitive information about certain properties.

Regarding the specific case of commercial property, the valuation of such properties is a complex area of valuation that has evolved over many years. All developed commercial property markets will have an active valuation profession supporting the industry. The vast majority of listed property companies (95%) in Europe (EPRA Deloitte Survey 2011/2012) have adopted the Fair Value model and 90% of those companies use external professionally qualified valuers to undertake these valuations.

The fact that most property valuations will fall within a level 3 disclosure is therefore a reflection of the nature, complexity and the range of inputs used in property valuation, rather than on the credibility of the valuation.

ILLUSTRATIVE DISCLOSURES

The illustrative disclosures in this section are intended to provide a starting reference which can aid in ensuring that IFRS 13 is applied on a consistent basis and are not intended to be a complete set of guidance. Preparers should be aware that more extensive disclosures may be required in complex situations; whereby the level of aggregation will depend on the characteristics, nature and risks of the properties and the number of countries and segments in which a company operates; and on the facts and circumstances surrounding companies operating in multiple countries.

Fair value measurement of investment property

IFRS 13 requires the use of valuation techniques for which sufficient data are available, maximising the use of observable inputs and minimizing the use of unobservable inputs. The degree of detail of the disclosure depends on the observability of the inputs used.

For this purpose, IFRS 13 establishes a fair value hierarchy that classifies the inputs into three levels:

- Level 1: unadjusted quoted prices in active markets
- Level 2: observable inputs other than quoted prices included within level 1
- Level 3: unobservable inputs

The level of disclosure is more extensive for Level 3 inputs.

For property, only inputs of level 2 and 3 are applicable with the vast majority being Level 3.

In addition, if these inputs are categorised in different levels of the fair value hierarchy, the fair value measurement is categorised in its entirety on the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

The property valuation process is normally carried out by qualified external valuers using, when available, relevant market information generated from transactions of comparable properties. Such information can be regarded as an observable input if it is publically available.

A high degree of judgment may be required from valuers when observable information is not available or when significant adjustments are made to the observable market information. If the adjustments made are significant to the entire measurement then the fair value is likely to be categorised within Level 3.

Categorisation in level 2 is possible if sufficient data is available and does not require significant adjustments. This could occur in markets where there are a significant number of comparable transactions disclosed to the market.

Disclosure categorisation will be determined by such factors as the nature, characteristics and risks of the asset and on the level of fair value hierarchy.

The level of disaggregation of the following quantitative disclosures may often be based on asset type and geographical location (city/country/region) – but the level of disaggregation is fact specific and our illustration may not be appropriate for all entities. The intention of IFRS 13 is that disclosures should provide sufficient detail to reflect the different characteristics of assets and enough information for users to assess whether the entity's views about individual inputs differs from their own.

Recurring fair value measurement as at 31/12/XX

IFRS 13 p93 (a)(b)

Class of assets	31/12/XX	Level 2	Level 3
Offices Paris CBD	2200	200	2000
Offices London	3800	800	3000
Offices Frankfurt	1450		1450
Offices under construction	600		600
Residential Germany	1200	1200	
Total Investment Property	9250	2200	7050

Valuation techniques used for level 2

IFRS 13 p93(d)

For some offices in London and some offices in Paris: observable rental values capitalised by observable capitalisation rates.

For residential Germany: observed prices per square meter in the close proximity multiplied by the area.

Valuation techniques used for level 3

IFRS 13 p93(d)

Based on a multi-criteria approach, the following valuation techniques can be used for a same class of assets :

Discounted cash flow using the following inputs: net current rent, estimated rental value (annual rent), terminal value, discount rate.

Yield methodology using market rental values capitalised with a market capitalisation rate.

The resulting valuations are cross-checked against the initial yields and the fair market values per square meter derived from actual market transactions.

For properties under construction, the fair value is usually calculated by estimating the fair value of the completed property (using either of the above mentioned methodologies) less estimated costs to completion. If the fair value is not reliably determinable, the property under construction is measured at the cost model in IAS 16 until such time as the fair value can be reliably measured.

Fair value measurements using unobservable inputs (level 3)

IFRS 13 p93 (b)

Opening balance	11050
Gains/(losses) recognized in P&L (fair value adjustment)	-200
Acquisitions	500
Sales	-400
Transfer from level 3 to level 2	-800
Transfer from level 2 to level 3	600
Closing balance	10750

IFRS 13 p93 (b)

Among net losses recognised on line item “fair value adjustment” of the P&L, -150 is attributable to a change in unrealised losses.

IFRS 13 p93 (c)

Reclassification from level 3 to level 2: an office in London under construction last year and categorised in level 3 has been rented out in the current year at an observable rental value and capitalised at an observable capitalisation rate. It has therefore been categorised under level 2.

Reclassification from level 2 to level 3: due to a significant decrease in the volume of transactions in the Frankfurt office market, all offices in this city have been categorised in level 3.

Quantitative information about fair value measurements using unobservable inputs (level 3)

IFRS 13 p93(d)

	Fair Value at 31/12/XX	Valuation techniques	Unobservable inputs	Range (Weighted Average)
Offices Paris	2000	Discounted cash flow	Annual rent per sqm	300-700 (500) €
			Discount rate	5.25-6.75 (5.75) %
			Capitalisation rate for terminal value	5-5.5(5.25) %
		Yield methodology	Annual rent per sqm	300-700 (500) €
			Capitalisation rate	4.5-5 (4.9) %
Offices London	3000	Discounted cash flow	Annual rent per sqm	600-1200(800) £
			Discount rate	5.50-7(6.5) %
			Capitalisation rate for terminal value	5.25-6(5.5) %
		Yield methodology	Annual rent per sqm	600-1200 (800) £
			Capitalisation rate	5-5.5 (5.4)%
Offices Frankfurt	1450	Discounted cash flow	Annual rent per sqm	200-500(300) € €
			Discount rate	5-6(5.5) %
			Capitalisation rate for terminal value	4.75-5.25(5) %
Offices under construction	600	Capitalised net revenues less cost to completion	Capitalised net revenues	(a)
			Cost to completion	(b)

(a) Capitalised net revenues have been calculated using estimated rental revenues and capitalisation rates available on databases of prior transactions

(b) Cost to complete the property is directly linked to each construction project (amount and stage of completion)

EPRA Note: If a multi-criteria analysis is used, depending on the deemed usefulness of the disclosure to users of financial statements, companies can select the most appropriate technique used. In the above table, only the principal valuation techniques used for each class of asset are reported.

The analysis above has been provided per city and segment. Companies can, depending on the facts, also provide this on a country or regional basis, or some other appropriate way.

Sensitivity of measurement to variance of significant unobservable inputs

IFRS 13 p93 (h)

A decrease in the estimated annual rent will decrease the fair value.

An increase in the discount rates and the capitalisation rates (used for both direct capitalisation method or for terminal value of DCF method) will decrease the fair value.

There are interrelationships between these rates as they are partially determined by market rate conditions.

For investment properties under construction, the cost to completion and the time to complete will reduce the fair value whereas the consumption of such a cost over the period to completion will increase the fair value.

Valuation process

IFRS 13 p93 (g)

The valuations of the properties are performed twice a year on the basis of valuation reports prepared by independent and qualified valuers.

These reports are based on both:

- information provided by the company such as current rents, terms and conditions of lease agreements, service charges, capital expenditure, etc. This information is derived from the company's financial and property management systems and is subject to the company's overall control environment.
- assumptions and valuation models used by the valuers – the assumptions are typically market related, such as yields and discount rates. These are based on their professional judgment and market observation.

The information provided to the valuers - and the assumptions and the valuation models used by the valuers - are reviewed by the property portfolio department and the Chief Financial Officer ('CFO'). This includes a review of fair value movements over the period.

When the CFO considers that the valuation report is appropriate, the valuation report is recommended to the audit committee. The audit committee considers the valuation report as part of its overall responsibilities