IFRS 13 Fair value measurement

21st century real estate values

Implications for the real estate and construction industries

Ernst & Young

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Contents

1. Introduction 2

2. Principal impacts of the new standard 2

3. The definition of fair value 3

4. The concept of 'highest and best use' 3

4.1 Assessment 3

4.2 Valuing the highest and best use — alternative use and asset modifications 4

4.3 Highest and best use and impairment testing 4

5. The valuation premise for property interests 5

6. Assessing whether an appraisal complies with IFRS 13 5

7. Appropriate valuation techniques 6

8. Applying the fair value hierarchy to real estate appraisals 7

9. Expanded disclosure requirements 8

10. Final thoughts 9

1. Introduction

IFRS 13 *Fair Value Measurement* has been recently released by the International Accounting Standard Board (IASB).

What you need to know

IFRS 13 establishes a single framework for all fair value measurements when fair value is required or permitted by IFRS. IFRS 13 does not change when an entity is required to use fair value, but rather, describes how to measure fair value under IFRS when it is required or permitted by IFRS. As a result of consequential amendments, much of the specific requirements for determining fair value in IAS 40 *Investment Property* will be deleted, and instead, fair value measurements will be made based on the requirements of the new standard.

IFRS 13 is effective for annual periods beginning on or after 1 January 2013.

In this publication, we concentrate on the implications of IFRS 13 for the real estate and construction industries. Refer to *IFRS Developments, Issue 2, Fair value measurement guidance converges*, which is available at www.ey.com/IFRS, for a more complete summary of this new standard.

2. Principal impacts of the new standard

For real estate entities, the adoption of IFRS 13 could result in significant changes to processes and procedures for determining fair value and providing the required disclosures. While the requirement to determine fair value by reference to market participants is not new, the definition of fair value in IFRS 13 differs from that proposed by International Valuation Standards (IVS), which are the generally accepted standards for professional appraisal practice in valuing real estate internationally. The fair value framework set out in IFRS 13 contains specific requirements relating to 'highest and best use', valuation premise, and principal market. This may require entities and their appraisers to re-evaluate their methods, processes and procedures for determining fair value.

The use of external appraisers, as is common for property interests (including investment property interests), does not reduce management's ultimate responsibility for the fair value measurements (and related disclosures) in the entity's financial statements. Management must understand the methodologies and assumptions used in the valuations and determine whether the assumptions are reasonable and consistent with the tenets of IFRS 13.

Real estate entities may be affected by the new standard in various aspects of their business when:

- Measuring investment property interests at fair value under IAS 40
- Determining the fair value of identifiable assets and liabilities as part of the purchase price allocation applied in a business combination
- Testing a property interest or a cash-generating unit for impairment under the cost model to the extent recoverable amount is based on fair value less costs to sell
- Measuring an interest in a real estate joint venture or associate at fair value using the exception under IAS 28 *Investments in Associates and Joint Ventures* (i.e., the investment is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust or similar entity including investment-linked insurance funds)
- Disclosing the fair values of property interests

The principal elements of the new standard that are relevant for real estate and construction entities are dealt with in the following sections.

3. The definition of fair value

The IASB defines fair value in the context of IFRS 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 (i.e., an exit price). This differs from IVS, which states in its proposed revised IVS Framework[1]:

"Fair value is the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties."

How we see it

The definition of fair value in IFRS is different from that in IVS, as IFRS requires any advantages that would not be available to market participants generally to be disregarded. Accordingly, management needs to be aware of this difference in concept in order to ensure any values used for financial reporting that are obtained from appraisals, whether external or internal, are consistent with the objective of a fair value measurement in accordance with IFRS 13.

4. The concept of 'highest and best use'

4.1 Assessment

Management is required to consider all relevant factors in determining whether the highest and best use of a property can be something other than its current use at the measurement date. IFRS 13 presumes that an entity's current use of an asset is generally its highest and best use, unless market or other factors suggest that a different use of that asset by market participants would maximise its value. IFRS 13 states[2]:

"A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its *highest and best* use or by selling it to another market participant that would use the asset in its highest and best use.

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

(a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).

(b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).

(c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use."

1 International Valuation Standards Council (IVSC) Staff Draft, *Proposed Revised International Valuation Standards*, February 2010 [sic] (actually issued February 2011), paragraphs 39-41.

2 IFRS 13, paragraphs 27 and 28.

How we see it

Considerable judgement may have to be applied in determining when an anticipated change is legally permissible. For example, if approval is required for rezoning land or for an alternative use of existing property interests, it may be necessary to assess whether such approval is perfunctory or not. Entities should document the evidence to support their view on market participants' assumptions about the ability to obtain the required approvals.

4.2 Valuing the highest and best use — alternative use and asset modifications

When management has determined that the highest and best use of an asset is something other than its current use, certain valuation matters must be considered. Appraisals that reflect the effect of a reasonably anticipated change in what is legally permissible should be carefully evaluated. If the appraised value assumes that a change in use can be obtained, the valuation must also reflect the cost and profit margin associated with obtaining approval for the change in use and transforming the asset, as well as capture the risk that the approval might not be granted (that is, uncertainty regarding the probability and timing of the approval). An entity should also evaluate inputs used in the valuation of similar assets that do not have similar uncertainties, for example, related to obtaining a permit. Refer to section 6 for considerations in assessing whether an appraisal complies with IFRS 13.

Expectations about future improvements or modifications to be made to the property interest to reflect its highest and best use may be considered in the appraisal, such as the renovation of the property interest or the conversion of an office into condominiums, but only if and when other market participants would also consider making these investments. The cash flows used should reflect only the cash flows that market participants would take into account when assessing fair value. This includes both the type of cash flows (e.g., future capital expenditure) and the estimated amount of cash flows. For example, net cash flows arising from future capital expenditure would be included only if other market participants would consider them in evaluating the asset. Only if this hurdle is met, the fair value of the property interest may be determined on the basis of the expected future cash flows of the "renovated asset" or the "transformed asset" (for example, a condominium) to value the asset in its current form (for example, an office property interest) on the basis of an alternative use.

The expected future cash flows of a renovated (transformed) asset are also adjusted for renovation or transformation costs (such as, legal, re-zoning and remodelling costs) and profits expected and required by a market participant in determining whether an alternative use of the asset would maximise the value of the asset. Accordingly, management should evaluate whether transformation costs and any associated profits resulting from the transformation process have been included in the appraised value and if the inclusion of such amounts is appropriate.

4.3 Highest and best use and impairment testing

The highest and best use concept is not only relevant for property interests carried at fair value, but also for impairment testing of investment property interests carried at cost and other non-financial assets held by real estate or construction companies where impairment is measured on the basis of fair value less cost to sell.

IAS 36 *Impairment of Assets* stipulates that impairment arises if the recoverable amount of an asset is lower than its carrying value. The recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. IFRS also states that:

- If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount[3]

And

- Fair value differs from value in use, as defined in IAS 36[4]

Fair value reflects the assumptions market participants would use when pricing the asset. Consequently, the highest and best use concept applies when fair value less cost to sell is the basis of the impairment test. In contrast, the value in use concept reflects the reporting entity's estimates based on its expected use of the asset, including the effects of factors that may be specific to the entity and not applicable to entities in general.

How we see it

Often, there is no active market for investment property under construction and land positions carried at cost. Accordingly, if fair value is used for impairment testing, it may have to be estimated on the basis of discounted cash flow projections or other proxies of fair value. The highest and best use concept is relevant in these situations as well.

[3] IAS 36, paragraph 19.
[4] IAS 40, paragraph 49.

5. The valuation premise for property interests

When determining the highest and best use for non-financial assets, such as property interests, it is important to determine whether the highest and best use of that property interest is within a group, or on a stand-alone basis. The fair value of an asset that has a highest and best use in combination with other assets (that is, in a group) is determined on the basis of the use of the asset together with those other complementary assets, even if the asset is aggregated or disaggregated at a different level when applying other IFRS. In contrast, the fair value of a property interest that provides maximum value on a stand-alone basis is measured based on the price that would be received to sell that property interest on a stand-alone basis.

To illustrate the above, consider a mixed-use property interest that has residential housing, a hotel and retail space: if the aggregate fair value of the mixed-use property interest is higher to market participants than the sum of the fair value of the individual property interests because of synergies and complementary cash flows, the fair value of that mixed-use property interest would be maximised as a group. That is, the fair value is determined for the mixed-use property interest as a whole (i.e., the higher amount) even if the asset is disaggregated when applying other parts of IAS 40.

While the mixed-use property interest is one example in which fair value would be maximised as a group, in many cases, it would not be appropriate to estimate fair value of property interests as a group. For example, entities generally should not assume the fair value of a property interest is maximised through its use with other assets, unless there is sufficient evidence to support this assertion. In many instances when valuing property interests, fair value is maximised based on the price that would be received in a current transaction to sell the asset on a stand-alone basis.

How we see it

Determining whether the maximum value to market participants would be achieved either by using a real estate asset in combination with other real estate assets as a group, or by using the real-estate asset on a stand-alone basis requires considerable judgement of the specific facts and circumstances.

6. Assessing whether an appraisal complies with IFRS 13

Although certain of the concepts of IFRS 13 may be similar to concepts in IVS, an assessment of the appraisal should be performed to determine that the appraised value is an appropriate measure of fair value for financial reporting (that is, the appraisal has been performed in accordance with the principles of IFRS 13). As a result, management may conclude that an adjustment to the valuation is necessary to comply with IFRS 13.

Such an assessment would include, but is not limited to, assessing whether:

- The principal or most advantageous market has been appropriately considered
- Appropriate market participants (or characteristics of market participants) have been identified and the assumptions that market participants would utilise in pricing the asset have been used
- Adjustments to valuation input data are (a) based on observable or unobservable inputs, or (b) significant to the overall fair value measurement (see section 8 below)
- All appropriate valuation approaches and techniques have been used; if multiple valuation techniques are used, the merits of each valuation technique and the underlying assumptions embedded in each of the techniques should be considered in evaluating and assessing the results
- Appropriate judgement has been applied in assessing the highest and best use and whether the expected future cash flows associated with this use are appropriately adjusted for the cash out flows associated with the transformation or renovation costs adjusted for a normal profit margin

7. Appropriate valuation techniques

IFRS 13 does not prescribe the valuation techniques that must be used in any particular circumstance. The valuation technique used to measure fair value should be appropriate for the circumstances, and should be a technique for which sufficient data is available.

Valuation techniques that are typically used include the 'market approach', the 'income approach' and the 'cost approach', which are summarised in Table 1, with the comparative IVS guidance provided by the International Valuation Standards Council (IVSC).

Table 1: Valuation techniques under IFRS 13 and IVS

Approaches described in IFRS 13		IVS equivalent	Application guidance provided by IVSC[5]
Market approach	Valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets	Market approach (or market comparison approach)	Under the *market approach*, the value is determined based on comparable transactions. Although property interests are not homogeneous, the IVSC considers the market approach most commonly applied. "In order to compare the subject of the valuation with the price of other real property interests that have been recently exchanged or that may be currently available in the market, it is usual to adopt a suitable unit of comparison. A unit of comparison is only useful when it is consistently selected and applied to the subject property and the comparable property interests in each analysis."
Income approach	Valuation techniques that convert future amounts (e.g., cash flows or income and expenses) to a single current (discounted) amount	Income approach (e.g., the income capitalisation/ discounted cash flow method)	Various valuation methods can be captured under this valuation technique. They all have in common that the valuation is based on estimated future income and profits or cash flows. Most commonly recognised are the *income capitalisation method*, also known as the yield method under which a constant income stream is capitalised, and, the *discounted cash flow method*. "The yield method is quick and simple but cannot be reliably used where the income is expected to change in future periods to an extent greater than that generally expected in the market or where a more sophisticated analysis of risk is required. In such cases, various forms of discounted cash flow models can be used."
Cost approach	Valuation technique that reflects the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost)	Cost approach (e.g., the depreciated replacement cost method)	IVSC considers that this method should be applied by exception only: "It is normally used when there is either no evidence of transaction prices for similar property or no identifiable actual or notional income stream that would accrue to the owner of the relevant interest. It is principally used for the valuation of specialised property, which is property that is rarely if ever sold in the market, except by way of sale of the business or entity of which it is part."

[5] IVSC Staff Draft, *Proposed Revised International Valuation Standards*, February 2010 [sic] (actually issued February 2011), IVS 230 *Real Property Interests* C13 – C18, C22. Guidance in paragraph C22 is subject to changes discussed at the 4 March 2011 meeting of the International Valuations Standards Board (IVSB).

The cost approach is seldom used to establish the fair value of investment property and applies more to fair valuing owner-occupied property (if the revaluation option under IAS 16 *Property, Plant and Equipment* is used). The decision to use one valuation technique over another, or to use more than one valuation technique, depends on the specific facts and circumstances. But, in all cases, a fair value measurement should consider all available observable market transactions, thereby maximising the use of observable market inputs. The objective is to use the valuation technique (or combination of valuation techniques) that is appropriate in the circumstances and for which there is sufficient data.

IFRS 13 requires that valuation techniques used to measure fair value should be consistently applied. Changes in valuation techniques (or their application) are appropriate only if the change results in a measurement that is equally or more representative of fair value in the circumstances.

When it is determined that use of multiple valuation techniques is appropriate, as is often the case for real estate (e.g., using the results from both a market approach and an income approach), IFRS 13 indicates that the results should be evaluated and weighted considering the reasonableness of the range indicated by those results. A fair value measurement is the point within the range that is most representative of fair value in the circumstances.

8. Applying the fair value hierarchy to real estate appraisals

When measuring fair value, an entity is required to maximise the use of relevant observable inputs and minimise the use of unobservable inputs. IFRS 13 includes a fair value hierarchy (described in Table 2), which prioritises the inputs in a fair value measurement. In addition, significant differences in disclosure requirements apply to each level within the hierarchy to provide users with insight into the reliability of the fair value measurement.

Table 2: Fair value hierarchy

Fair value hierarchy	
Level 1	Quoted prices (unadjusted) in an active market for identical assets and liabilities that the entity can access at the measurement date
Level 2	Observable inputs other than quoted prices
Level 3	Unobservable inputs

The fact that information is obtained from an external source (which is the case when an independent appraisal is utilised) is not by itself determinative in its classification in this fair value hierarchy.

The fair value hierarchy is instead based on the relative reliability and relevance of the information used in the valuation. Regardless of whether the valuation was compiled internally or externally, the reporting entity should, therefore, review and understand the inputs used in the valuation to determine the appropriate classification of those inputs in the fair value hierarchy. IFRS 13 requires that the significance of adjustments to observable data be considered in the context of the overall fair value measurement. That is, when an observable input is adjusted to reflect differences between the asset being valued and the observed transaction, the adjustment may render the input a lower level input in the fair value hierarchy.

How we see it

Due to the lack of an active market for identical assets, it would be rare for real estate to be classified in Level 1 of the fair value hierarchy.

In market conditions where real estate is actively purchased and sold, the fair value measurement might be classified in Level 2. However, that determination will depend on the facts and circumstances, including the significance of adjustments to observable data. In this regard, IFRS 13 provides a real-estate specific example, stating that a Level 2 input would be the price per square metre for the property interest derived from observable market data, e.g. multiples derived from prices in observed transactions involving comparable (i.e., similar) property interests in similar locations.[6] Accordingly, in active and transparent markets, real estate valuations may be classified as Level 2, provided that no significant adjustments have been made to the observable data. If significant adjustments to observable data are required, the fair value measurement may fall into Level 3.

In inactive or less transparent real estate markets, we believe that it is generally unlikely that real estate will be classified in Level 2, but, rather, will be classified as Level 3.

When selecting the most appropriate inputs to a fair value measurement from multiple available values, those that maximise the use of observable data, rather than unobservable data, should be selected. Even in a market that is inactive, there is not a presumption that all transactions in the market do not represent fair value or that the market is not orderly, just because that market is no longer active or the volume in that market has significantly decreased. Entities will need to consider the individual facts and circumstances in making this assessment.

Notwithstanding the need for judgement, an entity should have a reasonable basis for concluding that a current observable market price can be ignored based on a view that it represents a liquidation or distressed sale value.

[6] IFRS 13, paragraph B35

9. Expanded disclosure requirements

The IASB significantly expanded the required disclosures related to fair value to enable users of financial statements to understand the valuation techniques and inputs used to develop fair value measurements. For each of the disclosure requirements under IFRS 13, Table 3 below indicates whether it is currently required under IAS 40.

Table 3: Disclosure requirements in IFRS 13

	Investment property at fair value		Investment property at cost	
	IFRS 13	**IAS 40 Current requirements**	**IFRS 13**	**IAS 40 Current requirements**
Fair value at the end of the reporting period	√	√	√	√
Level of the fair value hierarchy	√	Not required	√	Not required
For Level 2 and 3 measurements, valuation technique and the inputs used, and changes in the valuation technique, if applicable, and the reasons for those changes	√	Not required	√	Not required
For Level 3 measurements, quantitative information regarding the significant unobservable inputs	√	Not required	Not required	Not required
Amount of transfers between Level 1 and Level 2, the reasons therefore, and related accounting policies	√	Not required	Not required	Not required
For Level 3 measurements, reconciliation from the opening balances to the closing balances (including gains and losses, purchases, sales, issues, settlements, transfers in and out of Level 3 and reasons and policies for transfer and where all such amounts are recognised)	√	√	Not required	Not required**
For Level 3 measurements, the total gains or losses included in profit or loss that are attributable to the change in unrealised gains or losses relating to those assets and liabilities held at the reporting date, and a description of where such amounts are recognised	√	√	Not required	Not required
For Level 3 measurements, a description of the valuation processes	√	Not required	Not required	Not required
For Level 3 measurements, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs might result in a significantly different amount and, if applicable, a description of interrelationships between those inputs and other unobservable inputs and of how they might magnify or mitigate the effect of changes in the unobservable inputs	√ *	Not required	Not required	Not required
If the highest and best use of a non-financial asset differs from its current use, disclose that fact and the reason for it	√	Not required	√	Not required

(*) The IASB decided not to require a quantitative sensitivity analysis for non-financial assets and liabilities (as previously proposed) at this time. The proposals had been heavily criticised by preparers, who were concerned about the additional cost, among other concerns. Instead, the Boards decided to defer adding this requirement until additional outreach could be completed.

(**) A reconciliation of the opening and closing fair value amounts is not required. However, a reconciliation of the opening and closing balances of the carrying value at cost is still required.

Although the above table focuses on a comparison between IAS 40 and IFRS 13 disclosure requirements, it is important to note that, in most cases where fair value is used or disclosed, the disclosure requirements have been expanded as compared to current IFRS. For example, entities that measure interests in a real estate joint venture or associate at fair value, or measure other financial instruments at fair value, will need to comply with increased disclosure requirements for such items as well.

10. Final thoughts

While many of the concepts in IFRS 13 are consistent with current practice, certain principles and disclosure requirements could have a significant impact on real estate and construction companies. In many cases, the concepts of highest and best use and the valuation premise may not be significantly different from current practice; nevertheless, careful consideration is required to identify those situations in which there is a significant impact. Although the definitions of valuation techniques are now brought in line with definitions applied by IVS, there are still differences in fair value concepts between IFRS and IVS. For example, IVS does not recognise a fair value hierarchy and IVS applies a different fair value definition. Management should be aware of these differences when assessing appraisals prepared pursuant to IVS.

Considerable judgement may be required when applying fair value measurement concepts included in IFRS 13, such as determining what is the highest and best use, valuing an alternative use, determining the valuation premise, and applying the fair value hierarchy. Management will want to have a good knowledge of the concepts when making judgements related to its fair value measurements.

For more information

If you would like to discuss fair value of real estate and construction property interests in more detail, or would like our professionals to assist with an initial analysis of the impact on your business, please contact your Ernst & Young representative or any of the contacts listed in Table 4 below.

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