

9 September 2010

International Accounting Standards Board 30 Cannon Street London, EC4M 6XH United Kingdom

Re: Exposure Draft; Measurement Uncertainty Analysis Disclosure for Fair Value Measurements.

Dear Sir/Madam,

We are pleased to submit this comment letter on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) (collectively "the Boards") joint Exposure Draft; Measurement Uncertainty Analysis Disclosure for Fair Value Measurements. We are submitting these comments on behalf of the following real estate organizations

British Property Federation (BPF)
European Public Real Estate Association (EPRA)
National Association of Real Estate Investment Trusts (NAREIT)® (U.S.)
Real Property Association of Canada (REALpac)

The above organisations, along with others, have formed an alliance known as the Real Estate Equity Securitization Alliance (REESA). The purpose and activities of REESA are discussed in Appendix II.

Members of the organizations identified above would be pleased to meet with the Boards or staff to discuss any questions regarding our comments.

We thank the FASB and IASB for the opportunity to comment on this important project. Please contact Gareth Lewis, EPRA's Director of Finance at <u>gareth.lewis@epra.com</u> or +32 27391014 if you would like to discuss our comments.

Respectfully submitted,

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European Public Real Estate Association Blvd de la Woluwe 62 Woluwelaan 1200 Brussels, Belgium

# **Comment Letter Submitted by the**

## **European Public Real Estate Association**

On behalf of the Real Estate Equity Securitization Alliance, which includes the following organizations:

British Property Federation (BPF)
European Public Real Estate Association (EPRA)
National Association of Real Estate Investment Trusts (NAREIT)® (U.S.)
Real Property Association of Canada (REALpac)

In response to the Limited re-exposure of proposed disclosure

Measurement Uncertainty Analysis Disclosure for Fair Value Measurements.

Issued by the Financial Accounting Standards Board and International Accounting Standards Board

**June 2010** 

International Accounting Standards Board 30 Cannon Street
London, EC4M 6XH
United Kingdom

Financial Accounting Standards Board 401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

# Re: Exposure Draft; Measurement Uncertainty Analysis Disclosure for Fair Value Measurements

Dear Sir/Madam,

We have included our comments on the specific questions raised in the Exposure Draft in Appendix I but would first like to make the following more general comments as they relate to the implications for companies that own and operate investment properties.

The organizations supporting this letter represent property companies which report under IFRS and US GAAP, as well as organizations which are in the process of adopting IFRS accounting. These regions have differences in the status and evolution of their valuation practices, including for example, the prevalence of an independent property valuation profession.

The comments in this letter do not necessarily reflect the detailed considerations and nuances arising from each of these different markets. However, the letter assumes a general trend towards disclosing property at fair value in financial statements as required under IAS 40 and evidenced by the recent proposal by FASB to develop an equivalent standard under US GAAP. The views expressed therefore draw more influence from the experiences of the European market which has a well established history of operating under IAS 40. Companies reporting under IFRS which are in the investment property business, and their stakeholders, have a significant interest in ensuring that valuations are as accurate as possible.

#### **Executive Summary**

We generally support the Board's efforts in trying to establish a framework for measuring and disclosing fair value on a consistent basis to all assets, liabilities and equity instruments. REESA previously submitted its comments on the FV Measurement Exposure Draft in our letter of 24<sup>th</sup> September 2009. In our letter we expressed the concern that this framework should not eliminate fair value guidance currently within IAS 40 that continues to be relevant and useful while remaining consistent with the principles of the framework. Removing this in favour of the more generic guidance contained in the FV Measurement Exposure Draft could create further uncertainty.

The organizations represented in this letter have strong concerns that the proposals to require an entity to disclose the effects of correlation between unobservable inputs will not result in an

improvement for users of the financial statements of investment property companies. Although the type of analysis described in the Exposure Draft is integral to any valuation of property, and is already substantially covered in IAS 40, the specific proposed disclosure requirements would give rise to significant compliance costs and frustrate the efforts of investment property companies to provide clear and relevant information on valuation uncertainty.

#### Application to investment property companies

Uncertainty in property valuations is a normal market feature deriving from the nature of property. It is variable from property to property and from market condition to market condition. Explicit disclosure of methods, assumptions and statements regarding connections to market evidence is one important way to assist users in better understanding this uncertainty. Information regarding valuation methods, significant assumptions in the valuations and explicit connections to market evidence should make analysis and the application of individual judgment by users of financial reports easier.

The valuation of investment property involves the judgment, skill and experience of the valuer who weighs all factors and arrives at a market selling price for the property at a point in time. We are concerned that the fact that valuations are not precise calculations will make it difficult to meaningfully analyze the fair value of investment property into segments in a way that will provide additional benefit to users of financial statements of investment property companies.

In property valuation the assumptions and inputs are made at an asset by asset level, whereas for other cases such as financial instruments, these are usually made across a whole asset class. Accordingly, whilst the costs of running sensitivities and correlation would be very high (as this would need to be analyzed and disclosed on a single asset basis in order to determine relevance), any disclosure on a portfolio basis (which is the level at which companies currently report) would be meaningless. Most users will not consider an asset by asset analysis and those that are inclined to do so will usually have enough understanding and knowledge of real estate to make their own assumptions.

Assuming the final standard requires categorization of inputs into Level 1, Level 2 and Level 3, for investment properties, FV measurements will fall into the Level 2 or Level 3 categories. Many of the most relevant inputs to a property valuation, such as rental levels and investor yield requirements, will be observable inputs. When the property markets are active, the significant inputs to valuations will be observable in the market and the valuations should fall into Level 2. In other cases, FV of investment property will require not only market observations but adjustments to those market observations as well as input of management's estimates. In these cases, the valuations of investment property may fall to a Level 3 category requiring significantly more disclosures as described in the Exposure Draft.

REESA's view is that the Exposure Draft should not erode good practices that have been developed or detract from preparers' and users' efforts to provide clear and relevant valuation information for the sake of producing generic guidance for all assets. This is particularly the case for investment property companies which operate under IAS 40. 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 International Valuation Standards guidance (followed by the vast majority of valuation professionals) has worked well. Removing this in favour of the more generic guidance contained in the Exposure Draft would create uncertainty.

The generic guidance of the Exposure Draft may work well for financial instruments, but we believe it is unlikely to enhance the quality of reporting for investment property where there is already a well established accounting standard and framework of guidance as described above.

In our view, a better approach would be to focus efforts on increasing users' understanding of the most significant inputs, methodologies and processes the company had used in valuing its properties. In some cases, this could also be accompanied by a meaningful sensitivity analysis. This approach would complement the significant improvements that have been made by the property industry to respond to the specific demands from investors for additional information over and above those currently required under global accounting standards.







National Association of Real Estate Investment Trusts United States



## Specific Questions in the Exposure Draft

## **Question 1**

Are there circumstances in which taking into account the effect of the correlation between unobservable inputs (a) would not be operational (eg for cost-benefit reasons) or (b) would not be appropriate? If so, please describe those circumstances.

We are concerned that the specific information required by the Exposure Draft would not represent a useful and cost effective improvement for users of financial statements of investment property companies who report property at FV under IAS 40 (or equivalent). The requirement to separately analyze inter-dependencies between unobservable inputs and disclose in the manner proposed will introduce excessive additional operational complexity, and is likely to reduce comparability through the introduction of a further layer of subjectivity into what is already a subjective area of accounting.

In real estate valuation, the assumptions and inputs are made on an asset by asset level, whereas in other cases such as financial instruments, these are usually made across a whole asset class. A typical REESA member company, involved, for example, in the operation and management of retail shopping malls, could own more than 500 properties and be responsible for more than 5,000 different lease contracts at any point in time. The Exposure Draft proposals would unnecessarily increase the burden on entities to assess and demonstrate that inputs are relevant (e.g. statistically supportable). In addition, most users will not require an asset by asset analysis and those that are inclined to do so will usually have enough understanding and knowledge of real estate to make their own assumptions. It is not helpful for a typical user of the financial statements of property companies to look at, for example, the impact of the change in the vacancy rate in London as a whole, as the situation might be fundamentally different for an asset in the City or the West End.

Accordingly, although the costs of running sensitivities and correlation would be very high (as this would need to be analyzed on a single asset basis), any disclosure on a portfolio basis (which is the level at which reporting is done) would be of limited value.

Furthermore, in BC 21 the Board states that it is aware of the practical considerations of how to determine which inputs are correlated to each other and the effect of that correlation on fair value measurement. The Boards must therefore recognize the likely inconsistent approaches which will result, that in our view, will increase the compliance burden for preparers without improving the consistency and transparency of disclosure.

A more practical and cost effective approach would be to focus efforts on increasing the users' understanding of the most significant inputs, methodologies and processes the company had actually used in valuing its properties. In some cases, this could include which values the company had attributed to these specific inputs. If necessary, this could also be accompanied by a meaningful sensitivity analysis - e.g. what would a 25 basis point change in yield do to the valuation? - as in certain cases requested by IAS 1 para 125 and as currently supplied by many property companies. This approach would complement the significant improvements that are already being made by the property industry, as discussed below, to respond to the specific demands from investors for additional information over and above those currently required under global accounting standards.

We provide further detail on the type of information that is useful to users of property valuations in response to Question 3 below.

BC 20 states 'it is not necessary to perform a statistical analysis such as a regression analysis using two independent variables to determine the r-squared'. It is therefore apparent that the Board does not require what a statistician would recognize as a correlation analysis - rather an illustration of the numerical effect of choosing different inputs. If that is the case then we would suggest that the Exposure Draft does not refer to it in this way as most preparers would infer that as meaning a proper numerical analysis was required.

#### **Question 2**

If the effect of correlation between unobservable inputs were not required, would the measurement uncertainty analysis provide meaningful information? Why or why not?

If the correlation between the inputs is not required, the measurement uncertainty analysis of fair value measurements could indeed provide useful information provided that the benefits outweigh the costs as described above. However, we believe that company management, together with the valuer, is best placed to determine this information based on knowledge of the market, and factors like the specific property, the level of activity in that geographic market and the overall market conditions.

#### **Question 3**

Are there alternative disclosures that you believe might provide users of financial statements with information about the measurement uncertainty inherent in FV measurements categorised within Level 3 of the fair value hierarchy that the Board should consider instead? If so, please provide a description of those disclosures and the reasons why you think that information would be more useful and more cost-beneficial.

REESA members are in constant communication with investors and other users of the financial statements of investment property companies. REESA organizations have, over the years, developed best practice recommendations aimed specifically at providing users with relevant information for the purposes of capital allocation decisions. Despite the different accounting standard bases used throughout the world and the variation in development of the property valuation profession, there are nevertheless clear and consistent signals as to the type of information that is most relevant for users with respect to the valuation measurement and analysis of valuation uncertainty.

A property valuation considers the impact of the inputs holistically. There are three main approaches to valuation in real estate: comparable sales, discounted cash flow, and replacement cost. Depending on the nature of the asset, all of these may be used from time to time, and more than one approach may be used in a single valuation. Replacement cost may be used to value unique physical assets that rarely trade and produce no income, such as an owner occupied industrial facility. Comparable sales may be used for assets that trade regularly but produce no income, such as houses and development land. Discounted cash flow analysis is used for assets that produce regular rental income, such as multi-tenant office buildings. These valuation approaches consider a wide variety of inputs and factors including, but not limited to:

- physical condition of the property
- revenues to be received under current leases if any
- historical operating data
- recent sales in the property's market

- recent sales of similar property in other markets
- market investor yield requirements
- economic outlook
- market sentiment
- management estimates
- cash flow projections

Although a quantitative measure of valuation uncertainty for certain types of financial asset may be of some benefit to users of financial statements, we believe that this data should only be considered in the context of a suitable explanatory statement that identifies the source or sources of uncertainty and impact they have had on the valuation process. For investment property companies which own large and diverse property portfolios, such an explanatory statement is more relevant than any attempt at a numeric expression of material uncertainty. Accordingly, where material valuation uncertainty exists we recommend that this should be disclosed in financial statements by way of a suitable qualitative statement in all cases; a quantitative statement can be an additional option in cases where it assists in illustrating the qualitative statement.

The type of information that we believe would be more useful to users than the correlation analysis proposed in the Exposure Draft are the key valuation performance indicators (KPIs) that are consistently requested by investors and increasingly provided by investment property companies. Over a number of years, market forces and industry cooperation has resulted in the emergence of these KPIs and supplemental metrics which faithfully report the economics of real estate investment and which are consistent with the concept of the valuation of property as a whole. These are reported on a portfolio basis and examples include:

- Adjusted earnings measures such as EPRA Earnings and NAREIT FFO
- Adjusted NAV measures
- Net Property Income applied in the valuation calculations and reconciliation to the income statement
- Discount/cap rates applied
- Assumptions on investor yield requirements

Information that would also be useful to users would include whether there is any abnormal uncertainty, i.e. conditions exist on the relevant date that mean that the valuation may not fall within the range that normally exists. In this respect, the Exposure Draft does nothing to explain whether the range given is normal for that asset in that market or whether they was something unusual happening at the valuation date.

In IAS 16 para 77 there are requirements to disclose who prepared the valuations, the methods and significant assumptions used and the key inputs used. Para 75 of IAS 40 contains similar provisions. Although there is no requirement in IAS 40 for property owners to use an external, independent valuer to determine the fair value of investment property, EPRA recommends that independent, external valuers are used in its Best Practices Recommendations<sup>1</sup>. At the time of writing, 95% of the companies in the EPRA/NAREIT/FTSE European index adopt the fair value option under IAS 40 and 94% of those companies use external valuers to determine those valuations.

<sup>&</sup>lt;sup>1</sup> EPRA BEST Practices Recommendations <a href="http://www.epra.com/media/EPRA">http://www.epra.com/media/EPRA</a> BPR July 2009.pdf

We therefore find it strange that the Exposure Draft does not recognise that wherever measurement involves judgement, confidence and credibility in a valuation opinion, the credibility and confidence in that valuation must depend at least as much on the professionalism, status and freedom from bias of the person or body issuing that opinion as it does from the mechanics of the process they have used. Accordingly, we believe disclosures which provide the user with information such as:

- the extent to which external valuers are used in valuing property portfolios
- the accreditation of those external valuers and experience in the relevant market
- the frequency of valuations
- whether valuations are in accordance with International Valuation Standards and national body standards

are more relevant in providing the user with relevant information on valuation uncertainty than the proposed correlation analysis.

If the goal is to improve investor confidence in valuation, we believe that IFRS should require disclosures similar to those currently appearing in IAS 16 and 40 generally. An explanation of any material uncertainty existing at the valuation date can then be added to the list of matters to be disclosed.

## **REESA – The Real Estate Equity Securitization Alliance**

The real estate industry has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. Collectively the organizations in REESA are responsible for representing a large proportion of the global real estate market. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards. Associations represented thus far in the alliance include:

- Asian Public Real Estate Association, APREA
- Association for Real Estate Securitization (Japan), ARES
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts, NAREIT®
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

Since its formation REESA members have exchanged views on a number of tax and accounting related projects and shared these views with regulators and standards setters. These projects include:

- FASB/IASB Financial Statement Presentation
- FASB/IASB Reporting Discontinued Operations
- FASB/IASB Real Estate Sales IFRIC D21
- FASB/IASB Capitalization of Borrowing Costs IAS 23
- FASB/IASB Accounting for Joint Arrangements ED 9
- FASB/IASB Consolidated Financial Statements ED 10
- IASB 2007/2008 Annual Improvements to IFRS
- FASB/IASB Leasing project
- FASB/IASB Revenue Recognition
- FASB/IASB FV Measurement
- OECD developments on cross border real estate flows and international tax treaties