DUFF & PHELPS

IVSC

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Response to IVSC Discussion Paper Investment Property

Contents

General Observations

We appreciate the IVSC's efforts to provide guidance on the topic of Investment Property. We have the following general observations on the Discussion Paper (DP), grouped by theme:

Form of the Guidance

- We believe that the state of the current guidance on Investment Property in IVS (including this DP) is reflective of the piecemeal nature in which the standards have been developed, which is not uncommon in standard setting when guidance is issued in response to specific developments. However, since the IVSC is taking another look at this topic, this may present a good opportunity to consolidate and simplify the guidance on **real property interests** in general.

  Completed investment properties, investment properties under construction, and real property interests in general are part of the same asset class. As such, they are subject to the same considerations, inputs and general approaches for valuation purposes, even if put to different principal uses.

  Therefore, we believe that the relevant guidance should be consolidated and simplified such that the existing IVS 230 and IVS 233 as well as the proposed DP are merged into a single standard on real property interests. The real property guidance in IVS should focus on the principles of valuing real property, and the appropriate approaches and inputs for this single asset class.

  An attempt to create or perpetuate a subset of this asset class (e.g. investment property) in part because such exists for specific valuation purposes (IFRS reporting under IAS 40) would create undue complexity in IVS.

Detail of Proposed Guidance

- Many of the areas that the Board is considering to provide guidance on, as noted in the DP, are not exclusive to the real property asset class (which includes investment property).

  Rather, the issues that the DP highlighted present common valuation challenges (e.g. markets that are not active, regardless of asset class), or are a function of specific facts and circumstances (e.g. property not leased since completion). We do not believe it would be helpful to have more elaborate guidance concerning specific situations that would in fact require judgment on a case-by-case basis.

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Subject to our comments above we have provided responses to the questions posed in the Discussion Paper.

Responses to Specific Questions

Question 1

Do you think that the current definition should be retained in full or that an amendment to the definition in IVS 233 is required?

Duff & Phelps response: We believe that carrying forward the definition from IVS 233 (Investment Property under Construction) will be problematic. For one, as the DP points out, there is a concern that the current definition may not be suitable outside of financial reporting. In fact, one current example of this is REITs, which would not meet the second point of the IVS 233 (IAS 40) definition that scopes out property held for sale in the ordinary course of business.

The bigger question is if a definition for investment property is even needed outside of financial reporting. The purpose of the definition in IAS 40 is to identify assets that meet certain criteria in order to subject them to a particular accounting model (in this case, fair value as a measurement basis at each measurement date); this model is different from the accounting model applied to other assets (for example, a lease accounting model).

Completed investment properties, investment properties under construction, and real property interests in general are part of the same asset class. As such, they are subject to the same considerations, inputs and general approaches for valuation purposes, even if put to different principal uses. In other words, outside of financial reporting (which already has a specific definition for investment property) labeling whether the property is held for rental or capital appreciation purposes or for business operation may be of little consequence. Instead, the real property guidance in IVS should focus on the principles of valuing real property, and the appropriate approaches and inputs. Such inputs would include, for example, costs to complete and adjustments for risk for properties under construction (of which investment properties under construction are a subset of).

Question 2

If you believe it should be retained in full, what guidance should be given to valuers when valuing for the non-financial reporting purposes referred to above?

Duff & Phelps response: Any additional guidance in this case would create unneeded complexity. Also please see response to Question 1.

Question 3

If you believe an alternative definition is warranted, please give reasons and suggest appropriate wording.

Duff & Phelps response: Creating a new definition would only capture a subset of an existing asset class subject to the same economics; to the extent that such definition is broader than the one in IAS 40, it would merely create confusion. Please see response to Question 1.

Question 4

Have you encountered valuations that explicitly refer to intangible assets associated with either the property interest or the business in occupation? If so, were these separately valued or not? For what purpose was the valuation required?

Duff & Phelps response: Whether or not intangible assets are included or excluded from the valuation of the real property interest depends on the purpose of the valuation.

For example, a property with an associated brand name, favorable management contract and a favorable lease would be segregated into:

- Three units of account for financial reporting purposes under IFRS (real property subject to, and inclusive of the favorable lease; trade name intangible; and favorable management contract intangible);
- Four units of account for U.S. GAAP purposes (real property; and three intangible assets: trade name, favorable management contract and favorable lease);
- Two units of account for U.S. tax purposes (real property, into which the favorable management contract and favorable lease are subsumed; and trade name, which is an IRC Section 197 intangible to be recognized separately).

As the above example demonstrates, one cannot generalize the guidance about the manner in which intangible assets are considered in the valuation of real property; rather, the guidance should state that this will be a function of the purpose of the valuation and its requirements.

Question 5

Have you encountered valuations of investment property where you believe that value of an intangible asset has been included in the value of the property interest but has not been expressly identified?

Duff & Phelps response: Please see our response to Question 4.

Question 6

Do you consider that the IVSC needs to provide guidance on this issue?

Duff & Phelps response: One cannot generalize the guidance about the manner in which intangible assets are considered in the valuation of real property; that is a function of the purpose of the valuation. Please see our response to Question 4.

Question 7

Which of these options do you favour or is there another option that you would suggest?

Duff & Phelps response: As stated in the General Comments section of our letter, we believe that the guidance should be consolidated and simplified such that IVS 230 and IVS 233, as well as the proposed DP are merged into a single standard on real property interests.

Question 8

Do you consider the provisions of IVS 230 and IVS 233 in relation to valuation methods to be sufficient?

Duff & Phelps response: Yes, we consider the current guidance to be sufficient, subject to our prior comments on consolidating and simplifying guidance about real property interests.

Question 9

If not, what specific aspects of valuation methodology for investment property do you think should be addressed in any future TIP?

Duff & Phelps response: NA

Question 10

Do you consider that the additional guidance to that provided in the IVS Framework (paras 33 – 35) is needed to apply the highest and best use concept to investment property?

Duff & Phelps response: We do not believe that additional guidance is needed with respect to highest and best use. Since highest and best use is a broad principle that underlies both market value and fair value, any more detailed and specific illustrations of its application would be a reflection of particular facts and circumstances.

Question 11

Please indicate which of the above most frequently presents a problem in the valuations that you encounter and the most common methods you see being used to address the issue.

Duff & Phelps response: We think that the list provided in paragraph 2.2.2 is not representative of issues specific to investment property valuation; rather, it is a short compilation of common valuation challenges and/or is a function of specific facts and circumstances which would require judgments that may vary.

For example, in regards to:

- Par. 2.2.2. a, the absence of sale transactions may be common for other types of assets (one example being intangibles) and may simply require the use of an Income Approach or a Cost Approach rather than a Market Approach
- Par. to 2.2.2 b., a case in which the investment property has not been leased since completion may be an indication of current market conditions, or a higher asking rent than the market could bear, or any number of factors that would be specific to the situation;

- Par. to 2.2.2 c, the issue of separability is not unique to real property, whereby at times legal or practical issues may preclude a separate sale. There are other asset classes that may only be transacted in combination with other assets (for example, certain intangibles), or are not transacted standalone (for example, most liabilities).
- Par. to 2.2.2 d, the notion of “completion” could vary. For example, in some cases, a property could be pre-leased; in other cases, it is not leased until construction has been finished.
- Par. 2.2.2 e, TIP #1 Discounted Cash Flow Method already contains some basic guidance on discount rates. We do not see a practical benefit in expanding upon discount rates other than noting one could be derived using a build-up method or based on published and private surveys.

In summary, we do not believe it would be helpful to have more elaborate guidance concerning specific situations that would in fact require judgment on a case-by-case basis. Further, some of these situations may simply require disclosure.

Question 12

If you are a valuation provider, please indicate why you prefer these methods. If you are a valuation user, please indicate if you are confident in the result obtained by these methods.

Duff & Phelps response: NA.

Question 13

Have you encountered material inconsistency in the approach adapted to the treatment of costs or tax in valuations of investment property? If so please indicate the nature of the inconsistency and its consequences.

Duff & Phelps response: We have not encountered such inconsistencies. Market value and fair value (IFRS 13) would not consider transaction costs or taxes, unless the taxes are related to the operation of the asset, rather than associated with a transaction. Perhaps the Board’s efforts should be directed at clarifying what market value and fair value represent in general, rather than focusing its guidance in this regard solely on real property interests.

Also, paragraph 2.3.2 seems to bring into the discussion the method and inputs used in deriving the value, and whether it this should be performed on a pre-tax or an after-tax basis. This aspect of the treatment of taxes (consistency between cash flows and discount rate) was addressed in TIP #1 Discounted Cash Flow.

Question 14

Do you consider that the IVSC should attempt to set benchmarks that indicate whether inputs and valuations should include or exclude different types of tax or other costs? If so, which specific benchmarks would you consider appropriate?

Duff & Phelps response: Please see response to Question 13.

Question 15

Do you consider that an opinion on where the inputs used in a valuation of investment property fall within the input hierarchy under IFRS (or any other accounting standard that contains a similar hierarchy of inputs) should be provided as part of the valuation report?

Duff & Phelps response: No, we believe that the current IFRS 13 requirements are sufficient. IASB's disclosure requirements for fair value measurements, including recurring fair value measurements (such as for investment property) have been developed as part of an open public due process and outreach to constituents to understand their needs. Separately (and preceding the issuance of IFRS 13), FASB had performed the same process as part of the development of FAS 157, Fair Value Measurements, which is now codified in ASC 820.

Also, we note that the IFRS 13 requirement is incorrectly summarized in paragraph 3.1.1. The financial reporting requirement is to indicate the level in the fair value hierarchy into which the measurement falls in the aggregate, based on the level in the hierarchy that the significant inputs used in the measurement fall (*not all inputs*). Significance is determined based on judgment.

Finally, Section 3 of the DP is confusing as it seeks to augment the existing financial reporting disclosure requirements; meanwhile at the outset the DP had stated that the investment property guidance is being developed with broad applicability, and is not limited to financial reporting.

Question 16

If so what guidance should the IVSC be providing to enable valuers to comply with the requirements of IFRS 13 in relation to disclosures on inputs?

Duff & Phelps response: We believe the guidance in IFRS 13 is sufficient. Also see our response to Question 15.

We also are left with the impression that the DP does not make a distinction between: 1) disclosures that are limited to the valuation report, whose users are the party commissioning the valuation and potentially others privy to the report as part of the arrangement with the valuation advisor; and 2) disclosures for much "wider consumption" such as the IFRS 13 disclosures that are made to users of a company's financial statements. The current discussion in paragraphs 3.1.1 and 3.1.2 of the DP and Questions 15 and 16 blur this distinction.

Question 17

Do you agree that not all investment property is capable of reliable valuation? If so please give any additional examples to those above.

Duff & Phelps response: We believe that all investment property is capable of reliable valuation. Just because an asset may have uncertain cash flows (which is what the factors listed in paragraph 4.2 of the DP allude to) does not render it incapable of valuation. Further, the pure concepts of market value and fair value do not recognize exceptions for "unreliable" valuation.

Also, we would like to highlight that the issues that paragraph 53 of IAS 40 pertains to are different from the ones articulated in the DP. Below is an extract from paragraph 53 (as amended by IFRS 13), effective for annual reporting periods beginning on or after January 1, 2013.

> "**Inability to Measure Fair Value Reliably**

> 53 There is a *rebuttable presumption that an entity can reliably measure the fair value of an investment property on a continuing basis.* However, in exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property after a change in use) that the fair value of the investment property is not reliably measurable on a continuing basis. This arises *when, and only when, the market for comparable properties is inactive (eg there are few recent transactions, price quotations are not current or observed transaction prices indicate that the seller was forced to sell) and alternative reliable measurements of fair value (for example, based on discounted cash flow projections) are not available*. If an entity determines that the fair value of an investment property under construction is not reliably measurable but expects the fair value of the property to be reliably measurable when construction is complete, it shall measure that investment property under construction at cost until either its fair value becomes reliably measurable or construction is completed (whichever is earlier). If an entity determines that the fair value of an investment property (other than an investment property under construction) is not reliably measurable on a continuing basis, the entity shall measure that investment property using the cost model in IAS 16. The residual value of the investment property shall be assumed to be zero. The entity shall apply IAS 16 until disposal of the investment property.
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> 53A Once an entity becomes able to measure reliably the fair value of an investment property under construction that has previously been measured at cost, it shall measure that property at its fair value. Once construction of that property is complete, it is presumed that fair value can be measured reliably. If this is not the case, in accordance with paragraph 53, the property shall be accounted for using the cost model in accordance with IAS 16.
>
> 53B The presumption that the fair value of investment property under construction can be measured reliably can be rebutted only on initial recognition. An entity that has measured an item of investment property under construction at fair value may not conclude that the fair value of the completed investment property cannot be measured reliably.” [Emphasis added]

With regards to the above, we believe that even in inactive markets or under a market disruption market participants do transact and are able to agree on how to price a transaction. Therefore, while judgment is required, it is always possible to derive valuation inputs from a market participant perspective.

Also, in the case of investment property specifically, sophisticated parties (presumably) have made an investment decision to acquire, construct or operate such property; therefore various uncertainties have been thought through and judgments about their impact on value have been made.

Even IVSC's own standard on Investment Property under Construction - IVS 233 does not have a reliably measurable exception.

Finally, similar to an earlier observation, we find Section 4 of the DP confusing as it discusses the unique financial reporting concept of "reliably determinable"; meanwhile at the outset the DP had stated that the investment property guidance is being developed with broad applicability, and is not limited to financial reporting.

Question 18

Please indicate the nature of guidance that you believe IVSC could usefully provide to help determine when a valuation cannot be reliably provided.

Duff & Phelps response: NA. See our response to Question 17.