

Valuation Uncertainty

Reply to IVSC Exposure Draft by

The Fédération Française des Experts en Evaluation (FFEE)
(The French Federation of Valuation Professionals)

REAL ESTATE VALUERS APPROACH

(Answer prepared by the AFREXIM and IFEI)

The FFEE is an association of valuation professionals active in the valuation of all types of assets in France, including real estate assets, companies and financial assets, including financial instruments. It's four full members are :

- AFREXIM
- IFEI
- APEI
- SFEV

We are grateful for the opportunity to comment on this exposure draft. Uncertainty in valuation is an important subject and one that requires a consistent approach among valuers to ensure that users of valuations can correctly compare valuations of different assets and properly understand the underlying degree of accuracy of the exercise. Given the difficulties of this subject, we also agree that it is best dealt with in a technical information paper, rather than in a standard.

We reply to the various questions set out in IVSC's paper as follows :

Question 1. "The proposed TIP defines valuation uncertainty at para 7.
Do you agree with this definition? If not, how do you think that it could be improved?"

We agree with the definition at paragraph 7.

Question 2. "Various prudential regulatory authorities either have or are contemplating introducing disclosure requirements for assets that are deemed to be subject to "valuation uncertainty" and to apply different risk weightings to these in capital adequacy regulations for banks and other financial institutions. The Board has decided to exclude prudential valuation adjustments for valuation uncertainty from the scope of this guidance. The reason is that the IVSC is only concerned with proper valuation practice, not with how valuations are then used by the recipient in complying with other standards, laws or regulations.

Do you agree with the Board's decision to exclude prudential valuation adjustments for valuation uncertainty from the scope of this guidance?"

We agree with the board's decision.

Question 3. “The proposed TIP provides guidance on the distinction between valuation uncertainty as defined in the paper and risk, in particular between market uncertainty and market risk. It was clear from comments received on the Discussion Paper and made elsewhere that the concepts are regularly confused. Some believe that the brief explanation of market risk in paras 16 and 17 is not needed given that the focus of the paper is on uncertainty rather than risk. Others consider that the inclusion of a brief illustration of market risk helps readers understand the distinction between this and market uncertainty.

Which of these views do you support?”

We support the inclusion of the illustration of market risk.

Question 4. “The paper identifies three main sources of valuation uncertainty: market uncertainty, model uncertainty and input uncertainty.

Do you agree that these three categories represent the main sources or causes of valuation uncertainty as defined? If not please explain why, and in particular identify any other source of uncertainty that is not mentioned.”

We agree that these three categories represent the main sources or causes of valuation uncertainty.

We suggest that the paper also points out that input uncertainty can arise in very opaque markets where pricing information is not shared between market players. Indeed, in some markets this goes as far as erroneous information being deliberately spread by some market players in the hope of influencing other actors in the market. In such circumstances the difficulties of obtaining reliable inputs for valuations are compounded significantly and this may contribute to a greater degree of uncertainty.

Input uncertainty can also arise where particular types of assets are traded very infrequently. This can be because of the size on the assets (for example, large specialised real estate assets worth several hundreds of millions), because a certain inherent scarcity means that their owners rarely sell them, or for other reasons. In such situations valuers may be relying largely on extrapolations made from the last transactions, which in some cases may have taken place several months or even years previously.

Question 5. “The proposed guidance indicates that because market uncertainty arises when the impact of events on value is unknown it is identifiable but not measureable. In contrast, model and input uncertainty can be both observable and measureable.

Do you agree with this position?”

Up to a point, yes. Nevertheless, referring to our reply to Question 4, above, we consider that in very opaque markets, or where assets are very rarely traded, it may be difficult to correctly assess and measure the degree of input uncertainty. Alternatively, if it is measurable, the margins of variation may be significantly larger than for more normal markets.

Question 6. “The requirement in IVS 103 is to disclose any material uncertainty that affects the valuation. Paras 29-39 of the proposed TIP provide guidance on identifying when uncertainty is material, with reference to the requirement in IFRS 13 for valuations for financial reporting and more general guidance where valuations are for other purposes.

Do you find the guidance on materiality to be helpful? Are there any improvements or other considerations that you would suggest be included?”

Yes, these comments are helpful.

As regards the Level 1, 2 and 3 hierarchy of IFRS 13, it is important in our view to avoid giving the impression to readers of this paper that Level 3 valuations carry a high level of uncertainty, simply because they are Level 3 and not Levels 1 or 2. In our view most valuations of real estate investment assets under IFRS 13 will fall within Level 3 because valuation of such assets very often requires significant adjustment of observed inputs : while in a few cases the valuer may consider that there is a higher than normal level of uncertainty, for the majority of valuations this will not be the case.

Question 7. Para 42 sets out matters that it is recommended be included in a qualitative disclosure of uncertainty.

Do you agree that this identifies the matters that should normally be included in a disclosure of uncertainty? If not please indicate any additional matters that you consider should be included or any matters mentioned that should be excluded.

Yes we agree that Para 42 identifies the matters that should normally be included.

Question 8. “Para 47 suggests that model and input uncertainty may be more readily measurable for financial instruments than for other types of asset.

Do you have experience of quantitative measures of valuation uncertainty for tangible or intangible assets being disclosed in reports? If so please indicate the types of asset and the techniques used to quantify the uncertainty.”

Real estate assets are unusual in many respects, particularly that each asset is unique in terms of location, condition, tenancies and revenues generated, etc. One particular characteristic is that the creation of the built property (development) takes a considerable time and that there is always the risk of changes in market pricing taking place during the development process, which can have a knock-on impact on the value of the bare site (before construction starts) or of the property in course of construction.

So in real estate valuation, it is quite common to use sensitivity analysis in residual valuations of development land or development projects. These calculations of the value of such assets are very sensitive to variations in the many inputs into the model – quite small variations can lead to much greater differences in value. In development appraisals this tool can therefore be useful to indicate the sensitivity of the analysis to small changes in inputs.

Illustrating sensitivity is clearly different from reporting valuation uncertainty. Nevertheless, if material uncertainty exists over the likely value of key inputs, sensitivity analysis can be a good way to indicate to the reader of the valuation report the extent to which values can change as a result of changes in the inputs. However, if this tool is used to explain uncertainty, we agree that the valuer should be careful to limit the range of variation in input values to that which covers the likely extent of the uncertainty. Otherwise, the reader of the report may come away with an exaggerated idea of the extent of the real level of the uncertainty.

Question 9. “Para 51 sets out proposed principles for quantitative measures of uncertainty.

Do you agree with this list? If not please indicate any additional principles that you believe should be included or any listed that you believe are inappropriate.”

We agree with this list.

In particular, we agree with the position in the paper that any such quantitative measurement must be accompanied by an explanatory text, to ensure that the reader has a correct understanding of the likely causes and extent of the uncertainty.

Question 10. It is proposed that the final TIP will include a few simple illustrative examples of uncertainty disclosures to assist readers understanding how the guidance may be applied in practice. The Board has decided not to develop these until it has received comments on the principles in this draft. The Annexe to this draft contains an indication of situations for which examples are being considered.

Do you agree with the Board's proposal to include illustrative examples of typical disclosures? If so, please indicate the situation for which you consider an example would be most useful.

If you have an example of either a disclosure or measurement of valuation uncertainty that you would like the Board to consider for inclusion in the final paper, please include this with your response.

We have given below an example of an uncertainty clause that was used in real estate valuation reports in the late 2008 / early 2009 period in the immediate aftermath of the Lehman Brothers collapse, in case this is useful for this paper as an example of market uncertainty.

“The continued turmoil and instability in the financial markets is causing volatility and uncertainty in the world's capital markets and real estate markets. There are low levels of liquidity in the real estate market and transaction levels are significantly reduced, resulting in a lack of clarity as to pricing levels and the market drivers. This, combined with a weakening of sentiment towards real estate, has resulted in a continual reappraisal of commercial property prices.

In this environment, prices and values are going through a period of heightened volatility whilst the market absorbs the various issues and reaches its conclusions. In addition, the market has also become more opaque and it has become more difficult to obtain reliable information about transactions. As a result there is less certainty with regard to valuations with the result that market values can change rapidly in the current market conditions.”

Other comments :

Finally, we suggest that the valuer’s appreciation of his reporting obligations as regards uncertainty may be influenced by the underlying context of the valuation and / or the assumptions agreed with his client.

For example, if the valuation is required for loan security purposes in order to assist a bank or financial institution with a “go / no go” decision involving substantial sums of money, the valuer may consider that it is more important to highlight potential uncertainty than he might in the case of regular valuations for information purposes for a non-listed investor committed to a long term hold of the asset.