In depth
A look at fair value disclosure in the Real Estate industry

IFRS 13 European real estate survey – 2016 update

12 December 2016

What's inside:

At a glance

IFRS 13 'Fair value measurement', introduced in 2013, has significantly expanded the disclosure requirements to provide users of financial statements with detailed quantitative and qualitative information about assumptions made and processes used when measuring assets or liabilities at fair value.

In 2014, we issued *IFRS 13 European real estate survey*. In that publication we looked at how a sample of European real estate companies had responded to IFRS 13 disclosure requirements in relation to investment properties, specifically, the quantitative information disclosed about significant unobservable inputs used in fair value measurement and the sensitivity of the fair value measurement to significant changes in those unobservable inputs.

The 2016 update of the *IFRS 13 European real estate survey*, looks into how company disclosures have evolved in the last two years.

The sample of European real estate companies used within this publication consists of 42 companies listed within the United Kingdom, France, Germany, The Netherlands, Sweden, Belgium and Italy.

Fair value hierarchy – Level 2 or level 3

Fair value measurements in IFRS 13 are categorised into a three-level hierarchy. The hierarchy is based on the type of inputs and is defined as follows:

- **Level 1** inputs are unadjusted quoted prices in active markets for items identical to the asset being measured. An entity uses that price without adjustment when measuring fair value. A quoted price in an active market is a Level 1 input.
- **Level 2** inputs are inputs other than quoted prices in active markets included within Level 1 that are directly or indirectly observable.
- **Level 3** inputs are unobservable inputs that are usually determined based on management's assumptions. However, Level 3 inputs have to reflect the assumptions that market participants would use when determining an appropriate price for the asset.

Fair value measurements of real estate are categorised as Level 2 or Level 3 valuations. There are two significant reasons for this:

- the nature of real estate assets: they are often unique and not traded on a regular basis; and
- the lack of observable input data for identical assets.

Certain IFRS 13 disclosures are only required for fair value measurements classified as Level 3. 41 out of the 42 companies reviewed identify investment properties as falling within Level 3 of the fair value hierarchy, with the remaining one company not disclosing this information. For this company, the extent of additional disclosures indicates a Level 3 classification.

Significant unobservable inputs

IFRS 13 paragraph 93(d) requires the following disclosures for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy:

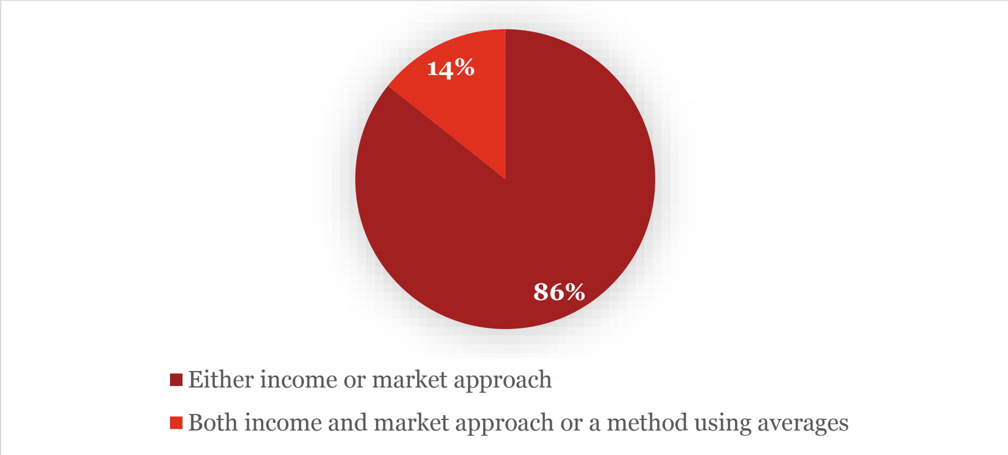
- a description of the valuation technique(s) used; and
- the inputs used in the fair value measurements .

An entity should provide quantitative information about the significant unobservable inputs used in the fair value measurement for fair value measurements categorised within Level 3 of the fair value hierarchy.

IFRS 13 states that the three widely used valuation techniques are the market approach, the cost approach and the income approach. The standard does not indicate a preferred valuation technique. The main aspects of those approaches are summarised in paragraphs B5-B11 of the standard.

IFRS 13 requires an entity to choose valuation techniques that are appropriate to the specific circumstances and maximise the use of observable inputs. An income approach or a market approach will often be more suitable to measure fair value. This is because market participants would usually estimate the price of an investment property based on their expectations about future income. IFRS 13 encourages an entity to apply multiple valuation techniques if appropriate. The respective indications of fair value should be evaluated considering the reasonableness of the range of values indicated by those results.

36 companies out of the 42 reviewed used only an income or only a market based approach to determine fair value for all properties. Three companies used both an income and market approach to determine the fair value of different types of properties and three companies used an average of the fair values determined based on an income and a market approach to determine the fair values of each of their properties.

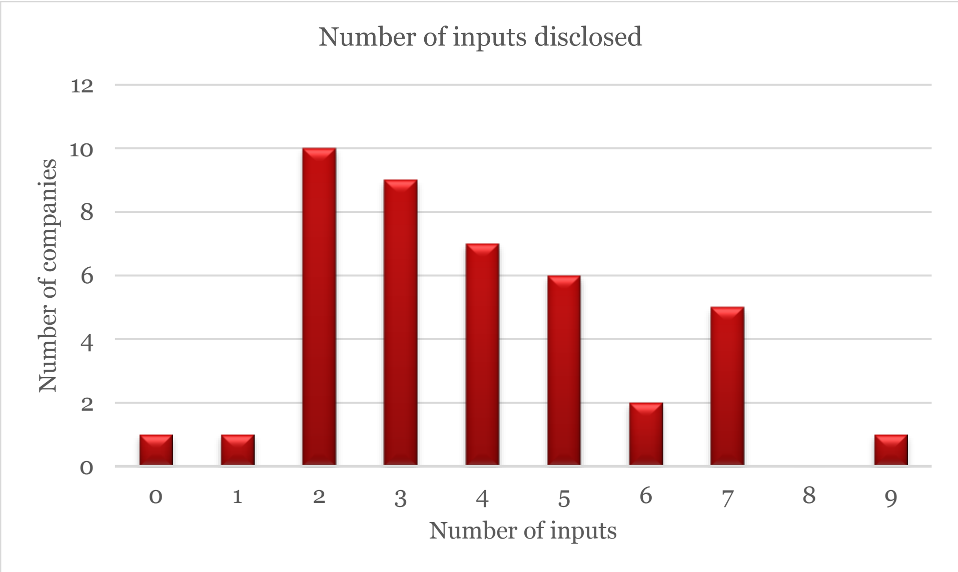


We have analysed the quantitative information disclosed about the significant unobservable inputs used in the fair value measurement when companies used the income based approach.

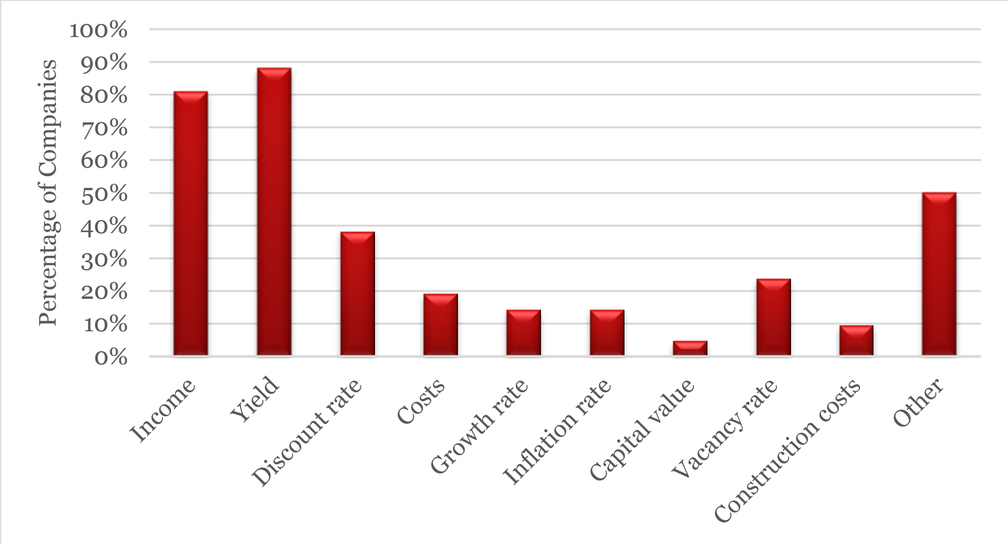
Income approach

The direct capitalisation method and the discounted cash flow method are the most commonly used valuation techniques within the income approach category. These methods are types of present value techniques. The fair value is determined on the basis of future income to be earned from the asset. We have noted a wide range in the number of quantitative inputs disclosed, ranging from one input to nine inputs.

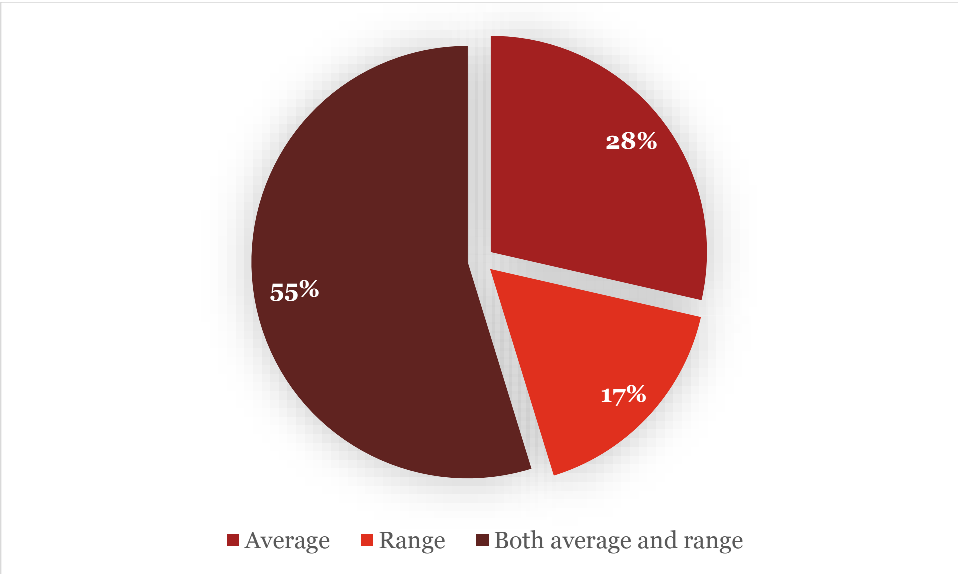
Most companies disclose two inputs as unobservable, being income and yield, consistent with our 2014 survey and also the nature of the income approach.



Inputs can generally be grouped into categories, although there is a wide range of inputs used. The chart below sets out the nature of inputs disclosed by companies using the income approach. As above, the two most popular inputs disclosed related to income or yield:



We have also noted that the way in which such quantitative data is presented varies with some companies disclosing an average, others a range and some both an average and a range. The results below are broadly consistent with our 2014 survey.



Asset classes

Paragraph 94 of IFRS 13 requires that 'an entity shall determine appropriate classes of assets and liabilities on the basis of the following:

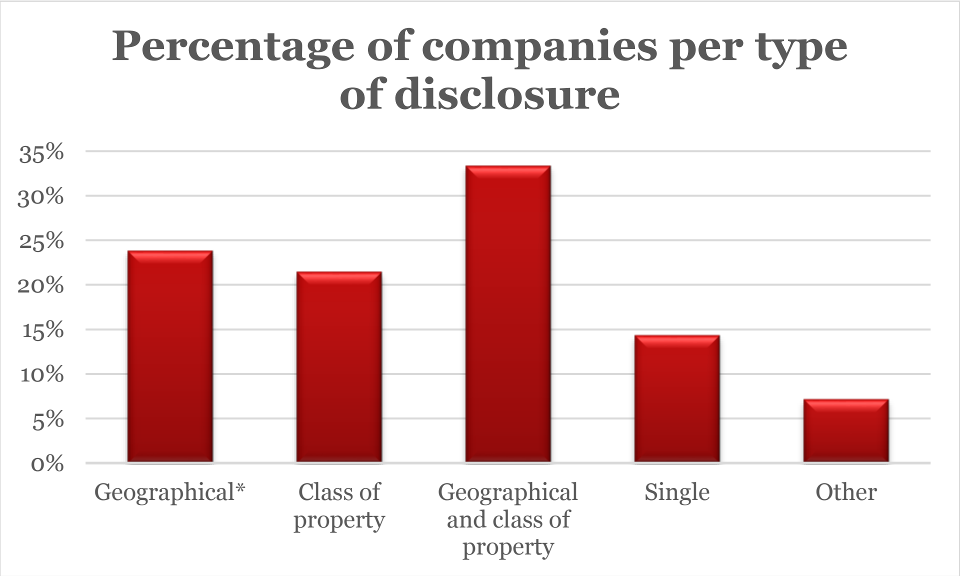
1. The nature, characteristics and risks of the asset or liability; and
2. The level of the fair value hierarchy within which the fair value measurement is categorised'

The number and classes are expected to be greater for fair value measurements categorised within Level 3 of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity. Judgement is required for the determination of appropriate classes of investment property for which disclosures about fair value measurements should be provided.

For each of the companies within our survey we compared the classes of properties used for the purposes of the IFRS 13 disclosures to the identified segments as reported in their segments note. 31% of companies have disaggregated the classes of properties in accordance with their disclosed segments. This compares to 43% in our 2014 survey suggesting a trend towards providing users with a greater level of detail.

Companies that disaggregated properties on the basis of something other than their disclosed segments used a variety of methods. However, 79% of these companies provided a greater level of disaggregation than their segment disclosures compared to 75% in our 2014 survey, again showing a trend towards providing greater detail. The most popular method for providing disaggregated disclosures continued to be by geography and class of property with 33% of companies disclosing information in this way compared to 30% in our 2014 survey.

The following chart summarises the categories used by the 42 companies within our sample to disclose their classes of assets for the purposes of IFRS 13:



**Geographical categorisation includes categorisation by country, region and individual property location*

Sensitivities

IFRS 13 paragraph 93(h) requires the following disclosures to be provided for investment properties measured at fair value categorised within Level 3 of the fair value hierarchy:

'*...a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those* *interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs shall include at a minimum, the unobservable inputs disclosed when complying with (d)'.*

The guidance does not explicitly require a quantitative sensitivity analysis. However such sensitivity analysis may be necessary in order to satisfy the requirements of IAS 1.

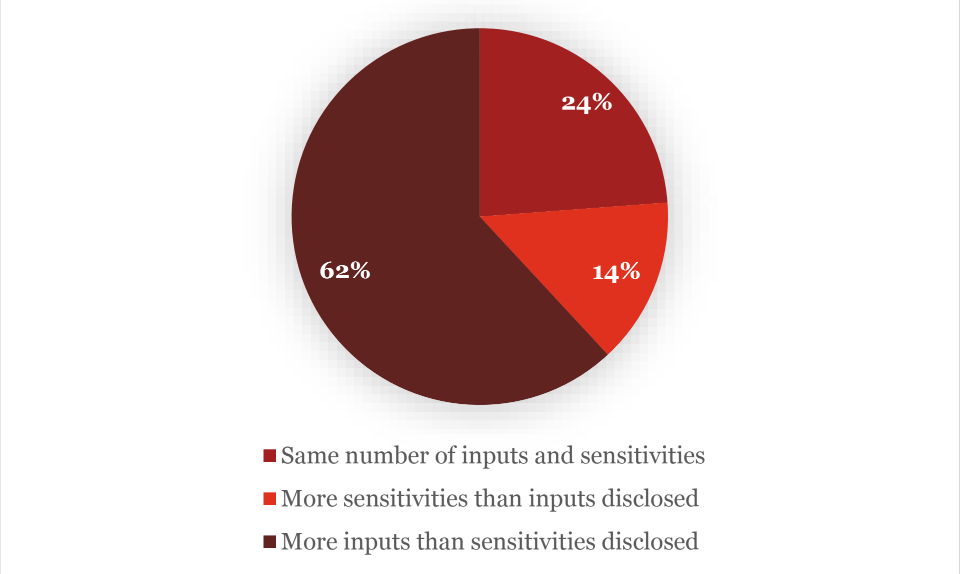
Paragraph 125 of IAS 1 requires that *'an entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of: (a) their nature; and (b) their carrying amount as at the end of the reporting period'.*

Where assumptions made in determining the fair value of investment property fall to be significant assumptions in the context of IAS 1, further information must be provided within the financial statements so that users understand the effect of estimation uncertainty. The disclosure of the sensitivity of carrying amounts to significant assumptions is an example of information to be provided in accordance with paragraph 129 of IAS 1.

28 of the 42 companies reviewed (67%), provided quantitative disclosure of sensitivities and 10 (24%) provided qualitative disclosure of sensitivities. Three companies did not provide any sensitivity analysis and one provided qualitative disclosures for some unobservable inputs and quantitative for others. This shows a slight increase in quantitative disclosure from our 2014 survey results where 62% provided disclosure in this way and the remaining 38% provided qualitative disclosure. The format of the disclosure varies significantly between companies, with some choosing to present the analysis in a tabular format and others providing a summary narrative.

For each of the companies in the sample we have compared the number of significant unobservable inputs disclosed to the number of sensitivities presented. As outlined above, IFRS 13 requires companies to include a narrative description of the sensitivity to changes in unobservable inputs; at a minimum, such a description should be provided for significant unobservable inputs used in the fair value measurement.

62% of companies disclosed less sensitivities than inputs perhaps suggesting that not all unobservable inputs disclosed were considered 'significant' in the context of IFRS 13 and were disclosed to enhance users' understanding of the valuation. This has also increased from our 2014 survey where 41% of companies disclosed more inputs than sensitivities. A further 24% of companies disclosed the same number of sensitivities and inputs suggesting all inputs disclosed were considered significant, compared to 41% in our 2014 survey. The remaining 14% disclosed more sensitivities than inputs, a slight decrease from 18% in our 2014 survey; these additional sensitivities are qualitative and provided as a narrative summary. The rationale for disclosing these additional sensitivities is unclear in all cases:



Where companies provided quantitative sensitivities, the most commonly used sensitivities were a variation of 25 basis points for yield/discount rate (69% of companies disclosed this measure) and a 5% variation for income (33% used this measure). The use of a 25 basis point variation for yield/discount rate has increased in popularity from our 2014 survey when it was used by only 42% of companies. However, the opposite is true for income sensitivities where 54% of companies used a 5% variation in our 2014 survey. Instead, companies now disclose different variations, ranging from 1% to 10%, or even monetary increases in income, rather than percentages.

Key takeaways

Two years after the adoption of IFRS 13, there have been some notable changes in disclosures made by entities in the real estate industry, specifically:

- Entities have increased the level of disaggregation when disclosing information about different classes of property. Entities have started to move away from disaggregation driven by segment reporting with disaggregation "by type and location" being more frequently used.
- More entities are providing quantitative instead of qualitative disclosure of the required sensitivity analysis for significant inputs compared to 2014.
- A significant number of entities have disclosed less sensitivities than inputs compared to 2014 suggesting that not all unobservable inputs disclosed were considered 'significant' in the context of IFRS 13.
- The most frequent sensitivity used for yield was 25 basis points, with more than a 25% increase in the number of companies using this variation compared to 2014. There is less consistency for income sensitivities with companies now providing a more diverse range of sensitivities compared to 2014.

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