APPLICATION OF FAIR VALUE CONCEPT: A CASE STUDY WITH REFERENCE TO REAL ESTATE ENTITIES

CA Upendra Wagle* & Dr. Umesh Maiya **

*Chartered Accountant and Research Scholar of Bharathiar University,
Amba Prasad, Siribail, Post Kadthalna, KarkalaTaluke, Udupi Dist.-574108, Karnataka State.

** Assistant Professor and Head, Department of Commerce and Business Management,
Govt. First Grade College, Byndoor-576214, Karnataka State

** Corresponding Author.

ABSTRACT

The purpose of this study is to overview the fair value concept that can be used by real estate companies by identifying the places where there is a possibility to apply fair value concept and appropriateness of applicability to a given scenario. Also an attempt has been made to bring out ways in which the fair valuation has been derived by real estate companies. The study has been restricted to application of fair value concept to immovable properties held by the real estate companies.

Key words: IFRS, Fair Value, Income capitalization, discounted cash flow, Real Estate companies.

Introduction:

Fair value accounting is a financial reporting approach in which companies are required or permitted to measure and report on ongoing bases certain assets and liabilities. Fair value concept has been on the ascent. In India, due to adoption of IFRS, there is a major departure from the centuries old traditional valuation of historical cost to fair value accounting. In many entities, where the properties have been shown at historical cost, which is just a nominal amount but actual value of the property is in millions. This not only distract the “true and fair” concept of accounting but also undermine the net worth of the entity, keeping the stakeholder’s in dark in understanding true worth of the entity.

Both FASB and IASB stress the importance of high quality financial reporting. The adoption of IFRS in India, steadily, shifts the historical cost to fair value reporting.

Objectives of the Study:

The present study has been undertaken keeping in view the following objectives:

• To understand fair value concept as per IFRS.
• To understand application of fair value concept to Immovable properties.
• To understand the methods used to arrive the fair value in case of immovable properties.
• To overview accounting policies adopted under IFRS by real estate entities in relation to immovable properties.
Literature Review:

There are hundreds of studies available on fair value concept. According to Ijeoma, N.A (2013), the implementation of fair value concept gives sufficient precision in assessing firm’s financial position and earning potential. Also, there is possibility of measurement errors in fair value concept.

Vera Palea (2013) claims that historical cost and fair value should not be considered as competitors and both of them should be provided. An attempt to choose either one would deprive financial statement users of access to complete and useful information for decision-making. For this reason, a dual measurement and reporting model should be a good solution. A dual measurement and reporting model could be more effective for assessing the success of an investment. Comparing expected events (i.e. fair values) with past events (i.e. historical costs) would improve the ability of financial statement users to evaluate both past performance, thus, fulfilling a stewardship objective, and to predict future performance, thus, fulfilling a decision-useful objective.

As per Izette Klueer (2012), fair value under IFRS is timely enough to impact the users decisions. However, the volatility of fair value numbers might necessitate more regular reporting.

R. Devi (2012) noted that users and preparers of financial statements have similar understanding of fair value accounting. Benefits identified were better disclosure and information. It also been identified the limitations of methods in terms of cost of valuation, training and application of subjective judgment.

According to Bond Market Association (2002), in additions to using fair value measures to comply with public reporting requirements, companies measure their financial instruments at fair value for a number of internal processes such as investing and trading decisions, managing and measuring risks, determining how much capital to devote to various line of business.

As per James A. Ohlson (2007), the ideal fair value accounting reports a book value that is sufficient to value the firm but earnings that are uninformative for the purpose. Ideal historical transactions accounting produces a balance sheet that does not report value but earning that are sufficient to value a firm.

As per Betakova (2014) both historical cost and fair value should be provided as only together they can deliver complete and useful information to the users. As a consequence adoption of dual measurement and reporting system should be considered and discussed at standard setting level.

Concept of Fair Value:

Fair value is defined in IFRS 13 ‘Fair Value Measurement’ 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. IFRS 13 provides principles-based guidance on how to measure fair value. It does not attempt to remove the judgment that is involved in estimating fair value, rather, it provides a framework that is intended to reduce inconsistency and increase comparability in the fair value measurements used in financial reporting.

Fair Value can be arrived considering three levels of inputs.

- Level 1 – Quoted (unadjusted) market prices in active markets for identical assets or liabilities.
- Level 2 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable.
- Level 3 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable.

Valuation Techniques:

The following approaches can be used to derive the fair value measurement.

a) Market Approach:

Under the market approach, the value is determined based on comparable transactions. The price of other property that have been recently exchanged or that may be currently available in the market can be used as comparable transaction. It is usual to adopt a suitable unit of comparison. Units of comparison that are commonly used are square meter of a building or per hectare for land. Other units used for price comparison include a price per room or a price per unit of output.

b) Income Approach:

i) Income capitalization method:

Under the income capitalization method, a property’s fair value is estimated by capitalizing net operating income generated by the property. The investor’s rate of return is right capitalization rate.
ii) Discounted cash flow method (DCF)
Under the DCF method, a property’s fair value is estimated using explicit assumptions regarding the benefits and liabilities of ownership over the asset’s life including an exit or terminal value. DCF method involves the projection of a series of cash flows on a real property interest. To this projected cash flow series, an appropriate, market-derived discount rate is applied to establish the present value of the income stream associated with the real property.

The duration and timing of cash flow are determined by events such as lease terms, rental amount, lease renewal, re-letting possibility, and redevelopment and so on. Cash flow is typically consist of gross rental less vacancy term, non-recoverable expense, collection losses, lease incentives, maintenance cost, commission and management expenses.

In the case of development properties, estimates of capital outlays and construction cost, development costs, and anticipated sales income are estimated to arrive at a series of net cash flows. Specific development risks such as planning, zoning, licenses, and redevelopment and so on need to be separately valued.

The effect of following factors needs to be considered while arriving fair value.

- Type of tenants actually in occupation or responsible for meeting lease commitments or likely to be in occupation after letting vacant accommodation.
- The allocation of maintenance and insurance responsibilities between the lessor and the lessee.
- Expected remaining economic life of the property.

c) Cost approach
“A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).” This assumes that fair value is the cost to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence (including physical deterioration, functional (technological) obsolescence and economic (external) obsolescence.

Accounting Policies adopted by real estates:
i) Atrium European Real Estate.

a) Standing investments:
Standing investments comprise properties held to earn rental income and land related to those properties. Standing investments are initially measured at cost, including costs directly attributable to the acquisition and, after initial recognition, are measured at fair value.

The fair value of standing investments is determined using a Discounted Cash Flow model. The Discounted Cash Flow model considers the present value of the net cash flow to be generated from the properties, taking into account the aggregate of the net annual rental income. The expected net cash flows are capitalized using a net yield which reflects the risks inherent in the net cash flows. The yield estimation is derived from the market and considers, among other factors, the country in which the property is located and the risk assessment of the asset. The Group categories the standing investments fair value as level 3 within the fair value hierarchy.

b) Development and land:
Developments and land comprise capitalized development costs and land, except for the land on which standing investments are situated. Developments and land are initially recognized at cost which includes directly attributable expenditures and subsequently at fair value with any change therein recognized in the consolidated income statement.

The fair value of developments and land was determined using the Comparable method and residual method. The Comparable valuation method is based on the sales (offering and listing) prices of similar properties that have recently been transacted in the open market. Sales prices are analyzed by applying appropriate units of comparison and are adjusted for differences with the valued property on the basis of elements of comparison, such as location, size of the plot and zoning etc.

The residual value method uses the present value of the market value expected to be achieved in the future from the standing investment once it is developed less estimated cost to completion. The rental levels are set at the current market levels capitalized at the net yield which reflects the risks inherent in the net cash flows.

ii) EUROPEAN REAL ESTATE INVESTMENT TRUST LIMITED

(a) Investment properties
Investment properties are those properties that are held either to earn rental income or for capital appreciation or both. Investment properties are measured initially at cost, including directly attributable costs of acquisition. After initial recognition at cost, investment
properties are carried at their fair value based on professional valuation at each reporting date representing the ‘market value’ assuming an asset sale of each property.

The fair value of investment properties is based on unobservable inputs and it is therefore disclosed as level 3. The fair value has been arrived at on the basis of valuations carried out by the Group’s external valuers. The valuation is based upon assumptions including future rental income, anticipated maintenance costs, expected vacancy rates and future development costs. The valuation technique used is capitalization of rentals which is estimated per square meter basis.

(b) Properties held for sale
Properties are classified as held for sale if their carrying amount will be recovered by sale rather than by continuing use in the business. For this to be the case, the asset must be available for immediate sale in its present condition; management must be committed to and have initiated a plan to sell the asset (and such a plan is unlikely to have significant changes made to it or be withdrawn); an active program to locate a buyer has been initiated; the asset is being marketed at a reasonable price in relation to its fair value, and the asset is expected to sell within twelve months. Property assets that are reclassified as held for sale are measured at fair value.

(iii) Kennedy Wilson Europe Real Estate Plc
(a) Investment property
Property held for long-term rental yields or for capital appreciation or both, and that is not occupied by the Group, is classified as investment property and recorded at fair value. Investment property also includes property that is being constructed or developed for future use as investment property. Properties that are currently being developed or that are to be developed in the near future are held as development properties. These properties are initially valued at cost. Any direct expenditure on development properties is capitalized and the properties are then valued by external valuers at their respective fair value at each reporting date. 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.

Valuations reflect, when appropriate, the type of tenants actually in occupation or responsible for meeting lease commitments or likely to be in occupation after letting vacant accommodation, the allocation of maintenance and insurance responsibilities between the Group and the lessee, and the expected remaining economic life of the property. When rent reviews or lease renewals are pending with anticipated reversionary increases, it is assumed that all notices, and when appropriate counter-notices, have been served validly and within the appropriate time.

To determine the value of investment property, the income approach is used. This involves applying market derived capitalization yields to current and market derived future income streams with appropriate adjustments for income voids arising from vacancies, or rent-free periods. These capitalization yields and future income streams are derived from comparable property and leasing transactions and are considered to be key inputs in the valuation. Other factors that are taken into account include the tenure of the property, tenancy details, planning, building and environmental factors that might affect the property. The comparison methodology is used for residential properties whereby the fair value is calculated using data from recent market transactions.

Investment property under development is valued using the residual method which is the investment method, with a deduction for costs necessary to complete the development together with an allowance for the remaining risk.

(iv) Sirius Real Estate Limited
(a) Investment properties
Investment properties are properties owned by the Group which are held either for long-term rental income or for capital appreciation or both. Investment properties are initially recognized at cost, including transaction costs. The carrying amount includes the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met and excludes the costs of day-to-day servicing of an investment property. Subsequent to initial recognition, investment properties are stated at fair value, which reflects market conditions at the reporting date.

(b) Investment property under construction
Property that is being constructed or developed for future use as investment property is accounted for as an investment property under construction until construction or development is complete, when it is then reclassified as investment property. Investment property under construction will be carried at fair value at the earlier of when the fair value first becomes reliably measurable and the date of completion of the property. Any gain or loss will be recognized in the statement of comprehensive income, consistent with the policy adopted for all other investment properties carried at fair value.
The valuation is based upon assumptions including future rental income, anticipated maintenance costs and the appropriate discount rate. The properties are valued on the basis of a ten year discounted cash flow model supported by comparable evidence. The discounted cash flow calculation is a valuation of rental income considering non-recoverable costs and applying a discount rate for the current income risk over a ten year period. After ten years a determining residual value (exit scenario) is calculated. A cap rate is applied to the more uncertain future income, discounted to a present value. All investment properties are categorized as Level 3 fair values as they use significant unobservable inputs.

c) Investment properties held for sale

Non-current assets that are expected to be recovered primarily through disposal rather than through continuing use are classified as held for sale. For this to be the case, the asset must be available for immediate disposal in its present condition subject only to terms that are usual and customary for disposals of such assets and its disposal must be highly probable. Immediately before classification as held for sale the assets are measured in line with the Group’s accounting policies. Thereafter the assets are measured at the lower of their carrying amount and fair value less costs to sell.

References:
3. European Real Estate Investment Trust Limited - Reports & accounts, www.ereit.co.uk