The Association of
Real Estate Funds

Fund Pricing Recommendations

August 2014

Contents

Executive summary

The Association of Real Estate Funds (AREF) established a Working Group in 2013 with the objective of reviewing the practices adopted for the valuation of the assets and liabilities, the calculation of the net asset value per unit and, in the case of open-ended funds, the determination of the dealing prices for fund units. The Working Group was asked to recommend best practice and to assist AREF in producing guidance for members and investors. The Working Group's Terms of Reference, approved by the AREF Management Committee, are set out in Appendix II.

Initially the Working Group considered the appropriate starting point for the valuation of the property assets held by funds and agreed that the most visible and appropriate definition is that of Market Value as defined in the RICS Red Book and this underpins the recommendations of this report. The Working Group observed that, whilst the valuer should not be seeking to forecast values, the valuer should be encouraged to make comment in respect of the direction of (market or asset specific) travel and in respect of the liquidity of individual assets in certain situations, for example, a significant or material liquidation programme. Notwithstanding the above, the 2014 Edition of the Red Book does allow the valuer to provide projections for scenario analysis purposes, so long as any assumptions made are realistic and credible, and clearly and comprehensively set out within the report.

Next the Working Group considered the accounting frameworks available to funds and the implications of the transition to a new UK GAAP framework based more closely on IFRS principles in 2015. The transition to new UK GAAP or IFRS has the potential to reduce significantly the net asset value compared to the existing UK GAAP accounting basis such as where a fund uses a derivative to fix the interest payments on their debt or is liable to tax on gains on disposals. Nevertheless, tax exempt funds with no significant debt and that carry all their assets at fair value are unlikely to see any material change to the current NAV.

However, a net asset value determined solely in accordance with any of the available accounting frameworks will still have flaws in terms of ensuring the fair treatment of clients. The Working Group recommends making a series of adjustments to the accounting basis in order to arrive at a "Standard NAV" to provide a better indication of value. In making these recommendations the Working Group considered the work of INREV but disagreed with INREV's NAV-enhancing approach whereby items such as fund set-up costs and acquisition and disposal costs are deferred. The recommendations are designed to ensure that all assets and liabilities are reflected at their fair value and that all actual and anticipated fees and charges are deducted.

The Working Group also considered circumstances specific to open-ended funds and recommends further adjustments to the Standard NAV (which is suitable for both open-ended and closed-ended funds) in order to determine the basis for the bid and offer prices in the primary market for issuances and redemptions. It was noted that, in general, the bid-offer spread rightly represents an allowance for acquisition and disposal costs. In addition, the Working Group recommends consideration of adjustments to ensure that incoming investors in the period following the launch or restructuring of a fund contribute towards the relevant costs incurred by the fund and that exiting investors contribute towards any outstanding debt arrangement fees or early settlement penalties. The primary consideration is to protect existing investors from the dilutive effects of new investors joining the fund and ongoing investors from the dilutive effects of investors leaving the fund.

Finally the Working Group noted two areas where it has not made specific recommendations. Firstly, the recommendations relate to funds operating in normal market conditions but consideration should be given to stressed-markets where managers become compelled to buy or sell assets. Secondly, the effect of gearing on the net asset value should be considered further.

Implementation

New UK GAAP is required to be adopted for accounting periods commencing in 2015 (although early adoption is permitted) but the effective date of transition for the new accounting is the beginning of the comparative period (ie 1 January 2014 for funds with a December year-end). The Standard NAV should be implemented in the same period as the switch to new UK GAAP, and may be implemented earlier where appropriate.

Key recommendations

1. Consider the impact of the implementation of new accounting standards in consultation with stakeholders.

2. Adjust the accounting net asset value (NAV) to arrive at a “Standard NAV”.

3. The recommendations are aimed primarily at open-ended funds but Managers of closed-ended funds should also publish the Standard NAV figure.

1. The use of RICS Red Book valuation

The Group spent time considering the appropriate starting point for the valuation of the property assets held by funds and agreed that the most visible and appropriate definition is that of Market Value as defined in the RICS Valuation – Professional Standards, issued by the Royal Institution of Chartered Surveyors ("the Red Book") – further details of which are set out in Appendix I.

The Red Book defines Market Value as "The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion." In general, for financial reporting purposes, the concepts of Market Value and Fair Value can be regarded as the same.

In the context of the valuation of the units issued by funds, it is important to remember that Market Value assumes that any marketing period that might be required has passed and that the value assumes the simultaneous exchange and completion of the contract for sale on the valuation date. As such, in arriving at an opinion of Market Value, the valuer does not seek to look into, or predict, the future – and the value reported should not be adjusted to reflect the fact that values might either be in a period of growth, or decline. Notwithstanding, where the valuer considers that the price offered by prospective buyers generally in the market would reflect an expectation of change in the circumstances of the asset in the future (often referred to as 'hope value'), the impact of that expectation is reflected in Market Value.

While the valuer should not be seeking to forecast values, the valuer is able to assist the recipient in making informed decisions regarding the assets and therefore is permitted to make comment in respect of the direction of (market or asset specific) travel and in respect of the liquidity of individual assets. In respect of fund valuations where a full narrative report may not be included within the scope, such commentary could easily be provided as part of the reporting 'schedule'. In addition, the 2014 Edition of the Red Book does allow the valuer to provide projections for scenario analysis purposes, so long as any assumptions made are realistic and credible, and clearly and comprehensively set out within the report.

2. The use of UK GAAP Net Asset Value ("NAV") for fund pricing

Background

For many AREF open-ended funds, pricing is based on a UK GAAP NAV as adjusted for certain items within a bid offer spread, such as property acquisition and disposal costs. The purpose of this section of the paper is to consider at a high level the limitations of UK GAAP as a base measure of value and to consider the impact of changes to UK GAAP scheduled for 31 December 2015.

Weaknesses with NAV as a measure of value

The UK Fund industry has traditionally determined Net Asset Value (NAV) in accordance with the UK GAAP accounting convention, in contrast to much of Europe which has now adopted both IFRS based accounting and "INREV NAV" calculation methodology. Differences in accounting conventions can result in materially different calculations of NAV.

From a corporate finance point of view, traditional valuation techniques will typically appraise the cash flows that an investment generates from distributions (both capital and income) within a discounted cash flow analysis. NAV under any GAAP is *unlikely* to represent a good proxy for valuation as there is a disconnect between the carrying value of assets and liabilities underpinning the NAV of an entity and the cash flows arising from an investment in that entity. There are also likely to be a number of factors inherent in calculating an appropriate discount rate for the cash flows from an investment that accounting standards are not equipped or designed to deal with.

Having accepted that NAV is not likely to be a perfect measure of value, it is possible to reduce the impact of some of the imperfections by seeking to ensure that, as a minimum, individual assets and liabilities underpinning NAV are stated at fair value as opposed to cost or on some other basis. Whilst a sum of the parts method, as opposed to a basis that looks at a valuation of the whole, to reach a valuation is still imperfect, it is likely to be a better starting place than accounting NAV.

Currently UK GAAP has particular deficiencies in this regard. The more significant of these are as follows:

- UK GAAP does not require recognition of the fair value of derivative financial instrument assets or liabilities on balance sheet, but only as a disclosure. Given that many real estate entities use interest rate swaps and that these are more often than not currently out of the money, this is likely to lead to an overstatement of value.
- UK GAAP allows an accounting policy choice for fixed asset properties that are not investment properties, such as assets in the course of construction, to be held at cost less provisions for impairment as opposed to valuation. In addition, all trading properties or those held as inventory are held at the lower of cost and net realisable value. This is likely to lead to an understatement of value.
- UK GAAP does not allow the recognition of a deferred tax liability in respect of recognised revaluation gains.

New UK GAAP

For periods beginning on or after 1 January 2015, UK GAAP is changing to be more in line with IFRS. Entities currently applying UK GAAP will need to apply either full IFRS or FRS 102 (new UK GAAP, more aligned with IFRS). Comparative numbers will need to be restated, although there are certain transitional provisions. Therefore, for an entity with a 31 December year end, an opening balance sheet on the revised basis will be required as at 1 January 2014.

Two of the key implications of this change are:

- For those entities currently pricing based on a UK GAAP NAV, there will be a step change in the price on adoption of new UK GAAP. Decisions will need to be taken on how to deal with this change and when it should first be applied.
- A number of the specific weaknesses with using a UK GAAP NAV as a measure of value discussed above will disappear, but not all of them.

Implementation

Managers are encouraged to anticipate the impact of the introduction of new UK GAAP at the earliest opportunity and to consider the effect on their funds' prices. In doing so Managers should ensure they can demonstrate they are meeting their obligations to treat customers fairly.

3. Standard NAV

The Working Group considers that, in general, using the fair value of the various balance sheet items achieves a more accurate NAV for a fund that allows for better comparability between the NAVs of different real estate funds. The adjustments to the accounting NAV below are considered to be necessary in order to comply with the minimum requirements of the AREF Code of Practice. The table should be read in conjunction with the details of each adjustment given in section 5 of this report.

	Adjustment[1]	Current UK GAAP	New UK GAAP (FRS 102)	IFRS
	Start with accounting NAV and adjust for:			
1	Restatement at fair value of investment properties	✘	✘	(✔)
2	Restatement at fair value of investment property in the course of construction or development	(✔)	(✔)	(✔)
3	Restatement at fair value of property classified as held for sale	✘	✘	(✔)
4	Restatement at fair value of property and other assets held as inventory	✔	✔	✔
5	Restatement at fair value of other real assets	✔	✔	✔
6	Restatement at fair value of property leased to tenants under a finance lease	✔	✔	✔
7	Restatement at fair value of indirect investments	(✔)	(✘)	(✔)
8	Restatement to nil of property holding vehicles with negative equity	✔	✔	✔
9	Restatement at fair value of debt	✔	✔	✔
10	Restatement at fair value of derivatives (eg swaps used to fix the interest rate on debt)	✔	✘	✘
11	Recognition of contingent fees (eg performance fees)	✔	✔	✔
12	Deferred tax on unrealised revaluation gains	✔	✘	✘
13	Purchaser's costs and tax mitigation strategies on potential sales of tax efficient holding vehicles	✘	✘	✘
14	Tax effect of the above adjustments	✔	✔	✔
15	Minority interests effect on above adjustments	✔	✔	✔
	To arrive at Standard NAV			

[1] Table key:
✔ An adjustment to the accounting value is required
✘ No adjustment is required
(✔) An adjustment may be required depending on the accounting policy option used to determine the accounting value

4. Bid and offer bases

The adjustments to the Standard NAV below are considered to be best practice and it is for individual Managers to determine their application to their own fund circumstances in the context of their investors and provisions of fund documentation. The primary consideration is to protect existing investors from the dilutive effects of new investors joining a fund and ongoing investors from the dilutive effects of investors leaving a fund. Further details on each adjustment are given in section 5 of this report.

Although the adjustments are presented in the context of a dual pricing methodology, that is operating a bid-offer spread, the adjustments are equally applicable to a single swinging pricing methodology where the fully swung price corresponds to either the bid price or the offer price as appropriate.

	Adjustment	Bid Basis	Offer Basis
	Start with Standard NAV and adjust for:		
16	Amortisation of initial set-up costs over 5 years		✔
17	Amortisation of subsequent fund restructuring costs over 5 years		✔
18	Add property acquisition costs to determine offer price		✔
19	Deduct property disposal costs to determine bid price	✔	
20	Unamortised debt/swap arrangement fees charged in full to determine bid price	✔	
21	Unamortised early settlement penalties on debt/swap charged in full to determine bid price	✔	
	To arrive at bid/offer prices		

The adjustments above are intended to be appropriate under normal conditions. In making these adjustments Managers should take account of any surplus cash or debt within the fund to determine the appropriate bid and offer prices. So, in simple terms, if acquisition costs are 5%, then a fund with 20% in cash might have an offer price that is 4% higher the “NAV per unit”.

Also, Managers should consider including in their fund documentation additional provisions to deal with stressed conditions. For example, the adjustments above do not include any forced sale discounts where a Manager faces large redemption requests in a falling market or any premium for over-eager purchases in a rising market. Nor do they take account of any additional costs for winding-up a fund or for suspensions once the decision to wind-up has been approved.

It may be that the above adjustments do not readily fall into the existing provisions of a fund’s constitutional documents. Therefore it may become appropriate for Managers to revise their constitutional documents and that in turn may require a level of investor consents.

5. Details of the adjustments

Accounting convention

The Working Group considers that IFRS based accounting is likely to provide a better estimate of the underlying NAV than UK GAAP because adjustments are made to carry derivatives at fair value and to provide for deferred tax on revaluation gains. The new UK GAAP “FRS 102” comes in to force for years commencing in 2015 and is aligned with IFRS in most relevant respects. It is expected that the need for significant adjustments due to the choice of accounting convention will be reduced.

Net Asset Value

A Net Asset Value that is determined solely in accordance with accounting convention still has flaws and this has been debated at length within INREV. The INREV NAV has sought to make further adjustments to give investors a better estimation of the underlying value of assets and liabilities on a going concern basis. However, it is important to understand that the INREV NAV is not intended as a measure of value, its principal purpose is to create a uniform reporting standard from which to make performance comparisons.

The Working Group is mindful that a large number of funds within the AREF universe are open-ended structures that provide periodic liquidity to their investors at a price which is determined based on the NAV figure. The Working Group is also mindful that the bid/offer spread in some open-ended funds already effectively recognises the cost of acquisition and disposal.

Whilst we recognise that the industry would benefit from a standardisation in the calculation of NAV, it cannot recommend adopting either the IFRS based approach or the INREV NAV as its principal measure, further adjustment is necessary. Accordingly, the Working Group sets out its recommendations below. These recommendations are consistent with the INREV approach unless stated otherwise.

Asset Level

The Working Group considers that:

- It is imperative that all reported written property valuations meet the requirements of the RICS Red Book.
- For financial reporting purposes special assumptions should be avoided wherever possible. However, where it is deemed necessary it is essential that the relevant parties are made aware of such assumptions and any adjustments that have been made by the valuer (for example, topped-up rents, rental guarantees etc.), so that appropriate allowances can be made elsewhere in the accounts.

Adjustments from accounting NAV to Standard NAV

In general investment properties audited under IFRS are carried in the accounts at fair value. However, accounting standards provide a number of options for classifying property in ways that may lead to it being carried at a different amount. Adjustments 1 to 6 are intended to ensure that properties are included in the NAV at their fair value and, where relevant, in accordance with the RICS Red Book.

1. *Restatement at fair value of investment properties*

- IAS 40 allows an option to carry investment properties at cost or fair value. Where cost is used the Working Group recommends adjusting the carrying value to fair value.
- FRS 102.16 and SSAP 19 do not allow the cost option so all investment properties are carried at fair value. Consequently no adjustment is required.

2. *Restatement at fair value of investment property in the course of construction or development*

- IAS 40 allows an option to carry property that is being constructed or developed at cost or fair value. Where cost is used the Working Group recommends adjusting the carrying value to fair value.
- Where property that is being constructed or developed is not treated as investment property under FRS 102.16 or SSAP 19, the treatment and recommendation specified in item 5 apply such that the carrying value is adjusted to fair value.

3. *Restatement at fair value of property classified as held for sale*

- IAS 40 allows an option to carry investment properties at cost or fair value. Where fair value is used, no adjustment is required. However, where cost is used and the property is classified as held for sale, IFRS 5 requires the property to be carried at the lower of cost and fair value less costs to sell. The Working Group recommends adjusting the carrying value to fair value with no deduction for selling costs.
- The held for sale classification does not exist in FRS 102 or current UK GAAP. Consequently no adjustment is required.
- This recommendation is different to INREV's approach which is to carry property classified as held for sale at fair value less selling costs. The INREV NAV will be lower by the amount of the selling costs deducted on properties held for sale. For UK funds such selling costs should be deducted in the bid price rather than in the NAV.

4. *Restatement at fair value of property and other assets held as inventory*

- IAS 2 requires inventories to be carried at the lower of cost and net realisable value. The same treatment is applicable under FRS 102.13 and SSAP 9. The Working Group recommends adjusting the carrying value to fair value.
- This recommendation is different to INREV's approach which is to carry property held as inventory at fair value less selling costs. The INREV NAV will be lower by the amount of the selling costs deducted on inventories. For UK funds such selling costs are deducted in the bid price rather than in the NAV.

5. *Restatement at fair value of other real assets*

- IAS 16 requires real assets to be carried at cost or fair value, in each case after deducting an allowance for depreciation/impairment. The same treatment is applicable under FRS 102.17 and FRS 15. The Working Group recommends adjusting the carrying value to fair value.

6. *Fair Value of property that is leased to tenants under a finance lease*

- IAS 40 requires that property leased to a tenant under a finance lease is initially measured at net investment value and subsequently based on a pattern reflecting the constant rate of return. The same treatment is applicable under FRS 102.16 and SSAP 21. The Working Group recommends adjusting the carrying value to fair value.

7. *Restatement at fair value of indirect investments*

- IFRS and FRS 102 require that indirect holdings of property via real estate funds to be carried at fair value as financial instruments. Under UK GAAP properties are carried either as cost or fair value. The best evidence for valuing these investments at fair value will be a quoted price, or failing that, a bid price provided by the Manager. However, in some cases it may be necessary to default to NAV as the only available measure. The Working Group recommends that indirect holdings should be carried at fair value in accordance with IFRS and FRS 102. Where a reasonable estimate of fair value cannot be determined, and NAV is used instead, adjustments should be processed in accordance with this paper to estimate the standard NAV as the carrying value.

8. *Restatement of property holding vehicles with negative equity*

- Where property is held via a special purpose vehicle (SPV) and the property is worth less than a loan secured on that property, the SPV will contribute a negative value to the fund's accounting NAV. Where the lender's recourse is limited to the property held within the SPV and a decision has been taken by the Manager not to provide further support to the SPV, the Working Group recommends that the fund's NAV should be adjusted by adding back the negative value of the SPV.

9. *Restatement at fair value of debt*

- IAS 39 requires debt to be carried at amortised cost. The same treatment is applicable under FRS 102.16. The Working Group recommends adjusting the carrying value to fair value. This adjustment applies to both fixed rate and floating rate debt.

10. *Restatement at fair value of derivatives*

- Interest rate swaps are used to hedge against interest rate fluctuations in relation to variable rate debt. IFRS and FRS 102 require derivatives to be carried at fair value. However, UK GAAP does not require derivatives to be carried at fair value. The Working Group recommends adjusting the carrying value to fair value.

11. Recognition of contingent fees

- A fee that becomes payable only on the occurrence of a future event or circumstance may not meet the criteria for recognition as a provision or liability in accordance with IAS 37 or FRS 102.21 at the balance sheet date. For example, a performance fee becomes payable only if certain performance criteria are met. The Working Group recommends adjusting the NAV to include an accrual for such fees, to the extent not already recognised, calculated as they become payable on the balance sheet date.

12. Deferred tax on unrealised revaluation gains

- Unlike IFRS and FRS 102, UK GAAP prohibits the recognition of deferred tax on timing differences arising when a real asset is revalued without there being any commitment to sell the asset. The Working Group recommends adjusting the NAV to include a deferred tax provision for unrealised revaluation gains.

13. Purchaser's costs and tax mitigation strategies

- Deferred tax is measured at the nominal statutory tax rate. The manner in which the fund expects to settle deferred tax is generally not taken into account. INREV recommends that the Manager applies judgement to reflect the manner in which deferred tax is likely to be settled in order to adjust the recognised deferred tax balances.
- Transfer taxes and other purchaser's costs which would be incurred in an asset sale are required to be deducted when determining the fair value of properties. INREV adjustments provide for the Manager to exercise their judgement and if deemed appropriate make a positive adjustment to NAV to reflect the likely cost a purchaser would incur in acquiring the asset through a structured sale.
- INREV's recommended adjustments relate to the transfer of the asset through a disposition of a trust or company structure. For such adjustments to be appropriate the Working Group believes that asset valuations would have to be prepared (or adjusted) so that they represent the value of the holding structure, not just the underlying physical assets and liabilities, so that both the cost and benefit of owning the asset through a structured vehicle are recognised. This would add significant judgement to the calculation of an adjusted balance.
- On that basis the Working Group recommends that neither the deferred tax adjustment nor the potential cost savings arising as a result of a structured sale should be part of the NAV calculation.
- This recommendation is different to INREV's approach. The INREV NAV will be higher by the amount of the potential benefits added back to the NAV.

14. Tax effect of the adjustments

- An adjustment should be made representing the tax impact of the above adjustments.

15. Minority interests

- An adjustment should be made representing combined effect of the recognition of minority interest on the above adjustments.

Adjustments from standard NAV to bid/offer basis

16. Amortisation of initial set-up costs

- Where the Manager elects to charge set-up costs to the fund, those set-up costs are charged to income immediately after the start/inception of a fund. INREV recommend making an adjustment in order to spread such set-up costs over the first 5 years of the fund's life, subject to an impairment test. The Working Group considers this adjustment to be more appropriate as part of the determination of the dealing prices.
- However, without the INREV adjustment, new investors in the fund will share in the benefits of the fund without contributing to the set-up costs and hence the interests of the initial investors would be diluted. In order to protect the initial investors' interests, the Working Group recommends that the offer price should be adjusted to reflect the spreading of set-up costs charged to the fund over the first five years of the fund's life. No such adjustment should be made to the bid price.

17. Amortisation of fund restructuring costs

- Where the Manager elects to charge to the fund significant restructuring costs incurred after the establishment of the fund (for example, to deal with tax changes or other constitutional matters) those restructuring costs are charged to income immediately. However, new investors in the fund will share in the benefits of the restructuring without contributing to the costs and hence the interests of the original investors would be diluted. In order to protect the original investors' interests, the Working Group recommends that the offer price should be adjusted to reflect the spreading of fund restructuring costs charged to the fund over five years. No such adjustment should be made to the bid price.

18. Property acquisition costs

- Under the fair value model, acquisition costs of investment property will be charged to income immediately as fair value changes since the fair value at the moment of measurement is lower than the total amount of the purchase cost of the property including the acquisition costs. INREV recommend capitalising and amortising property acquisition costs over the first 5 years after acquisition of the property, subject to an impairment test. The Working Group considers this adjustment to be more appropriate as part of the determination of the dealing prices.
- The Working Group recognises that UK open-ended funds generally recover acquisition costs arising as a result of new investor inflows through the offer price and recommends that this is where any adjustment should be dealt with.

19. Property disposal costs

- Disposal costs of investment property are charged to income immediately. The Working Group recognises that, where disposals are the result of investor redemptions, it is not appropriate for such disposal costs to be borne by the remaining investors.
- The Working Group recognises that UK open-ended funds generally recover disposal costs arising as a result of investor redemptions through the bid price and recommends that this is where any adjustment should be dealt with.

20. Debt arrangement fees

- Debt arrangement fees are spread over the life of the debt facility in the financial statements. The Working Group considers that redeeming investors should pay their share of the full cost of the arrangement fees and recommend that any unamortised balance in the fund should be deducted in full in determining the bid price.

21. Early settlement penalties on debt

- Early settlement penalties are charged to income immediately. The Working Group recognises that, where debt is settled early as a result of investor redemptions, it is not appropriate for such penalty costs to be borne by the remaining investors.
- The Working Group recommends that any penalty costs arising when investor redemptions cause debt arrangements (including any associated swap contracts) to be settled early should be deducted in full in determining the bid price.

Conclusion

Subject to the aforementioned adjustments we believe that the resulting NAV will give a good approximation of value in funds that are ungeared as the required discount rate should be similar to the property yield applied by the valuer and having given consideration to the benefits of diversification and ease/cost accessing that risk against the costs of management.

However, where gearing is employed in the fund strategy, the discount rate that equity is likely to demand probably will be higher than the property yield and reflective not only of the increase in risk, but the profile of investor returns. In such circumstances any NAV figure will become an increasingly weaker proxy for Fair Value.

Appendix I: The Red Book

The RICS Valuation - Professional Standards (the "Red Book") was most recently updated as at January 2014.

The 2014 edition adopts and is fully compliant with the International Valuation Standards (IVS).

- The RICS Valuation – Professional Standards January 2014 take effect from 6 January 2014 and apply to all valuations where the valuation date is on or after that day.

- The International Valuation Standards have an effective date of 1 January 2014.

The aim of the Red Book is "to engender confidence in and to provide assurance to, clients and recognised users alike, that a valuation provided by an RICS-qualified valuer anywhere in the world will be undertaken to the highest professional standards overall." *(Introduction 1.6)*

From the valuation provider's perspective:

The Red Book sets out procedural rules and guidance which:

a) Include the principles set out in the IVSC Code of Ethical Principles for Professional Valuers and expressly comply with the RICS Rules of Conduct
b) Impose on individual valuers or firms registered for regulation by RICS certain mandatory obligations regarding competence, objectivity and transparency
c) Establish a framework for uniformity and best practice in the execution and delivery of valuations.

They do not:

a) Instruct valuers how to value
b) Prescribe a particular format for reports: provided the mandatory standards are met, reports should always be appropriate and proportionate to the task
c) Override standards specific to individual jurisdictions.

From the valuation user's perspective:

For clients and other valuation users, the professional standards and valuation practice statements set out in the Red Book, ensure:

a) Consistency in approach, aiding understanding of the valuation process and hence of the value reported
b) Credible and consistent valuation opinions by suitably trained valuers with appropriate qualification and adequate experience for the task
c) Independence, objectivity and transparency in the valuer's approach
d) Clarity regarding terms of engagement, including matters to be addressed and disclosures to be made
e) Clarity regarding the basis of value, including any assumptions or material considerations to be taken into account
f) Clarity in reporting, including proper and adequate disclosure of relevant matters where valuations may be relied upon by a third party.

Bases of Value, Assumptions and Special Assumptions

There are four bases of value recognised in the Global Red Book:

- Market Value
- Market Rent
- Investment Value (or worth) and
- Fair Value (which has two definitions).
- In addition, the UK Valuation Standards recognise 'Existing Use Value' (for properties owner-occupied by a business or other entity).

For financial reporting purposes, the most relevant definitions are Market Value (where the accounts are audited under UK GAAP), or Fair Value (where the accounts are audited under IFRS).

Market Value (VPS 4.1.2)

"The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion."

- Where the price offered by prospective buyers generally in the market would reflect an expectation of change in the circumstances of the asset in the future, the impact of that expectation is reflected in market value. [Note – this used to be referred to as 'hope value']
- Market Value specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of special value.
- Market Value assumes that an appropriate marketing period has taken place, and that simultaneous exchange and completion of the contract for sale occurs on the valuation date.
- Although dealing costs are to be taken into account in calculating Market Value, the value reported is always the figure that would appear in a hypothetical contract of sale at the valuation date. It is not the gross cost that would be incurred by the buyer, or the net receipt that would be received by the seller.

Fair Value (VPS 4.1.5)

There are two definitions of "Fair Value", which are different. However, the definition adopted by the International Accounting Standards Board in IFRS 13 defines Fair Value 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."*

The reference to “market participants” and a “sale” make it clear that for most practical purposes Fair Value is consistent with the concept of Market Value. Thus, for financial reporting purposes, Fair Value and Market Value are the same.

Accepting the RICS definition of Market Value, how do we adjust it and who adjusts it?

Assumptions and Special Assumptions (VPS 4.2 & 4.3)

An assumption is made where it is reasonable for the valuer to accept that something is true without the need for specific investigation or verification.

A special assumption is an assumption that either assumes facts that differ from the actual facts existing at the valuation date, or that would not be made by a typical market participant in a transaction on the valuation date.

Special assumptions may only be made if they can reasonably be regarded as realistic, relevant and valid in connection with the particular circumstances of the valuation. If the valuer considers the special assumption to be unrealistic, the instruction should be declined.

Valuations reflecting an actual or anticipated market constraint and forced sales (VPS 4.4)

Wherever the valuer identifies that a valuation may need to reflect an actual or anticipated marketing constraint, details of that constraint must be agreed and set out in the Terms of Engagement.

A special assumption that simply refers to a time limit for disposal, without stating the reasons for that limit, would not be a reasonable assumption to make

The term “forced sale value” must not be used. While a valuer can assist a vendor in determining a price which should be accepted in forced sale circumstances, this is a commercial judgement and a reflection of the worth to that particular vendor. Any relationship between the price achievable on a forced sale and the market value is coincidental; it is not a valuation that can be determined in advance. It must not be used as a basis of value.

Special Assumptions related to projected values (VPS 4.5)

By their nature, projected values rely wholly on special assumptions about the state of the market in the future. Such special assumptions must be realistic and credible, and clearly and comprehensively set out in the report.

The valuation report should make reference to the higher degree of uncertainty that is likely to be implicit with a projected value.

The value reported is the valuer’s opinion of the price that could be achieved if the asset were traded on the date of valuation and assumes that the marketing period has already occurred. Notwithstanding the above, the valuation report can and should assist the recipient in making informed decisions regarding the assets and therefore the valuer is should comment on the direction of (market or asset specific) travel and the liquidity of individual assets. In respect of Fund valuations where a full narrative report may not be included within the brief, such commentary could easily be provided as part of the reporting ‘schedule’.

Client Disclosure Requirements Under IFRS 13 – Fair Value Measurement

IFRS 13, Fair Value Measurement, requires entities responsible for producing financial statements to make various disclosures.

Valuations undertaken in accordance with the Red Book will mostly have been prepared using either the “market approach” valuation technique (using prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets) or the “income approach” valuation technique (converting future amounts - for example, cash flows or income and expenses - to a single current amount.)

Virtually all property valuations undertaken for funds will fall within Level 3 of the Fair Value hierarchy, which categorises the inputs to valuation techniques used to measure Fair Value.

IFRS 13 also requires the entity to consider the following:

- The level of detail necessary to satisfy the disclosure requirements;
- How much emphasis to place on each of the various requirements;
- How much aggregation or disaggregation to undertake; and
- Whether users of financial statements need additional information to evaluate the quantitative information disclosed.

The paper produced by the European Public Real Estate Association (‘EPRA’) gives some very broad suggestions on how this might be done (EPRA Position Paper on IFRS 13 – Fair Value Measurement (February 2013).

Appendix II: Terms of Reference

Objective

The objective of the group is to review methodologies, practices and processes, including the application of accounting principles, adopted for the valuation of the assets and liabilities, the calculation of the net asset value per unit and, in the case of open-ended funds, the determination of the dealing prices of all types of unlisted real estate funds and to :

i. Recommend best practice
ii. Assist AREF in producing guidance for members and investors.

It is not the intention of the resulting guidance to be prescriptive as to methodology but to :

i. Aid managers in communication with investors and advisers
ii. Equip investors and advisers to ask appropriate questions of managers

It is intended that a period of consultation will take place with other working groups/committees of AREF to take input on the initial findings and reflect, as appropriate, this feedback into this working group's conclusions.

Membership

- Chair (member of AREF Management Committee)
- Fund Managers (to cover retail and institutional investors and open and closed-ended funds)
- Finance and Operations
- Valuers
- Accountants
- Consultants
- Indirect investment intermediaries
- Derivative specialists
- Investors and Advisers
- Depositaries and Administrators, as required
- AREF personnel as appropriate

Current Membership

Anthony Shayle (Chair)	UBS	
Douglas Crawshaw	Towers Watson	Consultant
Mischa Davis	Rockspring	Fund Manager
Elaine Gibson	SWIP	Finance and Operations
Bill Holland	KPMG	Accountant
Trevor McDonald	Standard Life Investments	Finance and Operations
Richard Peacock	Aviva Investors	Fund Manager
Paul Robinson	CBRE	Indirect investment intermediary
Richard Stubbs	Langham Hall	Fund Administrator
Jonathan White	CBRE	Valuer
Mark Sherwin	AREF	Meeting Secretary

Responsibilities

- Review approaches to pricing of bricks and mortar assets
    - Instructions to Valuers relative to Fund type, e.g. open or closed, i.e. liquidity considerations
    - Instructions to Valuers relative to market conditions
    - Consider significance of caveats
- Review approaches to pricing of indirect holdings, both listed and unlisted
    - Declared pricing or mark to market i.e. secondary market? Consider the relationship between secondary market pricing and primary market issuance/redemption pricing
    - Bid/offer spread
    - Timing assumptions
    - Valuation of wrapper and/or underlying
- Review approaches to pricing/assessment of other assets and liabilities
- Review application of applicable accounting principles
- Review consistency of industry terminology and consider standardisation
    - NAV, bid, offer, creation, cancellation, swinging prices and dilution levies
- Review approaches to bid/offer spread calculations and possibilities of standardisation
    - NAV, bid, offer, creation, cancellation, swinging prices and dilution levies
- Review pricing governance
    - pricing committees, independent reviews etc.
- Consider disclosure requirements of pricing methodologies
- Review and contrast methodologies and guidance from other organisations, e.g. RICS, INREV
- Review the report “AREF Working Group Report on Valuation of Indirect Property Funds” (2008)
- Review the report “Unlisted Funds: Lessons from the Crisis” (2012)
- Develop guidance on key topics to be published in a series of, publicly available, AREF guidance notes
- Keep under review the membership of the group

Timeline

Initial report to be produced within 6-9 months of first meeting

Reports to

Business Strategy Committee

Liaises with

AREF Corporate Governance Committee

AREF Indices and Data Committee

AREF Investor Committee

AREF Fund Accounting Working Group

Meeting timing and frequency

Initially monthly

Ad hoc, full or partial, meetings or teleconferences as required

Confidential minutes circulated to attendees, Business Strategy Committee and Management Committee

TOR Sign Off

Terms of Reference approved by : Business Strategy Committee