THE f WORD

On 1st January 2011, Canada will join the more than 100 countries, including Australia, the European Union, Hong Kong and New Zealand, that have adopted the International Financial Reporting Standards [IFRS]. This marks a departure for Canada: previously it had been moving its Generally Accepted Accounting Principles (GAAP) towards the American GAAP. Instead the United States has started the process of moving American GAAP towards IFRS and is expected to be compliant, in as much as it effects the treatment of real estate, by 2014. The financial crisis of 2008 and its aftermath has provided ammunition to those in favour of retaining GAAP, and the proponents of IFRS. The train however has already left the station, IFRS promises more transparency and compatibility of financial statements worldwide. The replacement of Canadian GAAP by the IFRS will be mandatory for all of the country's 4,500 Publicly Accountable Enterprises [PAE] (publicly traded companies, credit unions, insurance companies, trusts, REITs). Privately held companies can opt to adopt the IFRS but having done so cannot easily revert back again. Government Business Enterprises [GBE] i.e. self revenue generating bodies such as Canada Post, CMHC, public utilities, et al, have been directed by the Public Sector Accounting Board [PSAB] to adopt IFRS on 1st January 2011 but have been fighting a rear guard action. Government Business Type Organisations [GBTO] that rely on government subsidy (housing commissions, some First Nation corporations) are also resisting PSAB's directive to adopt the IFRS. Organisations that adopt the IFRS will require comparative (2010) financial statements: the starter's pistol has been fired, the race is underway. The major difference between GAAP and the IFRS is the option to replace historic cost with Fair Value, i.e. "mark to market", for assets such as real estate. Given that the country has rather a lot of the latter, this promises to be a monumental task. There is a plethora of information on the Canadian move to the IFRS, Google will reward your enquiry with almost 600,000 articles. We commenced our research eight months ago and it is apparent that the migration from GAAP to IFRS is a moving target. However given recent requests from clients for Year 2010 IFRS compliant valuations, and the resultant challenges that have surfaced, we deem it worthwhile to commit to print. The transition to IFRS is dominated by the accounting profession and naturally focuses on their sphere of concern. It is a world replete with acronyms … and not a little confusion. The move from historic cost to "mark to market" is a valuation problem and here the devil is in the details. Although the European Union only moved to the IFRS in 2005, the United Kingdom moved to "mark to market" in 1972. The Royal Institution of Chartered Surveyors' Valuation Standards (RICS Red Book) has a pedigree dating back to 1976. It incorporates the International Valuation Standards (IVS) published by the International Valuation Standards Committee (IVSC), the Board of which includes representatives of the RICS, the Appraisal Institutes of Canada and America and well as similar bodies in Australia, China, Germany, Hong Kong, Holland, Malaysia, New Zealand, Romania and Russia.

In October 2003, the International, Canadian and American Standards Boards met in Toronto together with representatives of the North American appraisal and valuation professions. Following that meeting, the latter (RICS, American Society of Appraisers, Appraisal Institutes of Canada and America, Centre for Advanced Property Economics, The Appraisal Foundation) agreed to co-ordinate their efforts to expedite the convergence of financial reporting standards and affirmed their support of the International Valuation Standards Committee (IVSC). Since the RICS Red Book already incorporates the International Valuation Standards (IVS) *and* is based on thirty five (35) years experience of marking to market it provides an excellent reference source on the subject. We have utilised it and the International Valuation Standards Eighth Edition 2007 for the real estate valuation aspects of IFRS in this article. Brace yourself; this is exciting.

Real Estate Assets

Broadly speaking real property falls into one of the following, mutually exclusive, International Accounting Standard (IAS) categories:

(1) Investment Property [IAS 40] - Property (land or building, or a part of a building, or both) held (by the owner or by the lessee under a finance lease) to earn rentals, or for capital appreciation, or both. It *excludes* owner-occupied property used for the production or supply of goods or services, or for administrative purposes, and also property held for sale in the ordinary course of business. Investment property is real estate that is not owner-occupied. If part of the property is occupied by the owner the entire property has to be categorised instead as "Property, Plant and Equipment" [IAS 16] unless the portion occupied by the owner is: **(a)** Insignificant e.g. an office building leased to tenants, a small portion of which is occupied by the building owner for its business or for the building property management office. ("Insignificant" is not defined by the IFRS but is probably ≤ 2% of the total rentable area) or **(b)** Could be sold off separately from the rest of the property (e.g. an owner occupied hotel built over a shopping centre which is also owned by the same party, both the hotel and shopping centre being separately registered condominiums).

(2) Property Plant and Equipment [IAS 16] - Operational assets the organisation owns, occupies and uses to conduct its business. IAS 16 defines them as tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and are expected to be used for more than one year.

Mark to Market

The IFRS gives owners the option of booking their assets at cost (as per GAAP) or Fair Value (basically Market Value) but there are a few twists:

(1) Investment Property [IAS 40]

At the initial or first time adoption of the IFRS, the property owner may choose to continue with the (historic) Cost Model (per GAAP) or utilise the Fair Value (Market) Model. If they choose the Fair Value Model they cannot easily switch back to the (historic) Cost Model. If they choose the Cost Model they must also disclose the current Fair Value in their financial statements. The IVSC considers that Fair Value is best represented by Market value i.e. *"the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion".* Presumably the value is free and clear of any financing.

A Leasehold Interest will be treated as a finance lease, and an investment property to the Lessee, where substantially all of the risks and rewards are transferred to the Lessee. Generally if ≥ 90% of the value of the fee simple interest has been transferred to the lessee, the Leasehold Interest will be a finance lease.

Prior experience with countries that have adopted the IFRS suggests that most (86%) organisations opt for the Fair Value Model.

(2) Property Plant and Equipment [IAS 16]

On the initial or first time adoption of the IFRS, the property's owner may, on a one time basis, revalue their assets to Fair (Market) Value and use this figure as their "deemed cost". Thereafter the owner may elect to adopt either the Cost or Revaluation Model. However the entity must restate all assets in the same class if it adopts the Revaluation Model. IAS 16 Paragraph 31 describes the "revalued amount" as "its fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses". However IVSC suggests that "Fair Value" is synonymous with "Market Value" and that this is the figure to be shown on the balance sheet. The key question is what assumption should underlie Market Value: Highest and Best Use or Existing Use Value? Take for example, a single storey industrial property now located, because of changes in the road network, in a neighbourhood of burgeoning car dealerships and other commercial uses. The property is fully utilised for industrial production and has an Existing Use Market Value of $1.5 million. As a redevelopment site, its Highest and Best Use Market Value is $5.5 million. Which value should be recorded on the balance sheet? The Highest and Best Use Market Value is more properly indicative of the asset value but would overstate the total asset value unless the firm's relocation costs were deducted. The RICS Red Book advocates the use of Existing Use Value (a term alluded to but not used by IVS) unless management intends to liquidate the entity or cease trading, to avoid double counting [IAS 1. Para. 23]. This is contrary to appraisal practice in North America which currently advocates valuing all land under the Highest and Best Use assumption. The RICS Red Book [IVS 6.3] requires that the Market Value under the Highest and Best Use (Alternative Use Value) has also to be computed and disclosed so that the entity can choose the most appropriate Market Value to declare as its "Fair Value". Where the property owner takes advantage of the first time adoption of the IFRS to adjust their cost base it will be necessary to allocate "cost" between the land and the building. The question again arises as to the basis for valuing the land, Existing Use or Highest and Best Use? If the building is more than twenty year's old, there will probably be a significant value differential between the two assumptions. In our view Existing Use Value would be the more logical assumption.

Surplus property: non-current assets held for sale, and discontinued operations, have to be identified [IFRS 5] and ultimately recorded at Fair (Market) Value less selling costs. Presumably this would only apply if the surplus property comprises a legal entity, separate and distinct from the operational or investment asset.

Property under development has to be valued at Market Value taking into account existing and potential development entitlements and controls. If the property is intended to be utilised as an Investment Asset, it should be re-categorised when ready for occupation.

Specialised Property is defined as *"a property that is rarely if ever sold in the market, expect by way of a sale of the business or entity of which it is part, due to uniqueness, arising from its specialised nature and design, its configuration, size, location or otherwise".* Atlantic Canada is replete with specialised properties: fish plants, saw mills, refineries, power stations, docks, feed mills, public facilities, churches, etc. The RICS Red Book mandates [IVS 6.4, IAS 16] the use of the Depreciated Cost and/or Income Approaches to determine Fair (Market) Value depending on the presence or absence of market data. In the absence of other potential purchasers for the business the Market Value thus derived implies that the present owner is a potential purchaser. (The RICS Red Book embodies a "value to the business model" for the United Kingdom FRS. The concept has not yet made it into the IFRS). Our own policy with respect to Specialised Property is to convert the Market Value into an annual rental, which can then be benchmarked against the entity's "ability to pay" to test the value. If the entity cannot afford to pay the rent, the Market Value is reduced until the rental payments can be borne by the business.

Prior experience with countries that have adopted the IFRS suggests that a minority (20%) of organisations opt initially to revalue their assets to Fair Value, to take advantage of the enhanced cost base. Thereafter only 5% of the total adopt the Revaluation Model for all their PP&E.

Frequency of Valuations

Investment Property [IAS 40] has to be revalued every year because the Fair (Market) Value has to be disclosed in the financial statements regardless of whether the (historic) Cost Model or the Fair Value (Market) Model is used.

Property Plant and Equipment [IAS 16] has only to be revalued each year if the Revaluation Model is adopted.

There is no requirement to utilise an External Valuer i.e. a professional with no material links to the property owner, the owner's agent or the subject of the assignment. An Internal Valuer can be utilised so long as they comply with the IFRS. However the entity is required to disclose in its financial statements the extent to which the Fair Value of investment property is based on a valuation by an Independent Valuer (i.e. External Valuer) who holds a recognised and relevant professional qualification and who has recent experience in the location and category of the investment property being valued. The entity must also disclose the valuation methodology employed to calculate the Fair Value [IAS 40] and the amount of market evidence available. Prior experience with countries that have adopted the IFRS suggests that 98% of entities use External Valuers to support their Fair Value. 86% of properties are valued annually (or more frequently) using external valuations. 76% of entitles disclose the name of their External Valuer in their financial statements: 22% include the External Valuer's report in their annual statement.

Other Changes

Although private companies are excluded from the IFRS, they are not forgotten. Effective January 1st, 2011, the Canadian Generally Accepted Accounting Principles (GAAP) are expected to be amended to reduce disclosure requirements. Companies will also be allowed, on a one time basis, to revalue their assets to Fair (Market) Value and use this figure as their "deemed cost". Thereafter the assets will be treated as per the Cost Model. This is an accounting change only and will not impact the company's taxable position … though it should make them more valuable in the eyes of their banker.

The final Word

The International Accounting Standards Board (IASB) decrees that "the objective of financial reporting is to provide information about the financial position, performance, and changes in financial position of an entity that is useful to a wide range of users in making economic decisions." The Canadian Institute of Chartered Accountant's (CICA) definition is more comprehensive: *"the objective of general purpose financial statements is to communicate meaningful information to investors, members, contributors, creditors, lenders and others in making a series of decisions about allocating limited resources, acquiring or replacing assets, collateral value, and management direction or stewardship."* Clearly the IFRS are more closely aligned with these objectives than is GAAP, because they are more:

(1) **Relevant -** they focus on the balance sheet part of the financial statements, not just the income statement.

(2) **Accurate -** assets can now be reported at their Fair (Market) Value, rather than historic cost.

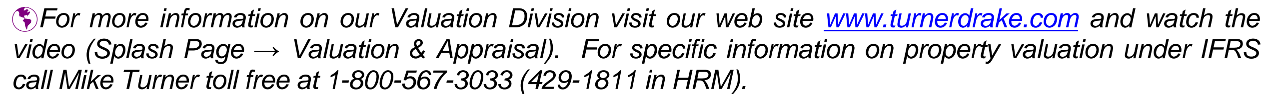
(3) **Comparable -** financial statements are prepared to a common standard that transcends national borders … and provided that they are prepared on the basis of Fair Value, it will be possible to compare balance sheets between entities.

(4) **Transparent -** since the entity is obliged to report on the methodology employed to arrive at the Fair Value, whether an Independent (External) Valuer was utilized and if so their involvement (% of assets so valued), and the market data available, the reader will be able to render a qualitative judgement on their accuracy.

IFRS is a big step forward. Will it accomplish the IASB/CICA objective in so far as the real estate assets are concerned? In our opinion no, not yet! The transition from GAAP to IFRS has largely been co-opted by the accounting community, but successful implementation will rely on many parties including the appraisal profession. In fact, entities whose balance sheets largely comprise investment property, such as Real Estate Investment Trusts (REITs), will be highly dependent on external appraisals. To be accurate, these estimates of Fair (Market) Value will have to be undertaken by external appraisers who are capable, honest, independent, and endowed with the resources to undertake the assignment. How does a reader of an entity's financial statements make the qualitative judgement that the foregoing attributes were present in the External Valuer? Experience abroad indicates that 76% of entities disclose the name of their External Valuer in their financial statements, and 22% include the External Valuer's report in their annual statement. This is obviously a good start, especially if the individual's name is disclosed rather than just that of the appraisal firm: however the Canadian financial statements prepared to the IFRS that we have seen so far, disclose neither the name of the individual nor the appraisal company. We suggest that the foregoing is critical since the name of the appraisal company may be irrelevant. Some appraisal companies exist as "companies within companies", effectively "renting" the brand name so the impression that the assignment is being undertaken by a large organisation is misleading. Even if this is not the case, there is the question as to whether the size of the organisation is useful in making the type of qualitative judgement required: the late Arthur Andersen, infamous for its role as auditors for Enron, WorldCom et al, was one of the largest five accounting firms in the world, with 85,000 employees, when the Enron scandal broke. There is the question too of the appraisal standards employed, the enforcement of those standards, and the accountability and independence of the appraiser. The events of the past thirty five years have eroded our confidence that the foregoing will pass muster … or that this situation will change. It is true that there are now International Valuation Standards (IVS) but of themselves they mean little. The devil is in the details. Our best hope is the United States as they journey towards IFRS in 2014. Whilst we learnt little, if anything, from the collapse of our Trust Companies in the early 1990s, the Americans responded to their earlier (late 1980s), and similar, Savings and Loans crisis by implementing the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in August 1989. Amongst other things it rendered illegal the practice of accepting appraisals commissioned by the mortgagor, as evidence on which Federally regulated institutions could advance a loan. Despite the obvious potential for fraud, this practice is still encouraged in Canada; indeed it is the norm. The U.S. Congress responded to the collapse, due to fraud, of Enron, WorldCom, Global Crossing, Tyco and others at the dawn of this century by passing the Sarbanes-Oxley Act (SOX) in July 2002. That Act legislated changes to financial practice and corporate governance *"to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws."* It focused, amongst other things, on auditor independence and resulted in the audit accounting firms divesting themselves of their consulting operations, the fees from which were thought to subsume auditor independence. Congress are now responding to the Sub-prime Crisis with legislation making it a criminal offence to attempt to influence appraisers on the quantum of a property's value: pressures that Canadian appraisers face, and in many cases probably succumb to, daily. In Canada meanwhile we still debate the necessity for a National Securities Regulator to replace the thirteen (13) provincial and territorial regulators. *(At the time of the Trust Company meltdown in the early 1990s, we wrote to the Office of the Superintendent of Financial Institutions suggesting that the crisis could have been avoided if he required federally incorporated institutions to commission their own appraisals, rather than require that they be provided by the mortgagor. He responded that it was outside his remit because appraisers were a provincial responsibility. So we wrote to the provincial regulators with the same suggestion. To a man [they were all men] they responded that financial institutions were a federal responsibility and the matter was therefore outside their control).*

What do we suggest? Put a woman in charge! All of the crooks appear to be men (Kenneth Lay - Enron; Bernie Ebbers - WorldCom; Bernie Madoff, Charles Ponzi …) so there is little point in putting a (male) fox to guard the chickens. Appoint a (female) National Securities Regulator and pass legislation, (1) making it a criminal offence to pressure appraisers, (2) requiring all federally incorporated financial institutions to commission their own appraisals, and (3) order all entities to name both the External Valuer and the appraisal firm in their financial statements. Get tough on white collar crime. At present the maximum sentence in Canada is ten years in prison … reduced to eighteen months in an open prison on evidence of good behaviour. Not so in the United States. Bernie Ebbers (WorldCom) is currently serving a twenty-five year prison term in the Oakdale Federal Correctional Complex in Louisiana; Kenneth Lay (Enron) died before being sentenced for a probable similar term; Bernie Madoff recently started his 150 year prison term. Jail appraisers, auditors and company executives for a long, long, time if they engage in illegal activity.

Insist on real appraisal standards: the RICS Red Book married to the American USPAP standard would be a good start. Insist that appraisal firms implement a recognised quality standard such as ISO 9001:2008 to ensure consistency, and require audits several times a year to ensure compliance. Ensure that the professional appraisal institutes live up to their claims of protecting the public by making them jointly and financially liable for criminal and/or reckless behaviour by any of their members. Insist that appraisers carry errors and omissions insurance through a third party and do not allow them to practice unless they can get it. (Some appraisal institutes have their own insurance program compulsory for, and available to, all members including repeat offenders. This results both in a moral hazard problem, and the tendency to focus on avoiding claims at the organisations' "standards" seminars).


For more information on our Valuation Division visit our web site www.turnerdrake.com and watch the video (Splash Page → Valuation & Appraisal). For specific information on property valuation under IFRS call Mike Turner toll free at 1-800-567-3033 (429-1811 in HRM).