

# VALUE: FAIR OR FOUL?

Chris Thorne

"Fair is foul, and foul is fair: hover through the fog and filthy air" chanted the three witches in Shakespeare's *Macbeth*. Centuries later, a similar refrain has been taken up by other siren voices who seek to blame fair value accounting for the economic ills now besetting the global economy. They claim the fog and filthy air arise from the pollution of balance sheets by values that are foul rather than fair, or at least not fair to the entity because they would never sell at that price unless forced to do so.

This is the first time I have witnessed attacks on the very notion of valuation, and heard suggestions that not only are valuations of no value but are actually harmful. It is not my place to opine on accounting conventions, and I can see that there is a particular problem with financial instruments held by banks and similar institutions due to the pro-cyclicality arising from the interaction of accounting standards and capital adequacy requirements. However, although I may be accused of bias, disclosure of the current value of assets and liabilities must surely be a fundamental requirement of any system aimed at providing transparency and comparability; regardless of how that information is then used in the calculation or presentation of financial performance.

Fortunately when it comes to the world of investment property and to EPRA in particular, there is greater enlightenment as to the relevance of fair value and the benefits this information brings to investors. Although there is possibly a threat of collateral damage caused by politicians blundering into the fair value debate, there appears to be little prospect of any serious revisiting of IAS 40 and the requirement to either

carry at, or disclose, the fair value of investment property. However, while valuation as a concept may be safe, can the same be said of the actual valuations?

## A brave new world

Although property market downturns are nothing new, few valuers under the age of 40 will have had significant professional experience of one. However, even the greybeards are experiencing something new with this recession. We have had periods during which values have fallen in the past, but not as rapidly or as far as they have in some sectors over the past six to 12 months. We have had periods of low transactional activity before, but not accompanied by sclerosis of the credit markets. We have had secondary banks collapse before, but not had virtual nationalisation of major lenders through government refinancing. We have had low interest rates before but not negative real rates (or at least not for any length of time). Against this background, you may wonder how can anyone value anything?

I believe that it is in conditions such as these that valuers have the opportunity to prove their own worth. It takes little skill to gently

project an established trend upwards or downwards, or to value something when there are truck-loads of concurrent transactions in the sector. Hitting a rapidly moving target takes greater skill than one that is static. If any valuer still believes that the key skill they can offer is knowledge of a list of comparables, the Darwinian process will soon see them go the way of the Dodo.

The job of the valuer is to understand the market in which they operate. When transactions are thin on the ground, this means understanding the collective mindsets of would-be buyers and sellers, and of the fundamental economic drivers of that market. It means understanding why property that is being offered is not selling and at what price level buyers would enter the market. A market valuation is a proxy for a price, and prices in the real world are not established by what has gone before, but by buyers' and sellers' future needs and expectations. The valuer has to understand and replicate those needs and expectations and reproduce them in their valuation model.

No one should pretend that valuation in an inactive market or when


values are moving fast is a simple task. But even though empirical transactional evidence may be lacking, a figure arrived at using a robust rationale based on thorough market understanding is generally more reliable than one based on a stale comparable transaction. I have heard cynics complain that valuers are now valuing on sentiment rather than fact. This misses the fundamental point that real prices in real markets reflect sentiment, and that market sentiment is itself a fact that should be reflected in the valuation.

## Whiter than white

Another challenge to the valuation process that always emerges in hard times is that of valuer independence. Too often clients, especially those of an entrepreneurial trait, believe that recession is something that affects everyone except them. They are therefore immune because their portfolio is special. In recent weeks I have heard a director of a listed UK property company explain how he was working hard on his valuers to ensure a robust balance sheet for the current year end. Now he might not have worked on his valuers in quite the same way as your average East End gangster, but the clear implication was that the required result

could be obtained by exerting influence. Valuers who are members of a recognised professional body will have to comply with ethical standards that will include a requirement to act independently and objectively, but resisting client pressure is always easier if it is not applied in the first place! Fortunately, most experienced clients in the publicly listed property sector realise that any advantage to be gained by such behaviour will only be short lived, as the truth will out in other ways.

Another threat to the integrity of the valuation process arises from flawed understanding of the valuation objective. It is sometimes argued that market value is either irrelevant or too low because the market value definition (which for all practical purposes equates to fair value under IAS 40) requires there to be a willing seller. Since the current owner would not be willing to sell at that price, it is of no relevance to the company or its shareholders. This is not the place for a lengthy dissertation on the concept of market value. However, the International Valuation Standards make it clear that a 'willing seller' in this context is simply a seller motivated to sell at the best price obtainable on the valuation



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date. Because market value is a hypothesis, the circumstances or policies of the actual owner are totally irrelevant. The owner may be able to demonstrate that the property is worth more to them than could be obtained from a sale on the valuation date. This is a perfectly valid proposition, but it does not invalidate the market value.

## The forced-seller myth

A variation on this theme is the argument that the only sellers in a falling market are forced sellers because no one willingly sells in a falling market, and therefore those sales are not evidence of the price between a willing buyer and seller. Again this confuses what may be rational behaviour by an owner in the real world with the hypothetical world in which market value is created. There has to be a hypothetical seller willing to transact, and strange though it may seem, that seller is under no duress or compulsion. In fact very few sales are truly forced, ie where the seller is under compulsion to sell in a timescale that does not allow for proper exposure to the market. Neither are sales by liquidators, receivers or mortgagees normally forced; indeed this type of seller has a duty to the general body →

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of creditors to act reasonably and obtain the best price. Only in very specific circumstances would a sale at below market value be justified.

So having applied their market knowledge, resisted any external pressure and correctly applied the basis of market value, the valuer faces one further task; communicating the valuation. Traditionally, valuation reports for use in financial statements have been minimalist in style, with little more than an address, a valuation figure and a signature. Some valuers have even liked to refer to their reports as certificates, which implies that the valuation figure itself gains additional credibility and weight by being 'certified'. Perhaps the intention was that it be framed and hung on the finance director's wall! However, client needs and expectations are changing. IAS 40, para 75, requires the entity to make various disclosures, including the methods and significant assumptions applied in determining fair value, and whether it was based on market evidence. It is therefore reasonable to expect valuation reports commissioned for this purpose to provide parallel disclosures, and indeed this is required under International Valuation Standards.

### Weighing up uncertainty

A further factor that the current downturn has brought into focus is the question of valuation uncertainty. Although talking specifically about financial instruments, the Financial Stability Forum's report to the G7 ministers in April 2008<sup>1</sup> identified the need for better disclosure of the uncertainty associated with valua-

tions. However, this is not a particularly new request. IAS 1, para 116, requires the sources of estimation uncertainty to be disclosed where there is a significant risk that there

will be a material adjustment to the carrying amount within the next financial year. Since 2003, the RICS Red Book<sup>2</sup> has required appropriate disclosures where the valuer considers that there is material uncertainty at the valuation date.




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This greater need for transparency is driving most leading valuation firms to include uncertainty statements in their recent valuation reports, and also more commentary on market conditions is being included to help users put the valuation figures into context. There has been some anecdotal evidence that some auditors are nervous about seeing uncertainty clauses appearing for the first time, but in my experience, and from discussions with the major firms, most are not only expecting to see them in valuation reports but also not accepting valuation reports that do not adequately reference the current difficulties in the market.

So although market volatility across Europe, and indeed in most parts of the world, is creating a major challenge for the valuation profession, I am confident that if you choose your valuer carefully and make sure that they both understand and are in touch with the market place, valuations that meet the reliability test in IAS 40 can still be produced even where transactional evidence is thin on the ground. However, as part of the process, expect to see the reports providing more information on the methods and key assumptions adopted, and for the valuer to indicate the degree of certainty that can be placed on the figure. 

<sup>2</sup> RICS Valuation Standards 6th Edition - January 2008: Guidance Note 5: Valuation Uncertainty

<sup>1</sup> Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience - 7 April 2008

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