Investment property: Common findings report

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Table of Contents

Why this report?

During the course of performing its proactive monitoring reviews of Annual Financial Statements (“**AFS**”) during 2020 (“**our reviews**”), the JSE identified common IFRS disclosure deficiencies relating to investment property.

Determining fair value has always been a subjective matter. It requires issuers to make assumptions about the future and can lead to the incorporation of significant levels of estimation uncertainty into valuation models. IAS 1.125 requires disclosure of these uncertainties. Our observations of these disclosures are that issuers often include generic (or ‘boiler plate’) statements without providing entity specific (or useful) information relevant to their particular situation. The consequences of uncertainties following the covid-19 pandemic are expected to elevate both the level of subjectivity and the importance of these (and other) disclosures.

It is imperative for issuers to clearly explain the particular estimation uncertainties applied to their valuation models.

> ***Users will benefit from both transparent and ‘easy to understand’ disclosures of the impact of the resulting uncertainty in making their investment decisions.***

We have issued this report as we believe that it can be of benefit to issuers and their auditors, assisting them to avoid what we have identified as common pitfalls.

What does IFRS say?

For many companies (particularly those in the property sector), investment property is a significant asset on the statement of financial position. *IAS 40: Investment Property* provides entities with an accounting policy choice (IAS 40.30) for the subsequent measurement of investment property being the application of either the:

- fair value model; or
- cost model.

Many issuers adopt an accounting policy of subsequently measuring investment property at fair value. Whilst the policy choice allows issuers to reflect investment property at a more current value, given the subjectivity, it brings with it a detailed set of disclosure requirements. Even in instances where the cost model is applied, IAS 40.79(e) requires disclosure of the fair value of investment property.

IFRS 13: Fair Value Measurement not only defines fair value and provides a framework for the measurement thereof, but also mandates certain disclosures. The extent of fair value disclosure is determined by the fair value hierarchy to which the fair value measurement has been classified.

Our observation is that investment properties are most often classified as a 'level 3' fair value - being the most subjective of the fair value categories. A level 3 fair value makes use of (predominantly) unobservable inputs into valuation models when determining fair value (IFRS 13.86).

Consequently, the disclosures required for a level 3 fair value are the most detailed of the fair value hierarchy classifications.

An important disclosure for assets and liabilities measured at fair value and classified as a level 2 or 3 fair value includes a description of the valuation technique and the inputs used in the fair value measurement (IFRS 13.93(d)). In the instance of a level 3 classification, disclosure is also required of quantitative information about the unobservable inputs used that are significant to the fair value determination.

An overarching objective of IFRS 13.91(a) is that the AFS should disclose sufficient information to help users assess the valuation techniques and inputs used to develop fair value measurements.

For investment property valued in terms of a discounted cash flow or income capitalisation method, those quantitative inputs requiring disclosure would include inputs such as discount rates, capitalisation rates, rental incomes, rentals per square meter, vacancy rates, yields etc.

Why fair value disclosures?

The basis of conclusions to IFRS 13 explains that the objective of the quantitative disclosures to fair value (required by paragraph 93(d)) is not to enable users to replicate the entity's pricing models, but rather to provide enough information for users to assess whether the entity's views about individual inputs differ from their own (IFRS 13.BC192).

So the question is how much is enough?

How many inputs?

The identification of only one (or even two) inputs when providing IFRS 13 disclosures for investment properties is insufficient. The valuation methodology is more complex (and sensitive) than one input implies.

In addition, the auditor often highlights that the valuation of investment properties was a significant matter in their audit of the AFS (i.e. a key audit matter). The audit report may list several key assumptions that were particularly judgemental in their audit of the valuation assessment. As these valuation inputs were significant to the auditor – we would expect them to also be included and quantified in the fair value disclosures within the AFS.

Disaggregated information

Quantitative information needs to be sufficiently disaggregated so as to provide users with the ability to assess management's views of the drivers of fair value. This enables users to either concur with the value disclosed or formulate an alternative view.

> ***A common trend observed in our reviews has been the tendency to provide quantitative disclosures on an overly aggregated basis.***

When approaching these matters, issuers should not just aim to tick the IFRS 13 disclosures box, but rather to consider whether the information disclosed is actually useful to users of the AFS.

IFRS 13 does not prescribe the aggregation criteria that should be applied or the manner in which quantitative information should be presented to meet the requirements of IFRS 13.93(d). The overarching objective of IFRS 13.91(a) was highlighted earlier. Paragraph 92(c) requires issuers to consider how much aggregation or disaggregation to undertake in order to meet that objective.

Illustrative example 17 to the standard provides an example which includes both the range per observable input as well as a weighted average within that range. The weighted average illustrates 'where in the range' the majority of inputs to the valuation range lie. This approach can be particularly useful where it is not practical to provide a narrow range through further disaggregation.

There are often a large number of properties in a portfolio, frequently across different sectors and geographies. In this instance we believe that it is even more important to focus on disaggregation, as the properties are likely to be non-homogenous and the impact of a specific portfolio may be material to the statement of financial position. IAS 1.30A emphasises that, in aggregating information an entity must not reduce the understandability thereof. Too much aggregation reduces the quality and usefulness of the information. This occurs (inter alia) when:

- too many inputs are combined without explaining how they are used; or
- when a wide range is disclosed that does not yield 'usable' information.

Example 1

In one instance, an issuer holding a portfolio of >100 properties across multiple geographic and asset classes provided poor disclosure by aggregating quantitative disclosures as follows:

- Discount rates applied for valuations on the discounted cash flow method ranged between 12.1% and 17.3%; and
- Capitalisation rates applied to valuations on the income-capitalisation method ranged between 8.3% and 13%.

Without additional information being provided in the audited financial statements we do not believe that the above disclosures are useful. How can this information be used to assess which properties (or even how many properties) were valued using a discount rate of 8.3% versus 13% or how these inputs impacted the fair value determination (IFRS 13.91(a)?

We understand that the valuation result is often extremely sensitive to even a small change (as little as 0.25%) in the capitalisation or discount rate. If a user wanted to assess the extent of the portfolio to which a discount rate of 12% was applied they would be unable to make this assessment given the disclosures provided above.

The issuer explained that factors such as geographic position, grading of building and tenant grading had an impact on the determination of the discount rate - but provided no further information to be able to link these inputs to the wide range disclosed.

The above mentioned aggregated disclosure is contrasted to the disclosure by another issuer who provided far more meaningful information.

Example 2

An issuer provided the following good disclosures for their unobservable inputs applied to the fair value determination. Whilst some of the ranges disclosed in the table may be wide, the information was further cross referenced to (audited) property portfolio information in which individual valuations and risk information per property was also disclosed:

At the reporting date, the key assumptions and unobservable inputs used by the Group in determining fair value were in the following ranges for the Group's portfolio of properties:

Investment property

		Significant unobservable inputs and range of estimates used			
Description	Valuation technique	Discount rate (%)	Exit capitalisation rate (%)	Capitalisation rate (%)	Rental growth rate (%)
Retail sector	Discounted cash flow model	11.0 – 15.5	7.5 – 13.5	7.0 – 13.0	2.5 – 6.0
Office sector		11.0 – 15.25	8.0 – 11.0	8.0 – 10.5	2.4 – 5.5
Industrial sector		10.5 – 16.5	8.5 – 13.0	8.0 – 13.75	2.85 – 5.5
Healthcare sector		13.5 – 14.5	8.5 – 9.5	8.5 – 9.5	5.0 – 5.0

When deciding on the level of detail to be provided, IFRS 13.94 requires consideration of the:

a) nature, characteristics, and risks of the asset (or liability); and
b) level of the fair value hierarchy within which the fair value measurement is categorised.

The significance of an input to the fair value determination may not always be uniform across all asset classes.

Example 3

An issuer provided the following good disclosure of inputs, recognising both that the nature of risks for each class of investment property is possibly different and that some inputs have greater bearing on certain asset classes than others:

At the reporting date, the key assumptions used by the group in determining fair value were in the following ranges for the group's portfolio of properties:

Unobservable inputs across sectors (%, unless otherwise stated)	2019	2018
Expected market rental growth	**3.00-6.00**	3.00-6.00
Expected expense growth	**6.50 -8.00**	6.50-8.00
Occupancy rate	**94.60**	95.68
Vacancy periods	**0-12 months**	0-12 months
Rent-free periods	**0-6 months**	0-6 months
Office sector		
Discount rate	**10.00-17.00**	10.00-17.00
Exit capitalisation rate	**7.75-12.25**	7.50-13.25
Bulk rate	**R2 000-R4 725 p/m²**	R2 000-R4 725 p/m²
Retail sector		
Discount rate	**12.00-17.00**	11.75-17.00
Exit capitalisation rate	**7.00-13. 00**	7.25-12.00
Bulk rate	**R330-R4 000 p/m²**	R330-R4 000 p/m²
Industrial sector		
Discount rate	**13.00-16.00**	13.00-16.00
Exit capitalisation rate	**8.00-12.00**	8.00-11.50
Bulk rate	**R400-R 1 850 p/m²**	R60-R1 900 p/m²
Specialised sector		
Discount rate	**14.00-14.50**	14.00-14.50
Exit capitalisation rate	**9.50-10.50**	9.50-10.50
International sector		
Core yield	**N/A**	6.25-7.50
Discount rate	**7.00-9.00**	6.25-7.50
Exit capitalisation rate	**6.50-7.25**	n/a
Bulk rate	**R398-R403 p/m²**	n/a

Consistent messaging

We have come across instances when the issuer lists five inputs as being 'significant' to the fair value determination, but then only provides quantitative disclosures for two of those inputs - usually only the capitalisation rate and discount rate. Vacancy rates are commonly described as having a significant impact on the fair value determination. In such an instance the required quantitative disclosures for this significant input should not be omitted.

The disclosures must also be read in the context of the entire AFS. We would challenge issuers who aggregate disclosures at a level higher for IFRS 13 purposes compared to information provided in the segment report. An example may be where quantitative disclosures are provided as one range but there are four individual segments with performance information provided elsewhere in the AFS.

Sensitivity disclosures

IFRS 13.93(h)(i) requires an issuer to disclose sensitivity information for fair value measurements categories within level 3 of the fair value hierarchy:

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

The requirement for a narrative (not specifically quantitative) description has, in the JSE's view, lead to many issuers providing boilerplate disclosures which potentially serve to only 'state the obvious'.

Issuers are encouraged to provide more entity specific information to explain how management's assessment to sensitivity was considered.

Example 4

The disclosure provided by this issuer is not meaningful as it merely 'states the obvious'. It does not provide any indication as to which inputs the fair value measurement is most sensitive to. Would a change in the rent free period have a greater or lesser impact to the fair value measurement than market rental growth rates?

Inter-relationship between key unobservable inputs and fair value measurements

The estimated fair value would increase/(decrease) if:

- expected market rental growth was higher/(lower);
- expected expense growth was lower/(higher);
- vacant periods were shorter/(longer);
- occupancy rate was higher/(lower);
- rent-free periods were shorter/(longer);
- discount rate was lower/(higher);
- exit capitalisation rate was lower/(higher);
- capitalisation rate was lower/(higher);
- bulk rate was higher/(lower); or
- core yield was lower/(higher).

Example 5

The sensitivity disclosure provided by this issuer, on the other hand, was beneficial to the user. Not only did it quantify the sensitivity (although not specifically required by IFRS 13.93(h)(i)) but it also highlighted the specific inputs to which the fair value measurement was most sensitive towards.

The valuations of the investment properties are sensitive to changes in the unobservable inputs used in such valuations. Changes to one of the unobservable inputs, while holding the other inputs constant, would have the following effects on the fair value of investment property and fair value adjustment in profit or loss:

		Group	
Input	**Change %**	**2020 R'000**	2019 R'000
Increase in discount rate	0.25	**(251.9)**	(287.7)
Decrease in discount rate	0.25	**264.6**	303.1
Increase in capitalisation rate	0.25	**(252.9)**	(656.4)
Decrease in capitalisation rate	0.25	**265.7**	528.2

Example 6

This good example (which relates to an entity not listed on the JSE) reflects sensitivities across more than one quantitative variable:

The impacts on the Group financial position that would arise from changes in capitalisation rates, market rents and incentives/voids are set out in the table below. This illustrates the impacts in respect of both the directly held stabilised investment properties and its share of those properties held by partnerships

	Directly held properties $M	Partnerships[1] $M
Book value at 30 June 2020	1,797.9	10,116.3
Changes in capitalisation rates:		
Increase in cap rates +50bps	(158.0)	(964.1)
Increase in cap rates +25bps	(82.6)	(506.4)
Decrease in cap rates -25bps	91.0	563.6
Decrease in cap rates -50bps	191.7	1,194.6
Changes in market rents:		
Decrease in rents -10%	(70.5)	(449.7)
Decrease in rents -5%	(35.3)	(224.8)
Increase in rents +5%	35.3	224.8
Increase in rents +10%	70.5	449.7

We urge issuers to not only provide disclosures according to 'the letter of the law' (as it is set out in the IFRS standards). Instead, they should question whether the disclosures provide meaningful information to users. Disclosure for the sake of disclosure should never be a defence when challenged by auditors and regulators alike.

External valuations

IFRS does not specify whether valuations should be performed internally or externally. IAS 40.32 states that an entity is encouraged, but not required, to measure fair value of investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. Under the JSE Listings Requirements, issuers utilise the services of independent valuation experts to value their property portfolio on a rolling/ rotational basis.

In our engagements during reviews, some issuers have maintained that - as fair value was derived by an independent valuer - the value 'must be correct' and that the AFS do not need to include all of the quantitative disclosures of IFRS 13.

Firstly, we remind issuers that they retain responsibility for the fair value estimation irrespective of who performs the underlying calculations. It is the issuer's business and inputs that drive the valuation and their obligation is to ensure that the calculation aligns with the criteria of IFRS 13.

Furthermore, the level of disclosure is not dependant on whether the valuation was derived internally or externally. IFRS 13 disclosures are driven by the relevant classification level in the fair value hierarchy. The fair value hierarchy, in turn, is determined by the extent to which significant inputs into the valuation method are quoted, observable, unobservable etc.

The fact that the issuer has contracted the services of an independent valuer does not absolve the issuer of its responsibility to disclose the detailed inputs into the valuation model.

Issuers are responsible for ensuring that the information needed for the IFRS disclosures in the AFS is appropriately sourced.

Linkage to property portfolio disclosures

Some issuers have pointed to the property portfolio information provided in the annual report (an obligation of paragraphs 13.37; 13.18 and 13.19(a)-(c) of the JSE Listings Requirements) as meeting the disclosure requirements of IFRS 13. We have challenged this reasoning as:

- the property portfolio information is not always audited;
- the information usually falls outside of the AFS;
- there is no obligation to include a valuation and it is difficult to understand the relative size of each property within the context of the AFS; and
- any valuations performed under section 13 of the JSE Listings Requirements are not necessarily in line with IFRS 13.

AFS are required to be comprehensive, stand-alone documents which include all material information regardless of whether such information is available in other sources (paragraph .25, materiality practice statement). Where issuers rely on disclosures elsewhere in the integrated report, we would expect these to be cross referenced (and therefore subject to audit) in the relevant notes.

Raising the bar for disclosures

Good corporate reporting is not only about ensuring the adherence to wording in a specific IFRS, but is about thoughtful reflection on the information and consideration of what additional disclosures would be of value to investors.

Example 7

In the following good example, the issuer provided particularly useful granular/ disaggregated information which went beyond the requirements of IFRS (specifically the reconciliations required by IFRS 13.93(e) and IAS 40.76). Whilst not directly 'fair value' related, the issuer further disaggregated their South Africa and United Kingdom segment information in the reconciliation of investment property balances. Not only is the fair value movement distinguishable on a disaggregated basis but information is also provided on all other material changes to this significant asset class for the Group.

Reconciliation of investment property continued

	South Africa							United Kingdom			
R'000	**Logistics**	**Industrial**	**Commercial**	**Properties under development**	**Zoned industrial land#**	**Strategic land holdings#**	**Right-of-use asset**	**Logistics**	**Properties under development**	**Strategic land holdings#**	**Total**
Balance as at 1 March 2019	**6 106 909**	**260 785**	**161 573**	**321 793**	**588 126**	**366 036**	**23 624**	**3 499 358**	**416 507**	**–**	**11 744 711**
Acquisitions	–	–	–	–	80 600	–	–	797 468	86 264	479 183	**1 443 515**
Improvements and extensions	49 904	5	23	–	–	–	–	6 355	–	–	**56 287**
Construction and development costs	–	–	–	248 914	97 460	18 650	–	–	424 613	63 858	**853 495**
Transfers*	(35 140)	203 251	(40 455)	(105 188)	126 321	(189 244)	–	828 692	(832 674)	3 982	**(40 455)**
Letting commission capitalised	3 298	–	–	6 775	–	–	–	3 305	–	–	**13 378**
Letting commission amortised	(661)	–	–	–	–	–	–	(700)	–	–	**(1 361)**
Lease incentives capitalised	1 650	–	–	–	–	–	–	–	–	–	**1 650**
Lease incentives amortised	(103)	–	–	–	–	–	–	–	–	–	**(103)**
Remeasurements	–	–	–	–	–	–	451	–	–	–	**451**
Fair value adjustment	2 581	2 214	(9 952)	11 446	(5 590)	(4 490)	(2 573)	28 127	–	–	**21 764**
Foreign exchange movements	–	–	–	–	–	–	–	381 579	76	42 152	**423 807**
Balance as at 29 February 2020	**6 128 438**	**466 255**	**111 189**	**483 740**	**886 917**	**190 952**	**21 502**	**5 544 184**	**94 786**	**589 175**	**14 517 138**

Estimation uncertainty in a 'post covid-19' environment

As discussed earlier, determining the fair value for an investment property has always been a matter in which subjectivity and significant estimation uncertainty is applied. IAS 1.125 requires disclosure of information about assumptions that the entity makes about the future as well as other sources of estimation uncertainty applied.

It is difficult to estimate (with certainty) the extent to which the pandemic will affect the future. Even assumptions and business practices that were previously considered to be 'fairly stable' have become difficult to predict with certainty. This level of uncertainty in fair value determinations are even more subjective under covid-19 than was previously present.

Under the current environment we therefore expect to see more detailed and granular disclosure of estimation uncertainty (IAS 1.125) and judgement (IAS 1.122) applied in the preparation of AFS.

We remind you that SAICA has prepared a suite of educational material to assist issuers in these (and other) matters relating to the covid-19 pandemic. We refer you to their website: https://www.accountancysa.org.za/covid-19/saica-resources/covid-19-ifrs/

Publication #3 deals specifically with the quality of disclosures with respect to judgement and estimation uncertainty exercised by management.

Furthermore, the JSE letter of 25 May 2020 entitled *Covid-19: Reflecting the impact of covid-19 on financial results highlights* (inter alia) that covid-19 is likely to be an event caught within the ambits of IAS 34.15B(h) which refers to "changes in the business or economic circumstances that affect the fair value of the entities' financial assets". IAS 34 read together with IAS 1 may require disclosures which are normally only included in the full AFS now being presented within the IAS 34 format of the results.

> ***Given the current environment, we would expect to see property entities providing full IFRS 13 disclosures for their investment properties in their interim and preliminary/ provisional results.***

The 25 May letter (together with other Covid-19 material) is available on the JSE website https://web.jse.co.za/issuer-regulation-covid-19.

Conclusion

Fair value disclosures are necessary to assist users in assessing (and drawing their own conclusions on) the fair value measures reported in the financial statements. Such disclosures are most useful if they provide detailed and entity specific information pertaining to the investment property (or property portfolio) in question. Issuers should remember that what is 'obvious' to a preparer, having spent many hours in the detail of the valuation, is less so to a user who is reading the information for the first time.