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## **Galvin discusses how the term Fair Value has taken on a whole new meaning**

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By John Galvin

Mention the term "Fair Value" to a seasoned real estate professional, and the typical response is one of disgruntlement. Twenty years ago, in the world of appraising, Fair Value essentially was a term used by regulators to provide a value, or price, of a property if it had to be liquidated in less than 12 months (when marketing periods were often longer than 12 months). However, the term Fair Value has taken on a whole new meaning in recent years. As of January 1, 2013, a change in Accounting Standards here in the U.S. pertaining to Fair Value is anticipated to create an increase in demand for professional appraisal services.

The Financial Accounting Standards Board (FASB) is a non-profit organization in the U.S. that governs the preparation of financial reports for non-governmental U.S. entities. Over the past few years, FASB has been diligently working with the International Financial Reporting Standards (IFRS) to create and converge accounting methods so that accounting treatment for investment property, along with disclosure requirements, are more uniform internationally.

IFRS has had accounting policy in place that the rest of the world has been using for investment property for the past 10 +/- years - referred to as Fair Value Modeling. This accounting practice allows the party responsible for creating financial statements on investment property to include the actual value of the asset on the books at the time of reporting and recognize gains and losses in value as they occur. Professional appraisers are required to determine the unbiased value opinion, but the party responsible for the financial report, typically the CFO or accountant, is ultimately responsible for the value reported. Currently, most investment property in Europe and other parts of the world use a Fair Value accounting model for financial reporting.

IFRS (IFRS 13) defines Fair Value as "the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the perspective of both parties". This definition considers the value measurement of non-financial assets and takes into account the ability of the asset to generate economic benefits under that asset's highest and best use. It also takes into consideration the exit strategy of the asset holder for that particular investment and its impact on current market value. IFRS also requires Fair Value accounting to be used for ALL investment property.

Two models for accounting of investment property are: 1) Cost Value Model and 2) Fair Value Model. In the U.S. accounting methods historically have followed guidance rules for Cost Value Modeling. The asset is recorded on the balance sheet based on the acquisition cost and depreciated over time with the gain or loss recognized at the end of the holding period. Whereas,

Fair Value modeling measures the value of investment property at the defined "fair value" (slightly different definition than our traditional "market value") with gain and losses arising from changes in value recognized as a profit or loss at the time of reporting. So why the push to switch to a Fair Value accounting model? The primary reason is disclosure, which is a good thing; however, the transition from Cost Value accounting to Fair Value accounting will not be an easy process for most businesses.

Consequently, FASB has been more cautious about creating and implementing the same Fair Value accounting requirements as IFRS. This is why the term Fair Value has been kicking around the appraisal industry for approximately 10 years but it has yet to have widespread use within our profession. FASB realized that just flipping the switch from Cost Model accounting to Fair Value accounting policy could have major repercussions in the market place (stock pricing, loan covenants, etc).

FASB identified three common objections to switching accounting practices for investment property. They boil down to 1) incurring additional reporting costs for appraisals every reporting period requiring an update (due to changes in market conditions, etc.) 2) disclosure concerns and the impact on financial statements (i.e. business values) due to fluctuations in market conditions that may or may not actually have an impact on the cash flow of the business / holding company (i.e. manufacturing firm, etc.) and 3) the auditing trail - how to actually audit the fair value accounting procedure. Using a professionally trained and experienced appraiser will help accounting professionals mitigate concerns.

FASB also recognized there were industry concerns over defining, or classifying, what was an investment property here in the U.S. Consequently, FASB, after working together with the IFRS and after diligently listening to various industry groups (including the Appraisal Institute), is leaning toward adopting a framework that is compatible with the IFRS policy yet accommodating to U.S. businesses. Though the concept of Fair Value modeling proposed by FASB will be similar to that of IFRS, one main difference will be the classification of an "investment property". FASB is looking to adopt a Fair Value modeling policy on an "entity based" guideline, whereas IFRS applies to all investment property. On an "entity based" method, the person responsible for making the financial reporting decisions will have more discretion as to the best accounting method for their specific business or industry group. There are also exceptions, such as life insurance companies who already have to follow specific Fair Value accounting rules, and developers, who are essentially creating value from an investment property over a short term period, and agriculture businesses.

The Appraisal Institute has taken a pro-active role in not only providing input and support to FASB and the IFRS, but also has created educational tools to prepare appraisers to meet the demand for valuation services in conjunction with fair value reporting. Two courses created to date include Introduction to Valuation for Financial Reporting and Financial Reporting. Appraisal Institute members have been gearing up to meet the projected increase in demand for our services to provide cost effective valuation analysis, as more and more entities are required, or chose, to report the value of their real estate investment property using the Fair Value model of accounting.

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