

Level 2 or 3 - What Does It Mean for Valuers and Appraisers Engaging in Valuations for Financial Reporting Purposes

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Application of Fair Value Hierarchy to
Investment Property

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Nova is a Deals partner and leads the valuation practices in PwC China. He has followed through the entire deal cycle and accumulated extensive experience in M&A advisory, due diligence, modelling, valuations, negotiation, post deal integration and divestiture. He serves clients making investments into China, corporates and joint ventures operating in China as well as Chinese enterprises making outbound investments.

He served as a member of the International Valuation Standards Council's (IVSC) Standards Board from 2008 to 2012 and currently is a member of both Global and Asia Business Valuation Committees for the Royal Institute of Chartered Surveyors (RICS). He has served as a member of the Valuation Standards Technical Committee in China for more than a decade and has deeply involved in drafting the Chinese Valuation Standards since 1998. He has involved in many milestone research studies on topics including business valuation, intangible valuation and fair value measurements, and drafting of national text books and training materials.

Nova received a BBA (1st Honor) degree from the Chinese University of Hong Kong. He is an associate member of the Hong Kong Institute of Certified Public Accountants (HKICPA), a fellow member (FCCA) of Association of Chartered Certified Accountants (ACCA), and the first and only non-Mainland China resident who has gained a Chinese Certified Public Valuer (CPV) title.

Section 1

Fair Value Measurements

1.1 Fair Value Hierarchy

Fair value measurements are categorised into a three-level hierarchy based on the type of **“inputs”** and no longer based on the valuation **“methods”**.

“Maximising” the use of observable inputs and “minimizing” the use of unobservable inputs - IFRS 13. IN10 (d)

Apply to market approach, income approach or cost approach

Level 1 inputs

- Quoted prices (unadjusted) for identical assets in an active market

Level 2 inputs

- Quoted prices for similar assets or liabilities in an active markets
- Quoted prices for identical or similar assets or liabilities in markets that are not active
- Inputs other than quoted prices that are observable for the asset or liability (for example, market observable interest rates)
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means

Level 3 inputs

- Unobservable inputs

Fair value hierarchy

1.2 Disclosure Requirements

FV measurements	Disclosure requirements
All	<ul style="list-style-type: none"> Fair value measurement at the end of the reporting period Level of the fair value hierarchy
All non-recurring	<ul style="list-style-type: none"> The reason for the measurement
All recurring	<ul style="list-style-type: none"> Amounts of transfers between Level 1,2 and 3 The entity's policy for determining when transfers between levels are deemed to have occurred
Level 1	<ul style="list-style-type: none"> Transfers from and into Level 1
Level 2	<ul style="list-style-type: none"> Description of the valuation techniques(s) and the inputs used in the fair value measurement Changes in valuation techniques and reasons for making those changes
Level 3	<ul style="list-style-type: none"> Description of the valuation techniques(s) and the inputs used in the fair value measurement Changes in valuation techniques and reasons for making those changes Quantitative information about the significant unobservable inputs used in the fair value measurement if reasonably available Description of valuation processes, policies and procedures If the highest and best use differs from its current use, an entity should disclose the fact and why the non-financial asset is being used in a manner that differs from its highest and best use Narrative description of sensitivity of the fair value measurement to significant changes in unobservable inputs (recurring only)

Source: IFRS 13 and PwC

1.3 Typical Inputs for Investment Property Valuation

Only Level 2 and 3 inputs are applicable with the **vast majority being Level 3**, which requires the most extensive level of disclosure

Level	Examples
2	<ul style="list-style-type: none"> • Sale prices per sqm for similar properties in similar locations • Observable market rent per sqm for similar flats • Property yields derived from latest transactions
3	<ul style="list-style-type: none"> • Yields based on the management estimation • Significant yield adjustments based on management's assumptions about uncertainty/risk • Assumptions about future development of parameters (vacancy, rent) that are derived from the market • Cash flow forecast using the entity's own data • Market rent with significant adjustment
	For Investment Property Under Construction (IPUC)
	<ul style="list-style-type: none"> • Estimated construction costs to complete • Developer's profit • Risk margin/contingency • Finance costs

Source: Application of fair value hierarchy to real estate (HKICPA A Plus, January 2014) and PwC

Section 2

Level 2 or Level 3 – Practical Challenges

2. Level 2 or Level 3 – Practical Challenges

Professional judgment (IFRS 13.73)

- The fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the “**lowest level**” input that is “**significant**” to the entire measurement.

Level 3 disclosure

- Level of details required vs. confidentiality

Not fully familiar with accounting requirements

- Management or its expert

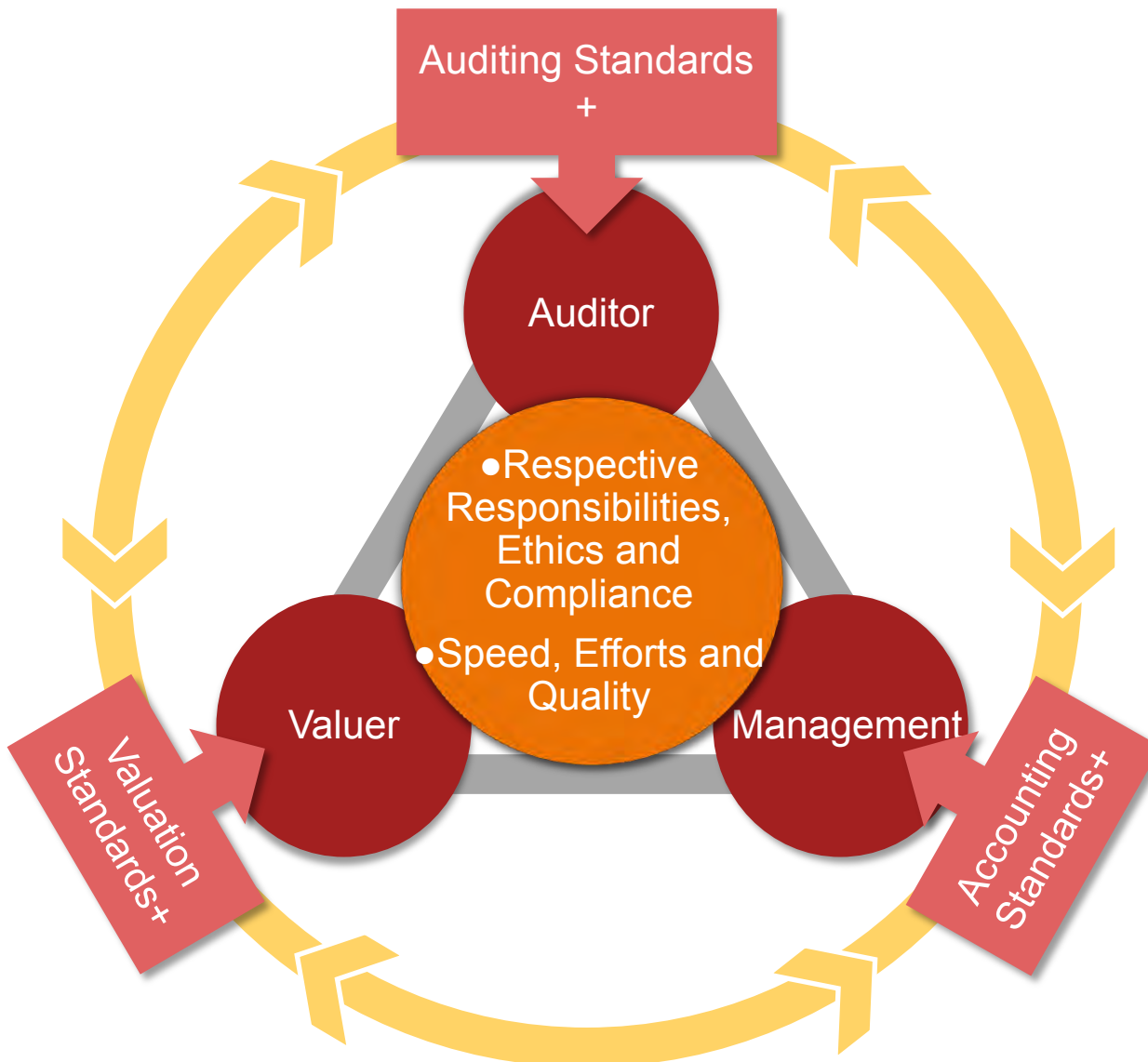
May become a last minute surprise

- Communication is critical

Section 3

Communication between Valuers and Auditors

3.1 Three Dimensional Interaction



- Valuers can be auditors' experts or management's experts;
- Valuers, management and auditors should closely communicate;
- Management and valuers should provide sufficient information for auditors to review, get comfortable and eventually discharge their professional responsibilities with respect to fair value measurement audits.

3.2 Mutual Understanding and Interaction

ISA 500 - Audit evidence

- Applicable when management’s experts are used.

ISA 620 - Using the work of an auditor’s expert

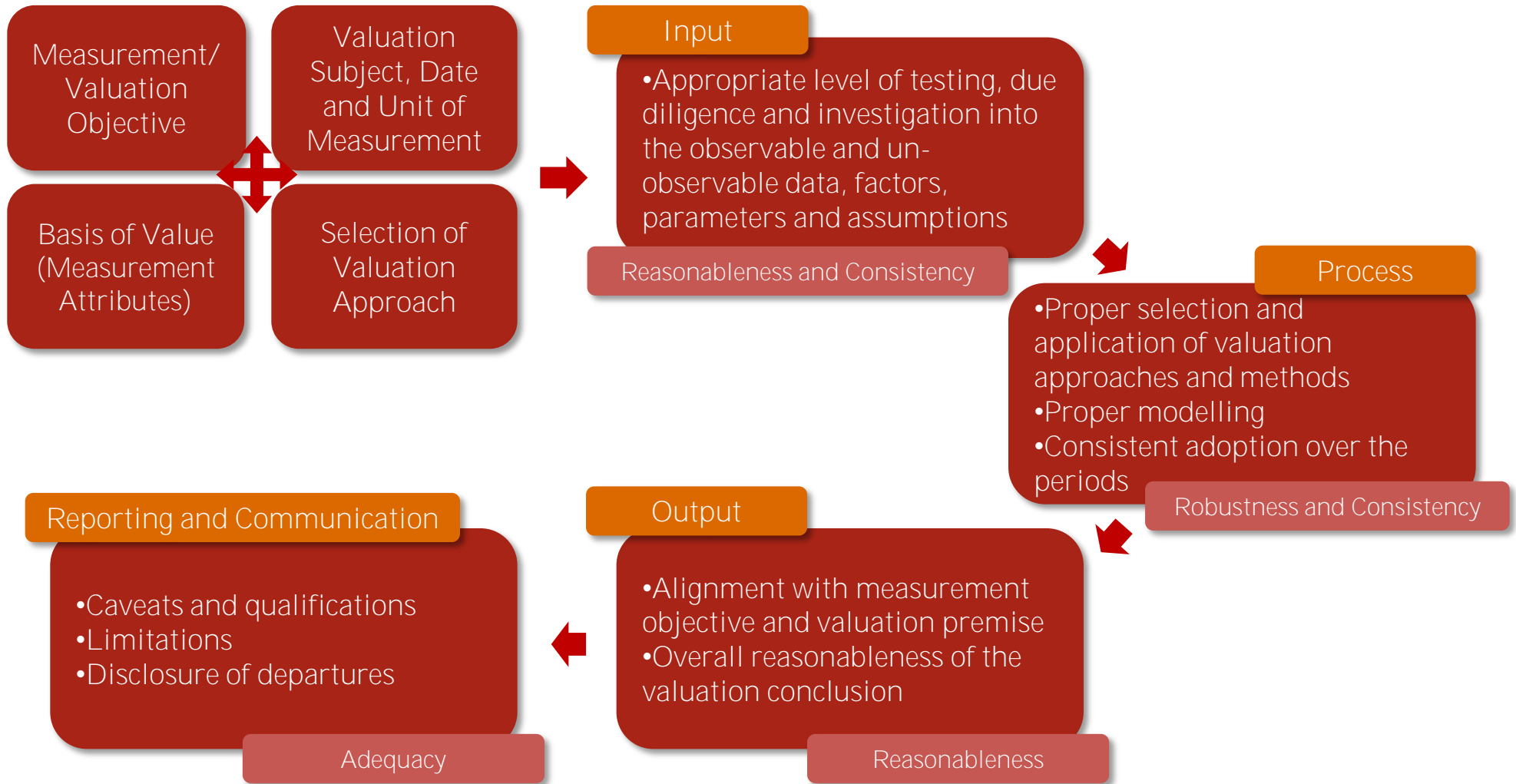
- Applicable when auditors’ experts are involved.

ISA 540 - Auditing accounting estimates, including fair value accounting estimates and related disclosures

- Specific requirements on fair value measurement audits, including testing on significant valuation inputs, parameters and assumptions.

Further guidance can be found in the **IVSC Paper – “A Guide to the Audit Process for Professional Valuers”** as well as IVS 101 and IVS 300.

3.3 Reasonableness, Robustness, Consistency and Adequacy



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