



National AICPA Real Estate Conference:

SFAS 157 and Real Estate Firms: Here We Go Again

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Agenda

- SFAS 157 Overview
- Real Estate Related Highlights and Differences
- Highest and Best Use
- Real Estate Fair Value Hierarchy

Overview and Effective Date

Why is this statement necessary?

- Different definitions of fair value and related measurement guidance in various standards led to inconsistency and added to complexity in GAAP
 - Statement 157 is **one-stop shopping** for guidance on fair value measurements
- FASB is seeking more **transparency** in financial statements regarding fair value measurements
 - Does not require any new fair value measurements, but provides guidance on **how to measure fair value**
 - Effective for fiscal years beginning after 11/15/2007
 - Transition is prospective with some exceptions

What Does the Statement Do?

1. Does not require any new fair value measurements, but provides guidance on how to measure fair value	5. Modifies the presumption that a transaction price is fair value; instead, provides indicators of when the transaction price may not be fair value
2. Clarifies and changes the definition of fair value	6. Eliminates the ability to value a large position in a security that is actively traded using a block discount
3. Establishes that an asset should be valued based on its highest and best use	7. Establishes that for a restricted security the fair value measurement should include the effect of the restriction (regardless of the term of the restriction)
4. Requires that an issuer incorporate its own credit standing when measuring its own liability at fair value	8. Requires new disclosures about items measured at fair value and their income statement effect

“How will SFAS 157 affect me in real estate?”

The following fair value measurements are scoped in:

- Assets measured at fair value for an **impairment test** under Statements 142 and 144
 - For example, impaired assets, long-lived assets held for sale, reporting units, and goodwill
- Certain assets and liabilities measured at fair value in a **business combination** under Statement 141 (i.e. intangible assets)
- Investments carried at fair value by real estate investment companies

Fair Value Hierarchy

- Standard establishes a three-level hierarchy
- What is the purpose of the hierarchy?
 1. To reinforce that a fair value measurement should:
 - Maximize the use of Level 1 and 2 (observable) inputs, and
 - Minimize the use of Level 3 (unobservable) inputs
 2. To classify fair value estimates for the Statement's required disclosures
- A fair value measurement is categorized within the hierarchy based on the lowest-level input that has a significant effect on the measurement
- Most real estate investments will likely be Level 3, although some may be Level 2
 - Application guidance is still evolving !!!!!!!!

What Does the Future Hold?

- The guidance in Statement 157 applies to all future FASB statements that would require or permit fair value. For example, the FASB is working on the following projects that include new fair value measurements:

Exposure Draft of Statement 141(R), *Business Combinations*, would require fair value measurements for:

- Contingent considerations
- Acquired contingent assets and liabilities
- Accounts and loans receivable
- Liabilities for restructuring or exit activities

SFAS No. 159 - The Fair Value Option for Financial Assets and Financial Liabilities permits fair value measurements for:

- Cost and equity method investments
- Certain insurance contracts
- Warranty obligations
- Debt

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SFAS 157 – Real Estate Related Highlights and Differences

Issue	Current	SFAS 157
Definition	Various definitions – for example: Amount at which an asset or liability could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale	Price that would be received for an asset or paid to transfer a liability between market participants at the measurement date
Transaction Entry Price	Presumed equal to fair value	May not be representative of fair value; provides indicators of when the transaction price may not be fair value
Highest and best use	Current practice is to value assets in continued use unless identified for disposition	Independent of the reporting entity's intent; considered from market participant perspective
Use of market data in valuations	Use of market data encouraged. In some circumstances entity intent permitted to be considered in valuations	Valuation techniques must maximize use of market observable data and minimize use of unobservable data
Hierarchy	No current mandated hierarchy	Three levels distinguishing between observable and unobservable inputs
Market participants	Current guidance on market participants is unclear. Buyer-specific intent may be considered	Buyer-specific intent should be dismissed if different from that of other multiple market participants

New Definition of Fair Value

“Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

Real Estate thoughts regarding:

- **Exit price:** Not necessarily the price paid for an asset (for example), which is an entry price
- **Market participants:** Buyers and sellers that are independent, knowledgeable, able, and willing
 - Skepticism of a risk averse buyer
 - Fair value should reflect how market participants would value the asset, even if market participants would use the asset differently than the owner’s intended use

Fair Value at Initial Recognition

- New model: transaction price = entry price; fair value = exit price
- In many transactions, transaction price may be fair value, but consider the following:
 - Whether transaction is between related parties
 - Whether transaction occurs under duress
 - Whether unit of account for the transaction price is different than the unit of account for the asset or liability measured at fair value (e.g., transaction price includes transaction costs or unstated rights or privileges that should be separately measured)
 - Whether the market in which the transaction occurs is different from the principal (or most advantageous) market in which the entity would sell/dispose of the asset or liability

Valuation Techniques

Consistent with market, income or cost approaches

- Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used
 - In some cases – single technique
 - In other cases – multiple techniques
- Valuation techniques to be consistently applied

Real Estate valuation techniques

- Land
- Special Purpose Manufacturing Asset
- CBD Office Property
- Super Regional Retail Shopping Center

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Highest and Best Use

- Application to Assets
 - Fair Value Measurement assumes Highest and Best Use by Market Participants
 - The Determination of Highest and Best Use Considers uses that are:
 - Physically Possible
 - Legally Permissible
 - Financially Feasible
 - Maximizes the Value of the Asset or Group
 - SFAS 157 criteria for highest and best use determination is consistent with standard Real Estate Appraisal Methodology

Highest and Best Use

- Assets:

- Fair value measurement for assets assumes the *highest and best use* (by market participants)

- Determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different
 - Maximizes fair value of an asset or group of assets
 - Establishes the valuation premise used to measure the fair value of the asset and can be either:
 - ***In-use*** – maximum value is derived from the operation of an asset in combination with other assets as a group,
 - ***In-exchange*** – maximum value is derived from the operation of an asset on a standalone basis

Highest and Best Use SFAS 157 – Land Example

- Entity X acquires land and a manufacturing facility in a business combination. Market data indicates that nearby sites have recently been developed for residential use as sites for high-rise condominiums.
- In this instance, the highest and best use of the land would be determined by comparing:
 - The fair value of the manufacturing operation (in-use), with
 - The fair value of the land as a vacant site for condominiums (in-exchange)
 - after consideration of demolition and other conversion costs
- The highest and best use of the land would be determined based on the higher of those values, regardless of the intended use.
- Generally, highest and best use assumptions should be consistently applied to other assets in the asset group

Highest and Best Use – Improved Property

Example

- Company acquires an operating hotel for \$10 mil which is supported using a market based income approach
- New development of similar sites in the local market indicate a highest and best use of the land as vacant for high rise condo development
- Comparable sales of similar sites for high rise condo development in the market indicate a value for the land associated with the acquired hotel of \$8 mil assuming a highest and best use of high rise condo development
- Demolition costs to prepare the site for condo development are \$1 mil
- Fair Value should be estimated for the land, improvements and intangibles, and the allocation should be made on a relative fair value basis assuming use of the assets as a hotel
- The impact of the alternative highest and best use of the land as vacant to the relative fair value of the assets is an unresolved implementation issue

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Real Estate Fair Value Hierarchy

- Inputs
 - **Observable inputs** are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.
 - **Unobservable inputs** are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.
- Techniques should maximize the use of observable inputs and minimize the use of unobservable inputs
- Inputs should include assumptions about the risk of valuation techniques used to measure fair value (e.g., a pricing model) and/or the risk inherent in the inputs to those valuation techniques
- Transaction Cost – price used to measure fair value should not be adjusted for transaction costs

Real Estate Fair Value Hierarchy

- Standard establishes a three-level hierarchy.
- What is the purpose of the hierarchy?
 - To maximize the use of observable market data and minimize the use of unobservable inputs
 - To establish classification of fair value measurements for disclosure purposes
- Fair Value Hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques

Real Estate Fair Value Hierarchy (continued)

–Level 1 inputs:

- Quoted prices (unadjusted) for identical assets or liabilities in active markets
- Most reliable evidence of fair value
- Positions in financial instruments for which there is an active market measured at fair value as the quoted price times quantity held
- In an active market, blockage factor prohibited, even if market's normal daily trading volume is not sufficient to absorb the quantity held, thereby potentially affecting the quoted price

Examples of Real Estate Related Level 1 inputs

- Valuation of an investment in the stock of a publicly-traded REIT

Real Estate Fair Value Hierarchy (continued)

– Level 2 inputs:

- Observable market data other than level 1 inputs
 - Quoted prices for similar assets or liabilities in active markets
 - Quoted prices for identical or similar assets or liabilities in inactive markets
 - Inputs other than quoted prices that are directly observable (e.g., interest rates, yield curves, default rates)
 - Inputs derived principally from or corroborated by market data by correlation or other means (market corroborated inputs)
Example: royalty rates, prices per square foot and valuation multiples

- Adjustments may vary depending on facts and circumstances

Examples of Real Estate Related Level 2 inputs

- Sales price per square foot for a Class A office buildings in Midtown Manhattan
- Discount rate for investments with similar risks
- Capitalization rate indicated for sales of self-storage facilities in similar cities
- Sales price per buildable lot for single-family developments in suburban Phoenix

Real Estate Fair Value Hierarchy (continued)

– Level 3 inputs:

- Unobservable inputs:

- Inputs derived through extrapolation or interpolation that cannot be corroborated by market data
- Other entity-specific inputs [historical or projected financial data (revenues, earnings, cash flow, etc.) that are not derived from market data]
- Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use
- In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions
- The reporting entity must not ignore information about market participant assumptions that is reasonably available without undue cost and effort

Examples of Real Estate Related Level 3 inputs

- Reporting entity's estimate of rent, expenses or cash flow on it's own Property
- Reporting entity's estimate of return rates demanded by market participants

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