

From: ALFI Real Estate Investment Funds Sub-Committee (C2)
Type of document: Real Estate Investment Funds - Best Practices Guidelines
Topic: Financial Reporting – August 2011
Date: August 2011

This document summarizes a series of guidance notes which were published by the ALFI Real Estate Investment Funds Sub-Committee between November 2008 and April 2011 into one combined document. It reflects the general consensus of discussions with market professionals, together with reference to certain Best Practice Guides and Standards, including those of INREV, EPRA and EVCA. The document takes the form of answers to frequently asked questions, primarily in respect of accounting and valuation issues, the calculation of the net asset value and the contents of financial statements including key disclosures, applicable to Luxembourg REIFs in the format of UCIs governed by Part II of the Law of 17 December 2010, SIFs governed by the law of 13 February 2007 and SICARs governed by the law of 15 June 2004. It should be read in conjunction with the Luxembourg Real Estate Investment Vehicles brochure, which is prepared jointly by ALFI and Luxembourg for Finance (LFF) and gives general background information on the legal and taxation aspects of unregulated and regulated real estate vehicles domiciled in the Grand Duchy of Luxembourg.

The answers to the frequently asked questions do not constitute regulation and should be considered guidance on common practice. Answers are provided on the assumption that the applicable Generally Accepted Accounting Principles (GAAP) used is Luxembourg GAAP¹ and/or International Financial Reporting Standards (IFRS), which are the most commonly used GAAPs in respect of Luxembourg domiciled real estate investment vehicles. In addition, answers are directed at regulated Luxembourg Real Estate Investment Funds (“REIFs”) (FCP, SICAV, SICAF, SICAR) and specifically do not address investment vehicles such as companies, partnerships and securitization vehicles, which will have different legal requirements. However, many of the principles will be relevant to such vehicles. Readers should seek the advice of qualified professionals before making any decision as to the most appropriate Luxembourg real estate vehicle for their needs, and the selection of their accounting framework and accounting policies.

This document does not cover any future requirements or implications of the Alternative Investment Fund Managers Directive (AIFMD). A revision of this document is planned and to include the AIFMD’s impact on Luxembourg REIFs when the level 2 measures are adopted in June 2012.

This document is published by ALFI as a general guideline and while reasonable care has been taken in compiling the information, ALFI does not accept any liability for the guidelines and does not guarantee in any way that they will be appropriate to specific circumstances. Readers should seek appropriate professional advice in order to decide how to apply best practice to individual REIFs.

This document reflects the legal situation as at 1st August 2011.

¹ Luxembourg GAAP means a set of accounting principles in compliance with Luxembourg legal and regulatory requirements for vehicles which fall under the laws of 17 December 2010 on undertakings for collective investment, as a specialized investment fund (SIF) under the Luxembourg law of 13 February 2007 on undertakings for collective investment, and the law of 15 June 2004 on investment companies in risk capital.

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1 PROPERTY VALUATION

1.1 What are acceptable valuation methods for investment property?

- 1.1.1 The actual cost of a recent acquisition.
- 1.1.2 Estimations made based on the cost of comparable transactions in a similar location and condition, often using a unitized method (e.g. value per square meter), or of a dissimilar property adjusted to reflect the differences.
- 1.1.3 Discounted cash flow of future income and expenses.
- 1.1.4 Multiples of annual rental income (rental yields).
- 1.1.5 Any other method recognized by applicable valuation standards, e.g. depreciated replacement cost, profits method, fair value at completion less costs to complete, (applicable to properties under development).
- 1.1.6 When determining the fair value of a property, lease adjustments, such as incentives, rent guarantees and insurance cover are usually taken into account. Attention should be paid to avoid double counting of such effects in the fair value of the property, when such effects are reflected as separate items on the balance sheet.

1.2 What are the generally accepted frameworks for determining fair value for investment properties?

- 1.2.1 CSSF Circular 91/75, and in other cases common and best practice (see Section 6.2), dictates that investment properties must be valued at least on an annual basis by an external valuer. There are no detailed guidelines specifying how this should be done; valuation rules are those as stated in the Fund Documentation. Best practice is to follow recognized property valuation standards such as IVSC/RICS /TEGOVA. If the financial statements are prepared in accordance with IFRS, then the valuation methodology should also comply with IAS 40 (Investment Property). IAS 40 regards current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts as the best evidence of fair value. In the absence of current prices in an active market, the standard considers information from a variety of sources including discounted cash flow projections based on reliable estimates of future cash flows.
- 1.2.2 INREV Guidelines 2008 (in the following “INREV”) provide further details on frameworks for performing property valuations for unlisted funds with the EPRA Best Practices Recommendations on Reporting of October 2010 providing guidance for listed funds.
- 1.2.3 For open ended funds, independent and regular valuation of the properties is particularly important as this ensures that subscriptions and redemptions of units / shares are carried out based on a Fund NAV directly linked to the underlying property value.

1.3 What is understood by the term ‘Fair Value’ for investment property and is this always the same as ‘Market Value’ as described in various property valuation standards?

- 1.3.1 In the context of real estate, Market Value generally refers to the valuer’s opinion of the best price that could be obtained in the open market on an arms-length basis at a specific date, assuming a willing buyer and a willing seller, and assuming marketing has already taken place e.g. special interests and/or operational value to the business are not taken into account.
- 1.3.2 Fair Value is the net present value of expected cash proceeds taken from the market value defined in point 1.3.1 above, which is expected to be received from the disposal of a property under normal market

conditions. This excludes transaction costs normally borne by a potential buyer from the appraised market value. In addition, costs which may be incurred by the seller on disposal of the property are not taken into account in both the fair value or in the market value.

- 1.3.3 Under IFRS the determination of fair value generally does not take account of the method of disposal (i.e. always assumes that the property is sold as an asset deal from the company that owns it). Essentially, it is the value that the investors in the fund can expect to recover from the sale of a property, as estimated at the date of the financial statements.
- 1.3.4 Although LuxGAAP generally follows IFRS rules, under LuxGAAP and INREV guidance, the method of disposal in certain circumstances could possibly be taken into account, e.g. the effect of a possible sale of shares of a property vehicle, rather than a property, reducing the actual transfer tax and/or purchasers costs to be paid upon sale by the seller. The assessment of the intended method of disposal should be substantiated and reviewed by the Fund management at each Fund NAV calculation date taking into account the most recent deals, changes in the market practice in each country, changes in the Fund structure and disclosure should be made in the financial statements explaining the approach applied.

1.4 Who can be appointed as an independent valuer to a Luxembourg REIF?

Assuming that an independent valuer (or appraiser) will be appointed:

- 1.4.1 The Fund should appoint one or more independent real estate valuation professionals/companies who are licensed where appropriate and who operate in the jurisdictions where any relevant properties are located.
- 1.4.2 Independent valuers should be adequately qualified and experienced in the markets they operate. Details of the intended arrangements with independent valuers should be disclosed in fund documentation and may be scrutinized by the CSSF.
- 1.4.3 The valuer must be independent, i.e. should not be an affiliate of the fund manager, the property manager or the investors. When other services are also provided by an independent valuer that could possibly affect independence, these must be disclosed. It is also good practice to establish the fees of external valuers on a basis which is independent of the outcome of the valuation (i.e. not linked to the value).
- 1.4.4 Valuers should prepare their reports in accordance with a recognized property valuation standard (e.g. ISVC/ RICS/ TEGOVA, see 1.2 above), and should only value properties where they can act as independent valuer, without any conflicts of interest arising due to other connections with the subject property, e.g. appointment as investment agent, property manager, letting agent or valuer for another party.
- 1.4.5 As recommended by INREV, an assessment of the re-appointment of the external valuer should be made at least every 3 years.
- 1.4.6 The name of the independent valuer(s) should be indicated in the annual financial statements for each year, including which properties each valuer has valued. In some cases, their valuation report to the Fund is included in the annual financial statements.

1.5 What is an acceptable property valuation frequency?

- 1.5.1 CSSF Circular 91/75, and in other cases (see S6.2) common and best practice, dictates a minimum of annual independent valuations. Under INREV, external property valuations are also performed at least annually for all properties, with (desktop) internal or external updates in line with the reporting frequency of the fund.

- 1.5.2 A significant number, especially if they are semi-open or open-ended, of Luxembourg REIFs commission quarterly valuations, which are typically carried out as a full valuation once per year and 3 'desktop' valuations.
- 1.5.3 For larger portfolios, a rolling cycle of full valuations throughout the year is considered practical, with desktop updates for the remaining quarterly valuation points. Such arrangements would need to be agreed with the CSSF as part of the approval of the Fund Documentation. Refer also to considerations in Section 2.3 regarding how recent a valuation should be.
- 1.5.4 In all cases, any exceptional events which are likely to significantly affect the value of a fund's portfolio or individual properties may require an 'out of cycle' adhoc revaluation. The decision to call for such a revaluation is the responsibility of the Fund's Management. Such events may include economic, interest rate, political, market, sector, physical and/or tenant-related issues.
- 1.5.5 The Fund management is under a general obligation to ensure that a best estimate of fair value is used at every Fund NAV calculation date, taking account of all relevant information known to the Fund management at the Fund NAV calculation date.

1.6 What is the best way of reconciling multiple conflicting valuations?

- 1.6.1 Ideally, Fund management should seek agreement between different valuers to enable them to agree on one value.
- 1.6.2 If agreement is not possible and both opinions are credible, a reasonable methodology for selecting the best point in the range must be determined by the Fund management and applied consistently. The methodology should support the value that the Fund is most likely to realize from the property in a normal sale.

1.7 How should a fund treat transactions where the purchase or sale price varies from the independent valuation?

- 1.7.1 CSSF Circular 91/75, and in other cases (see Section 6.2) common and best practice, dictates that a fund should disclose the reasons why it proceeded with a transaction where a 'significant' variation exists between actual price and the value per the valuation.
- 1.7.2 Often there is a difference between the theoretical fair value of a property and the price finally negotiated in an actual transaction. The threshold of 'what is significant' has been held in other countries to lie between 5 and 10% variation. The focus is on the downside – proceeding on terms more favorable than the valuation is obviously acceptable. For accounting purposes, adopting the transaction price in such a 'downside' case is preferred to using the valuation, as recent transaction information is considered to be stronger evidence of the likely market price.
- 1.7.3 The Fund may choose to proceed with a transaction where the price significantly exceeds the independent valuation, as this may, nonetheless, be considered a potentially valid investment management decision. However, such a decision should be justified in writing with appropriate detailed calculations to support the Fund's action and formally approved by the Fund management.

1.8 How should a fund treat property portfolio premiums?

- 1.8.1 When a portfolio of properties is acquired and a portfolio premium is paid, such premium usually does not satisfy the recognition criteria under IFRS and cannot be recorded in addition to the fair values of the individually valued properties. However, if it is an intention to sell the properties in the portfolio in the future and the premium can be justified (e.g. with a reference to valuation report and that it is compliant with the

REIF's governing documentation) an adjustment could possibly be made as a reconciling item between the Fund NAV and IFRS or, if the REIF is applying Luxembourg GAAP, directly in the statement of net assets. In either case, a full and detailed disclosure of the rationale for recognizing the amount, the methodology of its calculation and the quantum of the amount should be made. The estimate of the intended method of disposal should be reviewed by the Fund management at each Fund NAV calculation date.

2 VALUATION UNCERTAINTY

2.1 What is valuation uncertainty?

- 2.1.1 Practically all regulated real estate funds in Luxembourg rely on independent valuation reports to determine the reported fair value of their investment property portfolio at their year-end and interim reporting dates.
- 2.1.2 The vast majority of Luxembourg Real Estate Investment Funds ("REIFs") commission valuations according to the International Valuation Standards Council ("IVSC") Best Practice guidelines and/or the Royal Institution of Chartered Surveyors ("RICS") Appraisal and Valuation Standards ("the Red Book").
- 2.1.3 Material valuation uncertainty may arise from a variety of factors associated with a particular property, including but not limited to; location, unusual characteristics, lack of current information available about the property, development status, ongoing legal issues and market instability. Under RICS guidance², valuation uncertainty paragraphs, if included, should not cause the management of the fund or its auditor to question the validity of the valuation, and should not amount to standard caveats or general disclaimers.
- 2.1.4 Despite the RICS guidance, it is conceivable that valuation reports may contain emphasis of matter paragraphs making reference to specific circumstances relating to individual properties. It is also possible that valuation reports contain a qualification of the valuation or only provide a range of possible values.
- 2.1.5 Due to significant uncertainties as described above, particularly market instability, valuers have recently and are indicating that they may continue to include 'valuation uncertainty' paragraphs in some valuation reports. Most of the uncertainty paragraphs seen to date do not caveat the valuation opinion provided. However, they do typically draw the reader's attention to the financial backdrop against which the valuations have been assessed.

2.2 What actions regarding financial reporting should be taken by the management of the fund relating to the increased uncertainty in the valuation of real estate?

- 2.2.1 Management should review all the valuation reports received from independent valuers in order to understand the methods and assumptions used by the independent valuers to estimate fair value of the properties. This review should include an assessment whether the valuation reports contain only standard uncertainty paragraphs or whether the valuer has put a caveat on their valuations in any way. In addition management should check whether the conclusions reached by the independent valuer are not materially inconsistent with its own assessment and understanding of a particular market and with comparative market transactions.
- 2.2.2 In order to appropriately draw the reader's attention to increased uncertainty cited in the valuers' report (if any is stated), management should consider enhancing disclosures in the financial statements in the

² See RICS Red Book Guidance Note 5, and the 'Valuation Uncertainty and Market Instability' bulletin issued by RICS on 26 November 2008. (http://www.rics.org/Practiceareas/Property/Valuation/val_uncertainty_f_271108.html)

following areas:

- the investment property note, which typically already includes disclosures on the valuers used by the company, which could be extended to describe special assumptions used in the valuation reports and any other relevant information highlighting the increased uncertainty of the real estate valuation as stipulated;
- the accounting policy 'valuation method' note, if the valuation method used by the client or valuer has changed;
- the critical accounting estimates and judgments disclosures, to highlight increased uncertainty surrounding real estate fair value estimates;
- the disclosures around market risk and the impact on financial instruments that rely on covenant compliance.

2.2.3 These additional disclosures could include reference to some or all of the following topics depending on the particular situation:

- a sensitivity analysis on property yields or an indication of the range of potential valuation outcomes to the extent that the valuer is willing to provide this information within their valuation reports; and
- a reproduction of the additional 'valuation uncertainty' wording included in the valuation report by the valuers if the report is not reproduced within the financial statements, or a suitable cross reference if it is.

2.3 How recent should a valuation be to be relevant in current market conditions?

2.3.1 Many REIFs have previously organized themselves on an annual valuation cycle, which has meant that real estate valuations that were used for financial reporting purposes were often commissioned several months or quarters before the reporting date. Due to the increased volatility in the real estate market and the potential for significant change in values over time, excessively aged independent valuations do not seem any longer to be a prudent basis for financial reporting.

2.3.2 Independent valuation reports should be updated on a regular basis for reporting purposes. It is desirable to have independent valuations performed on the reporting date, e.g. 31 December 2010, or close to this date. What is to be considered close enough to a reporting date will depend on individual circumstances and a decision needs to be taken on a case by case basis. Where formal valuation reports have been issued at a significantly earlier date, management should consider requesting updates from the independent valuers.

2.4 What other considerations should management take into account in volatile market conditions?

2.4.1 A key example of this scenario is to consider the impact on the 'going concern' assumption. Management may find themselves in a position where the going concern basis is clearly threatened by a property valuation outcome that is within the potential variability of the valuation figure. This would typically arise through lower valuation levels breaching loan-to-value covenants within a Group's loan portfolio and therefore triggering repayments of the loan or at least additional cash deposit requirements with the relevant banks. Where this is the case, it is appropriate to conclude that the consequence of the valuation uncertainty on the presentation of the financial statements is significant, and therefore an emphasis of matter is required as a minimum in the audit report, and possibly consideration of adopting the break-up basis in extreme circumstances.

2.4.2 Management should review its funding in order to ensure that enough liquidity is available to the fund to continue as a going concern. Special attention should be paid to maturing credit facilities and lines of credit available from banks which themselves may have liquidity issues. Given the current economic climate management should also consider whether committed but uncalled capital is still available to the fund to overcome liquidity issues.

- 2.4.3 A review of any commitments or contingent liabilities the fund might have, e.g. from sales of properties in prior years, which might trigger cash payments due to the current downturn in the economy, should be carried out.
- 2.4.4 Any issues identified from the above should be considered in the preparation of the reporting of the fund.

2.5 How may this impact the audit of financial statements of Luxembourg real estate funds?

- 2.5.1 In general, auditors will perform work on the uncertain elements of the valuation as described above such as the valuation of properties and the going concern assumption. Auditors will review and assess the appropriateness of the assumptions made by Fund management and the reliability of the supporting documentation gathered to support their conclusions.
- 2.5.2 Auditors may also consider modifications to their audit report in certain circumstances, including where in their judgment:
- Assumptions and judgments made by Fund management in valuing the properties are inaccurate or inappropriate;
 - Insufficient evidence exists, or has been considered, to reasonably value the properties;
 - Disclosures with respect to the uncertainty of the valuation of underlying funds are inadequate;
 - The valuer has qualified the valuation of the properties;
 - Disclosures with respect to covenant breaches are inadequate;
 - There is doubt as to the 'going concern' basis of the Fund;
 - Disclosures with respect to the 'going concern' basis of the Fund are inadequate;
 - Assumptions and judgments made by management in respect of the 'going concern' basis of the Fund are inaccurate or inappropriate.

2.6 What actions should be taken by the Central Administration / Custodian?

- 2.6.1 Central Administrators should work closely with the Fund's Management to assess:
- What values should be included in the accounts for the Fund NAV calculation, if the independent valuation report includes a valuation uncertainty paragraph or a caveat to the valuation. The ultimate responsibility lies at Board level, who can ultimately decide whether or not to include impairment in the accounts.
 - What additional disclosures (if any) in the notes to the accounts of the financial statements are required.
- 2.6.2 No special actions need to be made by Custodians with respect to the above. The provisions of Chapter E of IML Circular 91/75 (the "Circular") are applicable and provide the regulatory framework regarding all Luxembourg funds irrespective of their legal form or regime. According to the Circular, the custodian "has to have knowledge at any time on how the assets of the fund have been invested and where and how these assets are available". The custody obligation has to be understood in the sense of supervision rather than safekeeping.

3 ACCOUNTING

3.1 Which GAAPs are appropriate for the financial statements of a Luxembourg REIF?

- 3.1.1 Luxembourg GAAP is common, especially for smaller closed-ended funds.
- 3.1.2 IFRS has become more common since 2005 in public interest or larger institutional funds with appropriate adjustment to arrive at a “best estimate” of the fair value of the NAV (refer to Section 4.1).

3.2 How should a fund treat development property not characterized as inventory?

- 3.2.1 Under IFRS, LuxGAAP, and INREV, property being developed as an investment property should be carried at fair value similar to properties being developed for trading purposes.
- 3.2.2 Under IFRS, a property under development where it is intended that the completed asset is to be held to earn rental income or for capital appreciation or both is classified as an investment property under IAS 40. Assuming the fair value model is applied under IAS 40, the property under development will be measured at its fair value, unless that fair value cannot be reliably estimated in which case the asset will be measured at cost until either its fair value becomes reliably determinable or construction is completed (whichever comes earlier) after which it is measured at fair value.
- 3.2.3 Neither LuxGAAP nor IAS 40 provide any specific guidance as to the valuation of properties under development. In practice, however, common methods found include: (i) the hypothetical developer’s method otherwise known as the ‘residual method’ of valuation; and (ii) the discounted cash flow (DCF) method. The hypothetical developer’s method deducts costs of construction, finance and anticipated profit (a percentage of cost) from an exit value i.e., the gross development value of the completed property. The DCF approach uses (project) risk adjusted discount factors. Detailed guidelines are limited in respect of such valuations. However the European Public Real Estate Association (EPRA) and the International Valuation Standards Board (IVSB) have both released more detailed guidance on the subject. EPRA’s guidance has been released as “Valuing Investment Property under Construction, EPRA recommendations to the IVSC” released in November 2008 while the IVSB published its new “International Valuation Standards” including “IVS 233 - The Valuation of Investment Property under Construction” in July 2011.
- 3.2.4 Where few key project milestones have been met (such as during the early stages of a development project) it may be that Fund management assess that it is not appropriate to recognize a gain above the cost of development in the property under construction when valuing an asset. In other words cost represents the fair value of the property under construction until a certain amount of the project risks have been eliminated or reduced. In any case, however, where cost is used as a proxy for fair value of a property under construction an assessment must be made as to whether the total costs of construction will exceed the fair value of the asset at completion and thus whether any write-down on the costs incurred to date is required to provide an accurate estimate of fair value of the asset.

3.3 How should a fund treat properties held for trading purposes?

- 3.3.1 Properties held for trading as part of a purchase, development and sales program should be treated as inventory when the developer takes the sales risk.
- 3.3.2 Under LuxGAAP, these are treated as inventory and carried at fair value which is established as described above in 3.2.3 and 3.2.4.
- 3.3.3 Under IAS 2, however, they would be carried at the lower of cost and net realizable value (NRV). This means that there could be a reconciling item between IFRS financial statements and the NAV in cases

where the fair value of such inventory was materially different to its cost. Such reconciling item is also in line with the INREV guidelines for the adjusted NAV calculation.

- 3.3.4 The methodology for calculating the NRV of property under construction classified as inventory is typically determined as the selling price of the completed asset less remaining construction costs to be incurred and a provision for selling costs. This is not identical to the estimation of fair value as discussed above in 3.2.3 and 3.2.4. Key differences include:
- The NRV includes a deduction for the estimated costs of selling the asset which the fair value of the asset will not; and
 - The fair valuation of a property under construction, as discussed, in 3.2.3, may include a deduction for the anticipated profit to be achieved on development which will not be the case for the NRV of inventory where no such margin is deducted.

3.4 Is there a requirement to carry debt at fair value?

- 3.4.1 Normally, the carrying value of variable interest debt arrangements approximates its fair value and such debt should be carried at amortized cost using the effective interest rate method under both IFRS and LuxGAAP.
- 3.4.2 INREV requires that fixed interest debt is carried at fair value. If economically justifiable, however, the fund documentation may provide a derogation from this principle so that fixed rate debts are recorded at amortized cost (rather than at fair value) dependent on how the debt will be settled. This could be acceptable in various instances, including:
- For closed ended funds where the fixed rate debts are almost certainly held until maturity, the liabilities may be valued at their amortized cost to avoid the impact of unrealized changes in the fair value of the instrument on the NAV during the life of the fund. This is in line with the INREV guidance for closed ended funds when determining the “NAV for property performance measures” as well as best practice in respect of the valuation of derivative hedging instruments;
 - For open-ended funds where, again, the fixed rate debts are almost certainly held till maturity and Fund management, therefore, do not believe that it is appropriate that the trading NAV of the fund is impacted by volatility in the fair value of fixed rate debts.

The assessment of the intended purpose of fixed rate debts should be re-considered at each NAV calculation date to substantiate the adjustment to value at nominal amount for the purpose of the NAV calculation. In any case, the fair value of fixed rate debt should be disclosed in the notes to the financial statements. Use of such derogations should be discussed with the fund’s auditors.

- 3.4.3 Under IFRS, there are both fair value and amortized cost options depending on the classification as of the financial liability per IAS 39. If the cost model is adopted as described above, the fair value should be disclosed in the notes to the financial statements. In IFRS financial statements, if fixed rate debt is carried at amortized cost, a reconciling item to arrive to the Fund NAV may be necessary.

See Section 3.10 for related guidance regarding accounting for currency and interest rate hedges.

3.5 How is revenue recognized in a real estate fund?

- 3.5.1 Under IFRS rental income and all rent incentives should be recognized on a straight line basis over the term of the rental agreement unless another systematic basis of recognition is more representative of the time pattern of which the REIF’s benefit derived from the property is diminished. This means that all rent

incentives, such as rent free periods, moving subsidies etc., should be straight lined unless the other circumstances noted above apply. This is implemented through movements in balance sheet accounts. LuxGAAP is consistent with IFRS in this regard in that it allows other methods of income recognition in addition to straight-lining if these are more appropriate based on the fund style.

- 3.5.2 One of the issues of applying this accounting principle is that revenue and cash flows from revenues are not matched. This means that definitions of distributable income often need to be adapted to revert to recognizing revenue when contractually due and billable. Also, this is a common practice in many countries from a tax perspective.
- 3.5.3 When applying the fair value model, it is important to avoid double counting of assets if the lease contract includes a rent-free or a period of reduced rent. The double counting results because the leases are straight-lined over the period of the lease, resulting in a lease receivable in the period of reduced rent/rent free period. The fair value model (i.e. the fair value of the real estate asset) is based on the future cash flows of the real estate asset and some of these future cash flows have already been included as an asset on the balance sheet in the form of a lease receivable. In the end, the lease receivable plus the value of the investment property should be equal to the fair value of the real estate asset determined with the fair value model.

3.6 What is the accounting treatment for property acquisition costs?

- 3.6.1 Under both LuxGAAP and IFRS, such costs must be initially capitalized. Subsequent fair value re-measurement does not take them into account as fair value excludes costs normally borne by the purchaser and does not take account of potential disposal costs of the seller. Effectively they are therefore written off through the income statement at the next NAV determination date, irrespective of whether it coincides with independent valuation on that date.
- 3.6.2 Often, to ensure that such transaction costs are borne proportionately by investors coming into the fund after the portfolio has been established, a swing pricing mechanism can be used to adjust the Fund NAV offered to new investors to add a premium to cover transaction costs borne by existing investors. Premiums or discounts to Fund NAV as part of a pricing scheme are recorded directly in equity.
- 3.6.3 Alternatively, to comply with INREV guidelines, an adjustment could be made to the underlying IFRS/LuxGAAP NAV basis for the capitalization and amortization (generally over 5 years, can be shorter if the rationale is justified) of acquisition costs to reflect in the NAV a fairer spreading of such costs between investors. If the property is sold before the amortization period expires, the remaining adjustment (unamortized part) should no longer be included in the IFRS/LuxGAAP NAV.
- 3.6.4 Alternatively, an up-front subscription and/or redemption fee is charged on units/ shares offered or redeemed at NAV. Up-front fees are recorded as income in the fund either at the date of issue/redemption of the units/shares, or over a certain period of time.

3.7 What is the recommended treatment of fund formation costs?

- 3.7.1 Under LuxGAAP, such costs can be capitalized and amortized over a period not exceeding 5 years.
- 3.7.2 Under IFRS, general fund launch costs must be written off immediately through the income statement. Costs directly associated with raising equity must be shown as a deduction to the proceeds raised from capital formation.

3.7.3 For many Luxembourg REIFs which prepare IFRS financial statements, amortization adjustments are made to the Investors Equity in the financial statements prepared under IFRS to reflect in the Fund NAV a fairer spreading of such costs between investors over the first 5 years of the fund. This adjustment is in line with INREV guidelines.

3.8 What is the method of accounting for performance fees/carried interest?

3.8.1 Performance fees generally represent financial incentives given to asset managers of funds to meet and exceed certain financial targets over the life of the fund. Generally they are structured as a kind of profit sharing arrangement between investors and the asset manager which is triggered based on certain targets being achieved either in a given financial period, on a cumulative basis over the life of a closed ended fund, or on a series of successive years in an open ended fund.

3.8.2 Performance fees represent either:

- a contingency of the fund which has not yet become a determinable or contractual obligation triggered by certain events or economic conditions, or
- an amount which has been earned and can be estimated or calculated and accrued for or invoiced as a liability of the fund.

3.8.3 Where performance fees are a contingent liability of the fund, they should be disclosed in the notes to the financial statements, giving enough information for the reader to understand the nature and potential size of the contingency when the possibility of any outflow is more than remote.

3.8.4 Where performance fees are an accrual or invoiced liability, the best estimate of the accrual or the actual amount of the liability is recorded as such in the balance sheet. Such performance fee accruals or liabilities are recorded as an expense of the fund, similar to management or other similar fees.

3.8.5 The need to accrue or record a payable for a performance fee in the financial statements in a given period is based on certain triggering events occurring in that period, for example reaching financial targets such as cumulative IRR targets or profit targets. Accruals (as opposed to payables) are recorded when such liability has not yet been invoiced or has not yet become payable as it is subject to a delayed payment clause or claw back mechanism under the terms of the performance fee model.

3.8.6 The amount accrued should represent the best estimate of the most likely amount to be ultimately paid based on financial performance up to the cut-off date, using the most recent and reliable information available. Accruals for performance fees may vary from period to period depending on changes in such information over time, and the impact of claw back, high watermark, catch-up and other similar contractual clauses.

3.8.7 Performance fees can also be paid as equity instruments in the fund as opposed to cash. Generally, in such cases, the estimate or actual value of such equity is recorded in the equity of the fund. This treatment should reflect the value of the equity being earned, vesting and being delivered as actual equity instruments of the fund. The overall impact of this treatment is to dilute the equity attributable to other investors, instead of recording it as a liability of the fund if it was payable in cash.

3.8.8 In all cases, performance fee arrangements and transactions are 'related party' transactions of the fund and should be disclosed in the notes to the financial statements.

3.8.9 The performance fee expense may or may not be included in the definition of distributable income of the fund, depending on the terms of the Fund Documentation.

3.8.10 In open ended funds, where investors enter or leave the fund at different times, there are mechanisms to

ensure equal treatment of investors with respect to performance fees. These are typically through the issuing of series of share classes with different terms with respect to performance fees, or performance fee equalization mechanisms used whenever capital enters or leaves the fund.

3.9 What are the typical accounting treatments for dividends?

- 3.9.1 Definitions of distributable income are specified in the Fund Documentation and will depend on the nature of the fund. Some definitions are very prescriptive (such as in income-generating core funds) giving little discretion to Fund management, while others give more flexibility. The definition needs to be aligned with the ability of the fund to realize cash as well as accounting profits, and should also allow the accumulation of cash at the fund level in the structure.
- 3.9.2 In addition, normal corporate law rules on dividends and distributions may apply, depending on the choice of vehicle.
- 3.9.3 From an accounting perspective, dividends are either, in substance,
- a contractual liability of a fund and therefore recognized as accruals in the period in which they are earned, or
 - discretionary dividends, payment of which is dependent on certain approvals as specified in the Fund Documentation, and are only recorded in the Fund NAV when approvals have been made.
- 3.9.4 This will depend of the nature of the fund and the provisions of the Fund Documentation. The determination of which of these scenarios is applicable will set the timing of when the Fund will declare the Fund NAV to be ex-dividend.

3.10 How do funds treat currency or interest rate hedges?

- 3.10.1 Under LuxGAAP, and INREV guidelines, interest rate hedges are recorded at fair value.
- 3.10.2 Under IFRS, a hedging relationship qualifies for hedge accounting if all of the conditions specified in IAS 39 are met. Interest rate hedges are typically classified as cash flow hedges. If the interest rate hedge qualifies for hedge accounting, then the portion of the gain or loss on the interest rate swap that is determined to be an effective hedge (under IAS 39), is recognized in other comprehensive income, and the ineffective portion of the gain or loss is recognized in the statement of comprehensive income. For interest rate hedges not meeting the conditions for hedge accounting, the gain or loss is recognized in the statement of comprehensive income.
- 3.10.3 The Fund Documentation may specify how interest rate hedges are to be accounted for in the Fund NAV calculation, which can differ from the financial statement treatment by taking into account their intended purpose. For instance, for closed ended funds where the effective interest rate hedges are almost certainly held till maturity, the value of these hedges at the end of the life time of the fund are nil and therefore an adjustment to derecognize the hedges may be specified to avoid their impact on the Fund NAV during the life of the fund. This is in line with the INREV guidance for closed ended funds when determining the “NAV for property performance measures”. The assessment of the intended purpose of the interest rate hedges should be re-considered at each Fund NAV date to substantiate the derecognition adjustment to the Fund NAV. In the case of the “fixed to variable” interest rate swap agreements, the approach should be consistent with the measurement of the fixed rate debt (refer to Section 3.4).
- 3.10.4 Under both IFRS and LuxGAAP, if currency swaps meet the applicable criteria for hedge accounting, and are being used to hedge specific balance sheet positions, they are treated as fair value hedges. Thus, by recording them at fair value through the profit and loss account, they offset movements in the carrying

value of the corresponding asset or liability as a result of currency translation.

3.11 How do Luxembourg REIFs treat deferred tax liabilities?

- 3.11.1 Under Luxembourg GAAP the Fund has the general requirement to account for tax liabilities including deferred taxation arising on revaluations of investment property on a fair value basis if they are likely to crystallize in the foreseeable future or resulting from a planned transaction, under the general provisions requiring the application of fair value principles in determining the LuxGAAP NAV of Luxembourg funds.
- 3.11.3 As well as providing for specific tax liabilities, there will be some deferred taxation impact (e.g. latent capital gains tax liabilities included in negotiated disposal prices of shares of SPVs holding investment properties or upon disposal of property assets directly), and this should be taken into their Fund NAV calculation if it is likely to crystallize in the foreseeable future.
- 3.11.4 In such cases, the notes to the financial statements should disclose more details with respect to the deferred tax accounting, e.g. to disclose the deferred tax amounts that were not recorded. A re-assessment of the intended method of disposal or impact of structuring should be made at each NAV date. This re-assessment should also take into account current market circumstances affecting disposal strategies.
- 3.11.5 Under IFRS, in general, deferred taxes need to be provided for in full irrespective of the method of disposal. The calculation of the amount of deferred tax is impacted by judgments on the effective tax rates to apply, and whether the asset was acquired through a business combination or an asset purchase.
- 3.11.6 For many Luxembourg REIFs which prepare IFRS financial statements, adjustments are made to the NAV to adjust the amount of the deferred tax included. This is done to reflect the likely outcome of tax structuring and real estate market conditions, thereby producing a better estimate of fair value. Such adjustments fall within the scope of Section 4.1 in this paper.
- 3.11.7 INREV guidance states that in calculating the fair value of deferred tax liability, management of the Fund should develop a written procedure to document the calculation methodology and review the policy on an ongoing basis (for example, with respect to changes in tax law and market conditions) in order to ensure its appropriateness. Further, INREV guidance states that the calculation of the fair value of the deferred tax liability should be assessed on an asset-by-asset basis and consideration should be given as to the most likely form of disposal (e.g. asset deal or share deal) based on the intended disposal method, tax structuring of the asset as well as market conditions relevant to that property as at the date of the calculation. The fair value of the deferred tax liability is then calculated corresponding to the assessed manner of settlement as well as the applicable rates at which the transaction will be taxed. The calculation should also take into account any discounts to the sale price of a property sold via a share deal that are likely to be given. For example, it may be that the sale of the shares of the property owning entity is exempt from tax (or attracts minimal tax) but a deduction in respect of the latent capital gain within the property owning entity is made in arriving at the sales price. This amount in addition to any tax likely to crystallize on the disposal transaction should be taken into account when calculating the fair value of deferred tax liabilities. LuxGAAP is consistent with INREV with regards to the calculation of the deferred tax liabilities.
- 3.11.8 On an ongoing basis, Fund management should make comparisons with current market practice and information to ensure that their deferred tax estimates remain realistic.

3.12 How do funds treat goodwill arising on acquisition of property owning vehicles?

- 3.12.1 It is common practice in the real estate industry to acquire properties in share deals (i.e. purchasing a SPV owning a property), rather than through a direct asset purchase.
- 3.12.2 Under IFRS, if a vehicle owning the properties does not represent "an integrated set of activities and assets", it does not qualify as a business (as per the definition of IFRS 3). Assets and liabilities of the acquired vehicle are recognized based upon their relative fair values, and no goodwill is recognized. However, when an acquisition qualifies as a business combination, goodwill may arise, being the excess cost of the acquisition over the Fund's interest in the fair value of the identifiable assets, liabilities and contingent liabilities.
- 3.12.3 The goodwill acquired in a business combination is reviewed for impairment at least annually. For the purposes of impairment testing, goodwill is allocated to cash generating units that are expected to benefit from the synergies of the combination and the impairment is determined by assessing the recoverable amount of the cash generating unit to which the goodwill relates. Since the fair value of all future cash flows from a property has been taken into account in the valuation of the property itself, there are no future cash flows that could be allocated to the value of the goodwill. It is common, therefore, that the entire amount of goodwill is impaired.
- 3.12.4 LuxGAAP has no rigorous concept of business combinations and is not prescriptive as to what constitutes a business. It is more common therefore to treat share deals as an acquisition of a group of assets and liabilities, where no goodwill arises.

3.13 What levels of leverage / gearing are allowed in Luxembourg REIFs?

- 3.13.1 Under CSSF Circular 91/75, gearing ratios are limited to 50% unless derogation is obtained from the CSSF. The basic ratio is generally defined as the ratio of external debt to gross asset value ("GAV"), calculated on a spot basis on each NAV date.
- 3.13.2 SIFs and SICARs do not have any gearing limits imposed by CSSF guidelines or applicable Luxembourg law, and thus are only limited by any restrictions defined in the Fund Documentation.
- 3.13.3 There is no detailed definition of how or when to calculate the leverage ratio in CSSF guidelines. However, it is normal practice to calculate the ratio on a spot basis each time an official Fund NAV is reported. The basis of the calculation should be detailed in the Fund Documentation.
- 3.13.4 It is the responsibility of the Fund's Management to calculate and monitor the ratio. Custodians, central administrators and auditors, in the normal course of their work, verify that this control is effective and that the calculation has been correctly made in line with the Fund Documentation.
- 3.13.5 External debt comprises the overall borrowings of the fund, excluding working capital credit balances such as creditors and accruals. This would normally mean that overdrafts which are used to finance the ongoing operations of the fund would be included, along with mortgage debt, subscription lines, revolving credit facilities etc., but does not include shareholder loans, other shareholder debt instruments or inter-company debt inside the REIFs holding structure.
- 3.13.6 Monitoring of compliance with the obligations of these various borrowing facilities is primarily the responsibility of the Fund's Management. Custodians may also consider the effectiveness of this control in so far as it is an encumbrance on the assets of the fund which they have a responsibility to supervise on behalf of investors. Auditors also consider this element in their review for potential contingencies, and in their audit of the presentation of borrowings in the balance sheet.

4 NET ASSET VALUE CALCULATION

4.1 Does the net equity or net assets attributable to unit holders/shareholders in the financial statements always correspond to the Fund NAV and unit/share pricing?

- 4.1.1 Not always, as there may be reconciling items between the GAAP applied in the financial statements, and the definition of the Fund NAV calculation per the Fund Documentation.
- 4.1.2 As discussed throughout this document, depending on the Fund GAAP the following adjustments (reconciling items) could be made to the fund GAAP NAV, e.g. based on INREV guidelines:
- fair value adjustment to properties under development or held for trading purposes (refer to Sections 3.2 and 3.3);
 - deferred tax adjustment to take into account the manner of disposal of the properties and tax structuring (refer to Section 3.11);
 - transfer tax and purchasers costs adjustments to the investment properties (refer to Section 3.6);
 - adjustment to bring the carrying value of fixed rate debt to its fair value (refer to Section 3.4);
 - adjustment to derivative financial instruments (refer to Section 3.10.3);
 - adjustment for formation costs (refer to Section 3.7)
 - tax effects and minority interest effect of the adjustment above;
 - other adjustments which would present fairer the Fund NAV in accordance with the Fund reporting objectives and investors requirements.
- 4.1.3 In addition, the NAV based price offered to new investors may include adjustments for property acquisition costs to reflect a fairer spreading of such costs between investors over certain period of time (refer to Section 3.6).
- 4.1.4 There may also be reconciling items due to information becoming available between the date of calculation of the NAV and the date of approval of the financial statements by the Fund.
- 4.1.5 Reconciling adjustments made between the financial statement GAAP and the NAV and/or Unit/Share Pricing calculation may contain some adjustments in order to bring the NAV closer to fair value in a real estate market context, or to rebalance the value of equity interests to reflect a fairer treatment over time of expense write offs or similar elements.

5 FINANCIAL STATEMENTS AND DISCLOSURES

5.1 What does a typical set of financial statements include?

5.1.1 Under LuxGAAP, the financial statements comprise:

- Balance sheet or statement of net assets
- Income statement (statement of operations)
- Statement of changes in net assets
- Statement of changes in the number of units/ shares
- Reconciliation of Investors Equity (IFRS/LuxGAAP NAV) to the Fund NAV
- NAV per unit/ shares statistics for the last 3 years
- Statement of investment in property (can also be included as a note to the financial statements)
- Notes to the financial statements
- Managers' report
- Audit opinion
- Various income statement layouts have been put forward within the industry. Commonly, the recommended layout per EPRA or INREV guidelines is often used to separate the results of rental and property management activities, fund management costs, finance income and expense, unrealized and realized gains from changes in the fair value of real estate or property disposals and taxation

5.1.2 Additional information provided under IFRS includes:

- Cash flow statement
- Statement of changes in equity attributable to unit holders/shareholders (similar to and often an adapted form of the statement of changes in net assets)
- Additional notes and disclosures required under IFRS

5.1.3 Additional optional and supplementary information may include:

- Reconciliations to other GAAPs (e.g. US GAAP)
- Additional information on the real estate portfolio
- The opinion(s) of the property valuer(s)
- EPRA, INREV or other trade association recommended disclosures (e.g. additional information on taxes)

5.2 Is there a requirement to disclose property portfolio information?

5.2.1 Funds prepare either a "statement of investments in property" or a note to the financial statements which gives a description of properties held and shows the movement in fair value. The granularity of the disclosure will depend on the number of assets and nature of the portfolio, the investors' needs, and concerns about confidentiality. For a typical fund with a limited number of properties, this is generally disclosed by individual property, but may be summarized by property sector or geography. In general, the level of disclosure should be sufficient for a reader to understand the nature and location of properties, and movements in their fair value as recorded in the financial statements. Often, investment diversification percentages are also added to this disclosure.

- 5.2.2 There is also a general requirement to disclose the names and location of significant subsidiaries, joint ventures and associated companies in consolidated accounts.
- 5.2.3 In addition, under IFRS, there is a requirement to consider the disclosure of segmental information if the fund is listed.
- 5.2.4 There may also be other situations where additional disclosures are required, e.g. under the Prospectus Directive.
- 5.2.5 Under LuxGAAP, all subsidiaries, joint ventures and associated companies included in the consolidated financial statements are subject to disclosure requirements.

5.3 What are the typical contents of the related party disclosure note?

- 5.3.1 Transactions with related parties need to be disclosed in the notes to the financial statements to enable readers to understand the nature of these transactions and to determine if they have been conducted on normal market terms or in line with the provisions of the Fund Documents. Related parties of a real estate fund are typically the promoter, asset managers, joint venture partners, key service providers such as custodians, officers and management etc.
- 5.3.2 Typical related party transactions are:
- Performance fees (if any)
 - Management fee / Asset management fees
 - Administrative fees (if self-administered) Distributors fees
 - Acquisitions from related parties
 - Loans to or from the asset management company or promoter
 - Co-investment of the promoter in the fund

5.4 What are the requirements for risk disclosures?

- 5.4.1 Risk disclosures are common both in the prospectuses of funds and are a requirement under IFRS in the financial statements.
- 5.4.2 Common financial risk disclosures for a real estate fund include:
- Diversification risks
 - Financial leverage risk
 - Credit risk
 - Liquidity risks
 - Currency risks
- 5.4.3 Pursuant to adoption of IFRS 7 and amended IAS 1, in addition to the above, Funds preparing IFRS financial statements are required to provide quantitative analysis of liquidity, credit and market risks (including sensitivity analysis) as well as capital management disclosures.
- 5.4.4 In addition, it is common practice and a requirement of IFRS and LuxGAAP to disclose the nature of key estimates made in establishing the NAV of a fund. These estimates of risks include:
- Property valuations
 - Fair value of financial instruments
 - Bad debt provisions
 - Accounting for acquisitions
 - Estimation of current and deferred tax provisions

6 SPECIFIC VEHICLES

6.1 What specific issues arise with the use of the SICAR and the SIF for real estate investment?

6.1.1 Under the SICAR and SIF legal frameworks, there is an exemption from the obligation to prepare consolidated accounts. This provision is generally targeted towards Private Equity and Hedge funds using the SICAR or SIF regulatory frameworks, rather than REIFs.

6.1.2 According to the SIF law: Art 52. (5)

“Notwithstanding article 309 of the Law of 10 August 1915 on commercial companies, as amended, the Specialized Investment Funds referred to in this law as well as their subsidiaries shall be exempt from the obligation to consolidate the companies held for investment purposes”.

According to the SICAR law: Art. 24 (3)

Notwithstanding article 309 of the Law of 10 August 1915 on commercial companies, as amended, the SICAR shall be exempt from the obligation to prepare consolidated accounts.

6.1.3 However, accounts prepared in accordance with IFRS would need to be consolidated in accordance with IAS 27.

6.1.4 Practically, in order to show a true and fair view, most funds will opt to prepare consolidated accounts, as in most circumstances, non-consolidated accounts would not represent adequately the funds' activities to the investors (e.g. profits from rental activities, borrowing money at a subsidiary level). This would be especially true for funds which have a core or core plus strategy where income yields, funds from operations etc., are critical performance measures for investors. In addition, most lending banks usually require consolidated accounts, and if a public listing is contemplated, it is very likely that consolidated accounts will be necessary.

The ALFI Real Estate Investments Funds Sub-Committee recommends REIFs to prepare consolidated accounts, which is followed in virtually all cases.

6.1.5 If the exemption not to consolidate is applied, then the SICAR/SIF must make the best estimate of the fair value of the investments it holds. The non-consolidated accounts would still need to contain sufficient information to present a true and fair view of the activities of the fund.

There is flexibility to derive the fair value of the SICAR/SIF investments on an overall basis by preparing consolidated accounts using fair value principles for the real estate assets at the level of the holding entity into which the SICAR/SIF directly invests, or by preparing such information for each “line” of investment in the structure and the holding structure.

6.1.6 If the SICAR/SIF elects not to prepare consolidated accounts, then statutory consolidated accounts may need to be prepared and audited under the applicable corporate law for some holding entities in the overall fund structure (generally determined depending on the type of entity and certain size criteria such as turnover, net equity and staff).

6.1.7 There is no requirement to make the Fund NAV public under Luxembourg law.

6.2 What specific valuation issues arise with the use of the SICAR or SIF?

- 6.2.1 Independent valuation and its frequency is not specified in the SICAR or SIF laws, but common and best practice is that in order to achieve a best estimate of fair value, an internal or external valuation of the properties should be prepared in accordance with a recognized property valuation standard, at least once a year to support the annual financial statements. For open-ended funds, common practice is to increase the frequency of external valuations to match the frequency of the dealing days, e.g. monthly or quarterly.
- 6.2.2 In most cases, Funds will appoint independent valuers.

Fund of Real Estate Funds (FOREF) questions (January 2010)

Due to current market conditions, a number of key issues and questions have been raised as regard to Funds of Real Estate Funds (“FOREF”) and particularly in the context of the calculation of Fund NAVs and the related production of financial statements. These are related to increased uncertainty with respect to the valuation of real estate and also the impact of current market conditions on other elements of the financial position of “investee” funds (also known as “target” or “underlying” funds) such as the “going concern” assumption and ongoing liquidity. This is crucial both in regard to Fund NAVs of *investee* funds which are reported for informational and statutory purposes, and for Fund NAVs that are used to price issues and redemptions, thus affecting the relative value of investors’ holdings in the *investee* fund.

7 HOW SHOULD THE VALUATION PROCESS BE ORGANIZED WHEN CALCULATING THE FUND NAV OF A FOREF?

In general, a FOREF invests in illiquid and/or hard-to-price assets, where valuation information is infrequent and it may be necessary for judgments to be made in arriving at a fair valuation of individual assets. The FOREF’s Governing Body³ should ensure that a robust valuation process is designed and clearly documented, with appropriate controls embedded to avoid or resolve conflicts of interest. IOSCO’s⁴ Technical Committee published a final report in November 2007 on “*Principles for the Valuation of Hedge Fund Portfolios*”⁵. ALFI REIF Sub-Committee believes that these principles are relevant for the valuation of FOREF portfolios.

7.1 IOSCO’s Nine Principles of Valuation

- 7.1.1 Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a [...] fund.
- 7.1.2 The policies should identify the methodologies that will be used for valuing each type of financial instrument held or employed by the [...] fund.
- 7.1.3 The financial instruments held or employed by [...] funds should be consistently valued according to the policies and procedures.
- 7.1.4 The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness.
- 7.1.5 The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed. Independence may be achieved by, *inter alia*:
- a) Third-party pricing services.

³ The Governing Body may be a FCP Management Company, the Board of the SICAV or the General Partner, depending on the legal form used.

⁴ IOSCO is the International Organization of Securities Commissions.

⁵ The report can be found under the following link: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf>.

- b) Independent Reporting Lines within the Manager.
 - c) Valuation Committee.
- 7.1.6 The policies and procedures should seek to ensure that an appropriate level of independent review is undertaken of each individual valuation and in particular of any valuation that is influenced by the Manager.
- 7.1.7 The policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party.
- 7.1.8 The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.
- 7.1.9 The arrangements in place for the valuation of the [...] fund's investment portfolio should be transparent to investors.

8 WHAT INFORMATION IS REQUIRED WHEN CALCULATING THE FUND NAV OF A FOREF?

What information in respect of investments in real estate funds should fund managers / accounting teams / administrators collect and consider when calculating the Fund NAV of a FOREF?

This information will typically include a mixture of direct source information and additional supporting information. The information should be addressed to the fund manager, the FOREF's governing body and/or the pricing committee. Examples of both types of information are listed below. These lists are neither all necessary nor exhaustive:

8.1 Direct source information

- 8.1.1 NAVs / financial statements of the *investee* fund (*in order of preference*)
- Audited, as at the date of the FOREF valuation;
 - Audited, close to the date of the FOREF valuation (either before or after) for non-coterminous period-ends;
 - Unaudited, as at (or close to) the date of the FOREF valuation;
 - Provisional, as at (or close to) the date of the FOREF valuation;
- 8.1.2 Details of all capital calls made to/distributions received from the *investee* funds since the last valuation of the *investee* funds;
- 8.1.3 Detail of significant subsequent events since the last date of the NAV calculation of *investee* funds, due to the potential mismatch of the NAV frequencies between the *investee* funds and the FOREF.

8.2 Additional supporting information

- 8.2.1 Additional financial and operational information received by the FOREF under the terms of side letter arrangements with the *investee* funds.
- 8.2.2 Information in respect to the control environment of the *investee* funds – this could include an understanding of the governance framework of the *investee* fund as well as specific reports on controls matters such as long form reports (where applicable). This will also include judgments around the quality of the promoter as well as service providers such as the administrator, valuers and auditors.
- 8.2.3 Analyses of historical accuracy of provisional NAVs released by *investee* funds by comparison to those contained in audited accounts.

- 8.2.4 Independent valuers' reports for the real estate portfolio of the *investee* fund.
- 8.2.5 Analyst or valuers reports regarding market conditions and valuations of the geographical and sector markets in which the *investee* funds have invested.
- 8.2.6 Meeting minutes or call logs between the FOREF and the *investee* fund.
- 8.2.7 Minutes of any meetings of supervisory bodies of the *investee* fund in which the FOREF is represented – e.g. investor advisory committees.
- 8.2.8 Confirmations from management/administrators of the *investee* funds in respect of their valuations/NAV.
- 8.2.9 Confirmations from custodians regarding the existence of investments in *investee* funds.

8.3 Use of information received from investee funds

- 8.3.1 It is important that this data is not just collected - the valuations that are assigned to each investment within the FOREF's portfolio should fully take into account all of this information. In other words, those deciding on the valuation of individual assets that will be included in the calculation of Fund NAV and financial statements of the FOREF, whether the FOREF's governing body, a pricing committee or a third-party administrator, need to have access to this monitoring information.
- 8.3.2 Consideration also needs to be given to the process of how this information is utilized in arriving at valuations and how this is controlled – for example the existence of, and input from, a valuation committee or the fund manager. This means that there must be adequate processes and controls at the FOREF level to monitor, utilize, and challenge the information received to enable this information to be used when determining the FOREF NAV.
- 8.3.3 Of particular concern are changes in or conflicts between GAAP, where an investee fund reports under a different GAAP to the one adopted by the FOREF. The FOREF's governing body should decide how such issues should be resolved when they establish the FOREFs valuation policy.

8.4 What is the recommended method for calculating the Fund NAV of a Fund of Real Estate Funds?

- 8.4.1 As a general principle, Fund of Fund NAVs must take account of the latest available published information at the NAV cut-off point. This includes the latest available NAV per unit/share for the investee funds, any transactions with the investee fund e.g. capital calls, distributions etc. up to the NAV cut-off date, and any other information relevant to the investment valuation known to the Fund including any estimates provided by or discussions with the investee fund manager. Refer to 8.1 and 8.2 for the more detailed information that might be useful for fund of real estate fund NAV calculations.
- 8.4.2 There may be a difference between the NAV published at the relevant NAV cut-off date and the valuations in the financial statements published subsequent to this date, as a result of further information being received. This difference is a reconciling item between the Investors Equity in the financial statements and the NAV, and should be presented as such in the NAV statement. Normally these differences are only accounted for on a prospective basis in the NAV computation and this should be specified in the Fund Documentation.
- 8.4.3 Consideration of the timing of receipt of investee fund NAV's and release of Fund of Fund's NAV is very important in achieving a fair but practical valuation process. Not all information received as at the NAV publication date will necessarily be audited. However audited information, when eventually received, should be reconciled with unaudited information and the results of this process taken into account in accordance with the principles described above.
- 8.4.4 Appropriate approval of fair values for Fund NAV and financial statement purposes is an important control in the valuation process of a Fund of Funds. Normally all the relevant information to establish the fair value

of investments will be summarized, reviewed and approved by the Fund on the date of release of the Fund NAV and the date of release of the financial statements. The Fund may also develop and document specific guidelines and principles relevant to this preparation and approval process, such as concerning the quality and timeliness of information received prior to the approval of fair value by drafting and applying a consistent Pricing Policy, duly approved by the Fund management.

8.4.5 For any listed securities holdings, the last available bid price should be used.

9 HOW DOES INCREASED VALUATION UNCERTAINTY AFFECT FUND NAV PRODUCTION?

9.1 With respect to investee property portfolios

9.1.1 Some valuations of real estate are uncertain and may be subjective due to a lack of comparable transactions for appraisers to consider. Valuers, for example, may draw attention to the increased uncertainty in their reports or even caveat the valuation amount calculated. The reliability of *investee* property valuations may impact the reliability of the NAVs reported by these *investee* funds on which FOREFs base the valuation of their investments.

9.2 With respect to financial position of investee funds

9.2.1 As well as the additional increased inherent uncertainties in respect of property valuations, current market conditions may have had further impacts on the financial position, and hence the valuation, of *investee* funds. These include “*going concern*” and liquidity issues due to:

- Breaches of loan covenants;
- The need to re-finance expiring facilities;
- Default of investors in terms of capital calls;
- Unavailability of capital from new investors;
- Default of lenders in respect of undrawn credit facilities;
- Increased difficulties in the rental markets in terms of achieving target rents and occupancy; and
- Increased requests for redemptions by investors.

9.2.2 FOREFs themselves, as well as *investee* investments, may be affected by the above factors. These, for example, may lead to uncertainties with respect to the *going concern* assumption that will need to be addressed in the FOREFs reporting.

9.3 With respect to delayed information from investee funds

9.3.1 The inherent valuation uncertainty is further exacerbated by the fact that there is a time lag between the reporting date of the FOREF and the receipt of information relevant to that date from *investee* funds. If valuations of *investee* investments are not based on up to date information there is a risk that these will be unreliable and potentially materially misstated given volatility of pricing due to current market conditions.

10 WHAT OPTIONS DO FOREFS HAVE IN RESPECT OF THE ISSUES IDENTIFIED ABOVE?

The above factors negatively impact the ability to calculate an accurate Fund NAV of a FOREF. Broadly speaking, management of such FOREFs has three main options in respect of dealing with these with regard to the calculation of Fund NAVs and fund financial reporting:

10.1 Delay reporting of NAVs/financial statements to collect more up-to-date information

- 10.1.1 Management should strongly consider delaying reporting in order to collect as much possible up-to-date and accurate information from *investee* funds on which to base the valuations. This may include, for example, delaying reporting until audited financial statements of the *investee* funds have been received so that more comfort exists with regard to valuations and going concern/liquidity issues facing the *investee* funds and, therefore, management of such funds have more support to base their conclusions for the Fund NAV. Further examples of additional information that could be received are listed in 8.1 above.
- 10.1.2 In such cases, management should be aware of their deadlines to deliver reporting, both on a contractual and regulatory basis. For example, SIFs in Luxembourg are normally required by law to deliver their audited financial statements within six months of their year end, so any delay beyond this date may require an approval from the investors and the CSSF.

10.2 Suspend issuance of the FOF NAV

- 10.2.1 Management may choose to suspend issuance of the FOREF NAV until such time that management believes that the Fund NAV can be produced with an appropriate level of accuracy.
- 10.2.2 If management judges that, due to current market conditions, it is not possible to calculate a reliable Fund NAV then consideration may need to be given to suspending the FOREFs NAV. This is particularly important with regard to open-ended funds where Fund NAVs not only are used for information purposes but are also used to price issues and redemptions and thus effect the distribution of value in the FOREF between investors.
- 10.2.3 In these circumstances the following options could be considered to the extent that they are commercially viable and in accordance with the FOREFs governing documentation and regulatory requirements:
- 10.2.4 Deferring issues and redemptions until a Fund NAV (pricing NAV if different) can be reliably calculated. It may well be, however, that this is not commercially viable – the fund may need, for instance, to contribute committed capital to investee funds to protect value and avoid defaulting; investors' capital may need to be drawn to do this.
- 10.2.5 Arranging short term funding in order to finance operations, to avoid the need to price new issues of units / shares.
- 10.2.6 Issuing/redeeming units but delaying pricing these transactions until a more reliable Fund NAV is available. This is a possible solution, subject to the regulatory framework of the fund, where management wants to draw capital from investors and also provide them with liquidity.

10.3 Continue to produce Fund NAVs/financial statements within normal timeframes

- 10.3.1 If management does not wish to delay the issue of Fund NAVs/financial statements then consideration will have to be given to the adequacy of the information received as regards to producing accurate reporting.
- 10.3.2 Where this is not sufficient, given current market conditions, management should seek additional information so as to base own-valuations of *investee* funds on as much data as is available. This could take the form of increased monitoring calls with management of *investee* funds and further detailed analysis of trends in the geographical markets and sectors in which the *investee* funds invest.
- 10.3.3 It is the primary responsibility of management to ensure that sufficient, reliable data is available and has been used in calculating the Fund NAV.
- 10.3.4 Given the current market volatility compounded by time lags in receiving information in a *FOREF* environment, and especially if the NAV is used for pricing issues and redemptions, and thus affects the distribution of value in the fund between investors, careful consideration needs to be given as to whether this approach is appropriate. The Valuation Policy of the *FOREF* should specify whether any adjustments may be made and under what circumstances.
- 10.3.5 In any of the above scenarios, management should also provide additional disclosures in their financial statements with respect to valuations and, if necessary, the *going concern* status of the *FOREF*. Examples of the information to be disclosed regarding the valuation of *investee* funds may include:
- a discussion of the uncertainties in the valuations based on the review of audited financial statements,
 - any caveats made by the valuers of the *investee* funds in their reports
 - sensitivity analysis of valuations and
 - a discussion of the uncertainty in respect of the property types and geographical markets that the *investee* fund is exposed to.

11 HOW MAY THIS IMPACT THE AUDIT OF FOF FINANCIAL STATEMENTS?

In general, auditors will have to perform more work with respect to the uncertain elements of the *FOREF* reporting as described above, such as the valuation of underlying investments into *investee* funds and the *going concern* assumption. Auditors will have to review and assess the appropriateness of the assumptions made by management and the reliability of the supporting documentation gathered to support their conclusions.

11.1 Additional information requests

- 11.1.1 Auditors may also require additional information to be able to assess the *going concern* assumption such as:
- Additional representations from the management of the *FOREF*;
 - Cash flow forecasts to evidence that the *FOREF* has a sufficient level of cash to sustain its activities with sensitivity analyses in connection with the market uncertainty.

11.2 Modifications to audit reports

- 11.2.1 Auditors may also consider modifications to their audit report in certain circumstances including where, in their judgment:
- Assumptions and judgments made by management in valuing the *investee* funds are inaccurate or inappropriate;
 - Insufficient evidence exists, or has been considered, to reasonably value the *investee* investments;

- Disclosures with respect to the uncertainty of the valuation of *investee* funds are inadequate;
- There is doubt as to the *going concern* status of the FOREF;
- Disclosures with respect to the *going concern* status of the FOREF are inadequate;
- Assumptions and judgments made by management in respect of the *going concern* status of the FOREF are inaccurate or inappropriate.

ANNEX: USEFUL DEFINITIONS

91/75	The IML Circular on Undertaking of Collective Investment (UCI), which specifies among others the rules of Real Estate Funds established under the 2002 law
CSSF	Commission de Surveillance du Secteur Financier (the Luxembourg Financial Authority)
EPRA	European Public Real Estate Association
EVCA	European Venture Capital Association
Fund Documentation	The constitutive documents of the Fund, e.g. the prospectus and the management regulations (FCP) or articles of incorporation (SICAF/SICAV/SICAR).
Fund	Where this capitalized term is used, it usually refers to decisions to be taken by the management body of the Fund, e.g. management company for an FCP, or board of directors for a corporate entity (SICAV/SICAF)
Gross Asset Value	The gross value of the assets of the Fund, mainly property, cash and other investment securities
IFRS	International Financial Reporting Standards
INREV	European Association of Investors in Non-listed Real Estate Vehicles
Investors Equity	This refers to the combined interests of investors in the Fund, regardless of whether they are held by means of equity (shares/units) or debt securities such as shareholder loans etc.
IVSC	International Valuation Standards Committee
LuxGAAP	A set of accounting principles in compliance with Luxembourg legal and regulatory requirements for the vehicles which fall under the law of 17 December 2010 on undertakings for collective investment, unless they have been established as a specialized investment fund (SIF) under the law of 13 February 2007, and the law of 15 June 2004 on investment companies in risk capital (SICAR)
NAV	Net asset value
Fund NAV	The NAV of the Fund, calculated in accordance with the provisions of the Fund Documentation
IFRS NAV	The NAV of the Fund, calculated in accordance with the provisions of the International Financial Reporting Standards
LuxGAAP NAV	The NAV of the Fund, calculated in accordance with the provisions of LuxGAAP
REIF	Real Estate Investment Fund (In Luxembourg, this would typically include SICAR SICAV, FCP, SIF, SICAV PART II)
RICS	Royal Institution of Chartered Surveyors
TEGOVA	The European Group of Valuation Association