association of the luxembourg fund industry

guidelines

Real Estate Investment Funds: Financial reporting

table of contents

introduction

The Real Estate Investment Funds - Best Practice Guidelines are intended to act as a guide for the industry.

Therefore these guidelines may not be suitable for every circumstance. Please note that ALFI, being the representative body of the Luxembourg investment fund community, is a non-profit organisation pursuant to Luxembourg law and does not provide legal advice. Please note that these guidelines have not been validated by any regulator and serve for information purposes of the reader only.

These guidelines must not be relied upon as legal advice and are provided without any warranty of any kind by ALFI nor its members who contributed to this framework nor does ALFI accept any liability whatsoever for any action taken in reliance there upon.

Readers of these guidelines are invited to seek the advice of their advisers for any specific queries they may have.

1. Foreword

This brochure has been prepared by the Association of the Luxembourg Fund Industry (ALFI) in order to provide the reader with general background information on the financial reporting framework for REIFs and the components of financial statements for regulated real estate vehicles domiciled in the Grand Duchy of Luxembourg.

This brochure provides information and guidance for real estate funds in respect of financial reporting. The document seeks to outline key considerations any fund manager is facing when setting up a real estate investment fund.
We explore the practical considerations that concern real estate funds with the intention of informing the reader with our observations for any strategic debate.
This brochure is not intended to be a comprehensive study. Readers should seek the advice of qualified professionals before making any decision as to the most appropriate Luxembourg real estate investment.
The following sections will outline the structure of this document.

1.1 Scope

The Best Practice Guidelines apply to all Luxembourg Real Estate Investment Funds (hereafter "REIF" or "Fund") and vehicles that fall under the following Luxembourg laws:

- Undertakings for collective investment (UCI) governed by Part II of the law of 17 December 2010, as amended;
- Specialised Investment Funds (SIFs) governed by the law of 13 February 2007, as amended; and
- Investment companies in risk capital (SICARs) governed by the law of 15 June 2004, as amended.

(Together referred to as the "Luxembourg Law")

These regulated Funds and vehicles as described above are subject to financial reporting standards, which need to be complied with when preparing financial statements, as required by the Luxembourg Law.

Please note that this document reflects the legal situation in Luxembourg, which will change from time to time. This document takes account of IFRS standards and Luxembourg GAAP principles applicable for periods beginning on or after 1 January 2014.

As an additional information, on 9 December 2015, the Luxembourg Chamber of Deputies has adopted the draft bill 6718 (published on 28 December 2015) which amends the current basis of the Luxembourg accounting framework. This is the first step of the implementation by Luxembourg of the 2013 EU Accounting Directive which aims to conform Luxembourg Law to the Directive's requirements.

A second step will consist of deciding on optionality of certain accounting provisions foreseen in the new EU accounting directive, and to recast more deeply the Luxembourg Accounting Law.

Main amendment in the context of the first step of the implementation, which also might indirectly impacting REIF include the introduction of the materiality principle applicable to presentation and disclosure in the financial statements.

Considering these changes are applicable for financial years starting on or after 1st January 2016, this is not covered in these best practice guidelines.

This Best Practice Guide covers:

1. "Direct REIFs" invest in real estate assets either directly or via intermediary entities (special purpose vehicles or SPVs).
2. "Funds of REIFs" invest in other REIFs or SICARs, although other assets may be held.
3. "Real Estate Debt Funds" invest in debt related to real estate either directly or indirectly.

1.2 What are the components of Annual Reports for REIFs?

Generally for REIFs the financial reporting frameworks most used are Luxembourg GAAP, IFRS and US GAAP. Other reporting frameworks and GAAPs are also used depending on the need of the investors, strategies and other legal considerations. This paper focuses on issues arising under Luxembourg GAAP and IFRS. Issues within each section address the different consideration under Luxembourg GAAP and IFRS. Where relevant, additional guidance is provided for (e.g. AIFMD, INREV, LPEA etc.).

Annual reports of Luxembourg REIFs prepared in accordance with the Luxembourg legal and regulatory requirements (Laws and accounting principles) as mentioned above consist of (further explained in the sections hereunder):

- Financial statements;
- Audit report;
- Additional optional and;
- Supplementary information;
- Management discussion and analysis (sometimes referred to as MD&A).

In case of REIFs qualifying as AIFs and managed by an authorized AIFM, the annual report also include additional mandatory information such as some remuneration disclosures, etc. For more details, specific guidance and Q&A have been issued by ALFI in connection with AIFMD reporting (please refer to www.alfi.lu).

1.2.1 Financial Statements

Financial statements and annual accounts are used inter alia in this paper.

Under Luxembourg GAAP (Lux GAAP) financial statements consists of:

1. The balance sheet, or the statement of net assets;
2. The profit and loss account, or the statement of operations;
3. The statement of investments and other net assets (for UCI);
4. The statement of changes in net assets (for UCI);
5. The accounting policies and explanatory notes to the financial statements.

Under IFRS financial statements consists of primary statements (1 to 4) and explanatory notes (5):

1. The statement of financial position;
2. The statement of comprehensive income and/or other comprehensive income;
3. The statement of cash flows;
4. The statement of changes in net assets/equity.
5. The accounting policies and explanatory notes to the financial statements.

Several NAVs can be included in the Annual Report:

Accounting NAV - The Net Asset Value (NAV) per the appropriate GAAP in accordance with the regular reporting framework based on Luxembourg legal and regulatory requirements, also often known as "net equity" and shown in the balance sheet/statement of financial position of the financial statements.

Fund NAV - The Net Asset Value per the REIF documents (private placement memorandum, prospectus, management regulations, limited partnership agreement or laws of incorporation as appropriate. There can be different REIF NAV defined in the REIF Documents, as for example for redemption or subscription purposes, or liquidation purposes.

Typically the REIF NAV of Luxembourg REIFs is not simply the IFRS/Luxembourg GAAP equity but is adjusted for various items (e.g. deferred taxes, set up costs as appropriate and depending on the REIF Documents) in order to arrive at the NAV of the REIF as per the REIF Documents.
Where the REIF has defined a REIF NAV, it is part of the audited financial statements. Where the disclosure of another NAV (i.e. a NAV other than the REIF NAV) is done on a voluntary basis, it is presented in the MD&A.

1.2.2 Audit Report

Under Luxembourg Laws, REIFs are audited by a *Réviseur d'Entreprises Agréé*. The audit report is prepared under International Standards on Auditing (ISA) as adopted for Luxembourg by the Luxembourg financial supervisory commission, the *Commission de Surveillance du Secteur Financier* (CSSF). The financial statements are included within the scope of the audit report. Other information within the annual report such as the MD&A, are supplementary and thereby not subject to an audit.

1.2.3 Additional optional and supplementary information

"Supplementary information" (or "other matters") to the financial statements and/or annual report can include, depending on the legal form of the REIF, some or all of the following:

- Statistical information (as required by the Law of 2010 and the SIF Law);
- Management discussion and analysis/ MD&A (see section 4. below);
- Additional supplementary information such as reconciliation to other GAAPs, information by property valuers, etc.

The supplementary information is generally driven by investors and management of the REIF.

1.2.4 Management Discussion and Analysis (MD&A)

The MD&A section should provide the reader with an integrated and intelligent compilation of historical and prospective information summarising the REIF's performance and future prospects currently under assessment by management of the fund.

This element of the annual report should contain a greater scope of information about the REIF, much of which may be non-financial, and commonly includes some or all of the following (non-exhaustive list):

- Statement of the manager of the fund;
- Statement of the portfolio manager or investment advisor;
- Fund statistics;
- Market update;
- Regulatory update;
- Fund fact sheet;
- Corporate governance report;
- Statement of compliance with INREV or other industry guidelines.

Market practice currently favors the incorporation of "disclosure recommendations from industry bodies" such as INREV in this section of the annual report. This allows management to provide more holistic and comprehensive information about the REIFs without obscuring the financial statements (as discussed above), which have been prepared in accordance with a relevant financial reporting framework.

1.2.4.1 Market Practice and disclosure recommendations from industry bodies

As referred to above under section 1.2.4 MD&A, industry bodies such as INREV have issued guidelines that can be voluntarily adopted by REIFs.

INREV Guidelines

Some Luxembourg REIFs have adopted the INREV guidelines to report to investors in their annual reporting.

Generally, the disclosure requirements set out in the INREV guidelines are included in the MD&A section. For this reason when making an assessment of compliance with INREV guidelines, the annual report should be considered comprehensively. The structure of this statement of compliance with the INREV guidelines can either take the form of a narrative or a table/ diagramme outlining to what extent the fund has complied with the various modules of the INREV guidelines. Clear disclosure on this matter and any potential deviation is critical.

For the benefit of the reader, the various modules of the INREV Guidelines, which can be found on the INREV website (www.inrev.org), are:

- Module 1 - Corporate governance;
- Module 2 - Reporting;
- Module 3 - Property valuation;
- Module 4 - INREV performance measurement
- Module 5 - INREV NAV;
- Module 6 - Fee and expense matrix;
- Module 7 - Liquidity
- Module 8 - INREV Data delivery.

1.3 NAV – Net Asset Value

This best practice guide refers to various net asset values throughout the document. Generally the net asset value of a REIF is represented by the amount of assets minus all liabilities of the REIF.

The NAV calculated in accordance with a GAAP is generally referred to as the "Accounting NAV". Here the assets, liabilities, income, expenses, equity, if applicable, are determined in accordance with the applicable GAAP.

The fund documents of a REIF (such as the fund's issuing document, offering memorandum, prospectus, management regulations, limited partnership agreement or articles of incorporation as appropriate – hereafter the "Fund Documents") may sometimes define or refer to other NAVs, known as the "Fund NAVs".
These Fund NAVs may in practice be used for subscription, redemption purposes, etc., as set out in the Fund Documents.

In addition to the above NAVs, the INREV Guidelines, as referred to above, define an INREV NAV, which seeks to provide a more accurate economic value of the REIF. This INREV NAV is based on the Accounting NAV adjusted for by a number of different items.
A REIF may elect to disclose or use the INREV NAV as the Fund NAV.

Disclosure on a voluntary basis of another NAV (other than the Fund NAV), it is usually presented in the MD&A.

direct real estate investment funds

1. Valuation

Direct REIFs invest directly or indirectly (via SPVs) in real estate assets, generally known as "investment property". Real estate assets are accounted for and valued in different ways depending on the legal requirements and the applicable GAAPs.

Most of the REIFs operating in Luxembourg are subject to the Alternative Investment Fund Manager Directive ("AIFMD")[1] . Even for a REIF not falling under the requirements that are laid down in the AIFMD, the use of the best practices on valuation matters remains relevant. The AIFMD was transposed into Luxembourg Law on 12 July 2013 (the "AIFM Law"). On 17 December 2013 the European Commission adopted a so-called "delegated regulation" supplementing the AIFMD with regard to regulatory technical standards determining types of alternative investment fund managers (hereinafter referred to "Level 2" or "Level 2 Measures").

The AIFMD is more prescriptive on the valuation process to be implemented by a manager than was previously required. The AIFM, who has been appropriately appointed by the board of the REIF (AIF), shall ensure that a so called "valuation function" is performed, as set out in article 17 paragraph 4 of the AIFM Law (Article 19 of the AIFMD). The valuation function can take the form of a valuation committee. This valuation function oversees the implementation of the valuation policies, approving valuation methodologies and overseeing the valuation process conducted internally or by independent appraisers.

The board of the AIFM is responsible for establishing a standard approach to the valuation process for the assets of the fund in accordance with accepted valuation frameworks (IVS, RICS, etc.), GAAPs and relevant constitutive documents of the REIF. These valuation policies should be in line with the AIFM Law and with the rules set-out in the valuation policies of the AIFM and taking into consideration, where appropriate, the risk management function.

The AIFM may use independent appraisers to determine the valuation of real estate and other underlying investments. These valuations are reviewed and validated by the management of the fund. The ultimate responsability for the valuaton of the underlying assets remains with the AIFM.

1.1 What is investment property?

Investment property is a term used to describe real estate investments made for capital gain, through a future resale of a property, or, earning investment income in the form of rental income, or both. An investment property can be a long-term commitment, or a short term transaction, and can also refer to real estate construction, refurbishment, or development projects. It is generally immovable property under construction, or interest in property held directly, indirectly or through a lease. Furthermore, investment property can also refer to different asset classes such as residential, retail, commercial, office, industrial, etc.

1.2 How is investment property valued?

Luxembourg GAAP

Investment property is initially recorded at its acquisition cost, being the purchase price of the investment property. The related transaction costs should also include other costs directly related to the acquisition, for example legal and professional fees. Internal costs are generally not included (e.g. staff costs). For investment property under construction, its initial cost would be its costs of construction which may also include eligible borrowing costs and other directly attributable expenditure.

In respect of SICARs, subsequent to its initial recognition, investment property is valued at fair value. For Part II funds and SIFs, investment property is generally also valued at fair value unless a different valuation method is provided for in the prospectus of the fund. Other valuation methods provided for in the prospectus may include valuing investment property at cost less depreciation and impairment.

[1] DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

IFRS

Investment property is initially measured at its cost, being the purchase price and any directly attributable expenditure. For investment property under construction, its initial cost would be its costs of construction and other directly attributable expenditure.

The initial cost of property interest held under a lease and classified as an investment property is the lower of the fair value of the property and the present value of its minimum lease payments. Any premium paid for a lease is treated as part of the minimum lease payments and included in the cost.

It is subsequently valued using the fair value model or the cost model. For property interest held by a lessee under an operating lease classified and meeting the definition of an investment property, the fair value model is applied.

AIFMD

Article 17 of the AIFM Law (Article 19 of the AIFMD) on valuation outlines the duties on the valuation function and defines that the appointed AIFM will assume the responsibility for the valuation of the underlying assets of an AIF. More specifically, the AIFM must establish and maintain valuation policies and procedures and implement control mechanisms to ensure that the designated valuation methodologies are applied consistently. These methodologies shall be applied to all assets within an AIF taking into account the investment strategy, the type of asset, and the existence of external valuers, if applicable.

1.3 What is 'market value' or 'fair value' for investment property?

Luxembourg GAAP

In the context of real estate, 'market value' generally refers to the valuer's opinion on the best price by selling the investment property in an orderly transaction between market participants at the measurement date.

'Fair value' is the exit price taken from the market value described above. The price in the principal (or most advantageous) market used to measure the fair value of the investment property shall not be adjusted for transaction costs.

Fair value is estimated based on:

- Estimations on the cost of comparable transactions in a similar location and condition, often using a unitised method (e.g. value per square meter), or of a dissimilar property adjusted to reflect the differences;
- Discounted cash flow of future income and expenses;
- Multiples of annual rental income (rental yields);
- Any other method recognised by applicable valuation standards, e.g. depreciated replacement cost, profits method, fair value at completion less costs to complete, (applicable to properties under development).

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.

IFRS

Under IFRS fair value is the price that would be received to sell the investment property in an orderly transaction between market participants. It generally does not take into account the method of disposal, it assumes that the property is sold as an asset deal from the entity that owns it. Essentially, it is the amount that is expected to be received from the sale of the investment property estimated at the date of the financial statements under current market conditions regardless of whether the price is directly observable or estimated using another valuation technique. Characteristics taken into account when pricing the investment property at fair value include the condition and location of the asset and restrictions, if any, on the sale or use of the investment property.
Fair value also takes into account the ability to generate economic benefits by using the investment property in its highest and best use or by selling it to a buyer who will use it in its highest and best use. It of course has to be physically possible, legally permissible and financially viable.

1.4 Who can be appointed as a valuer of a Luxembourg REIF?

Assuming that an external valuer (or appraiser) is appointed, the REIF should appoint one or more independent real estate valuation professionals/ organisations who are appropriately qualified or licensed to operate in the jurisdictions where the relevant properties are located.

Independent valuers adequately qualified and experienced in the markets they operate in should have sufficient experience and knowledge of the properties being valued. Details of the arrangements with independent valuers relevant to the investors should be disclosed in the fund documentation and are subject to scrutiny by the CSSF. The independent valuers are sometimes named in the financial statements.

Should the REIF not appoint any independent valuers, management of the REIF is responsible for valuing the investment property of the REIF.

As a best practice, the valuer should be independent of the fund, the investors, the promoter and the management of the fund depending on the nature of REIF, its management company, its general partner or its trustee. When other services or transactions are also provided by the independent valuer, these should be disclosed. It is also strongly recommended to establish the fees of external valuers on a basis, which is independent to the outcome of the valuation (i.e. not linked to the value of the properties). The valuers should prepare their valuations in accordance with a recognised property valuation standard (e.g. ISVC/ RICS-red book/ TEGOVA, etc.).

AIFMD

As set out above the AIFM shall ensure that a valuation function is performed, which may take the form of a valuation committee.
As the case may be the AIFM may delegate the valuation function to an external valuer. In such cases the AIFM must ensure that the delegation provisions set out in the AIFMD (see Article 20 of the AIFMD and Article 18 of the AIFM Law) are adhered to and must be able to demonstrate that the external valuer has the right level of expertise and resources to perform the valuation.

External providers must also be able to provide, upon request, professional guarantees to demonstrate their ability to perform the valuation function, as it is defined further in Article 73 of the Level 2 Measures. The external valuer is not permitted to sub-delegate the valuation to a third party.

The AIFMD also provides that the AIFM maintains the responsibility for the proper valuation of the AIF's assets, and the liability towards the AIF. Important to note that the investors are not affected by the fact that an external valuer has been appointed. However, the external valuer is liable towards the AIFM for any losses arising as a direct result of the external valuer's negligence or intentional failure to perform its tasks.

Under certain conditions (see Article 19 (4) of the AIFMD and Article 17 (4) of the AIFM Law), the depository may also act as an AIF's external valuer if the depository is able to clearly indicate that it functionally and hierarchically can separate both functions, and that any potential conflicts of interest can be identified and consistently supervised.

Other

INREV recommends that an assessment of the re-appointment of the external valuer be made at least every three years.

1.5 How frequent should an investment property be valued?

CSSF Circular 91/75, applicable to UCIs (Part II funds), requires an annual valuation for investment property. It also states that a valuation is required when a sale of the investment property occurs more than six months after the last valuation.

The frequency of valuations in most REIFs are generally governed by their Fund Documentation. Industry best practice is generally an annual full scope valuation with quarterly desktop valuations. The practice varies depending on whether the REIF is open or close-ended and on the frequency of asset and capital transactions.

Typically for larger property portfolios, a rolling cycle of full valuations throughout the period supplemented by desktop valuations are performed. Such arrangements are detailed in the Fund Documentation.
Exceptional events that significantly affect the value of a REIF's portfolio or specific properties may require a special ad-hoc valuation. Such events may include economic, interest rate, political, market, sector, physical and/or tenant-related matters. The REIF's management is responsible to ensure this is performed in accordance with the REIF's constitutional documents and that the appropriate value is applied at the NAV calculation date using all relevant information available.

AIFMD

An AIFM must ensure for each AIF it manages that a NAV is properly calculated when new subscriptions and redemptions of shares or units are issued by the AIF, with a minimum requirement of one valuation per annum. Article 74 of the Level 2 Measures further distinguishes that for open ended funds the valuation of the underlying assets shall take place every time the NAV per share or unit is calculated and/or every time there is evidence that the last determined price is no longer fair or proper.

Other

INREV recommends that external property valuations are performed at least annually for all properties, with (desktop) internal or external updates in line with the reporting frequency of the fund.

1.6 What is valuation uncertainty?

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.

Most of the uncertainty paragraphs (if any) included in the independent valuation report 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.
As part of its review of the independent valuation report and in order to appropriately address uncertainties cited in the independent valuer's report (if any), management should consider enhancing disclosures in the financial statements in the following areas:

- The investment property note;
- The accounting policy "valuation method" note;
- The critical accounting estimates and judgments disclosures.

In certain circumstances, the "going concern" assumption may also not be appropriate anymore, which may impact the presentation of the financial statements.

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

CSSF Circular 91/75 requires a REIF to disclose the reasons why it proceeded with a transaction where a significant variation exists between the transaction price and the most recent valuation.

Often, there is a difference between the theoretical fair value of an investment property and the price finally negotiated in a transaction. Whilst there is no threshold defined, the industry considers that a deviation between 5% and 10% remains acceptable. The focus during a sale will be on the downside, since terms more favorable than the valuation is obviously acceptable and beneficial to investors. Whereas the focus on the purchase of a property will be on whether a significantly higher price was paid than the one outlined in the independent valuation report.

Where there is a significant variation, appropriate disclosures are necessary in the management and investors' reports and, in the financial statements.

1.8 What is the responsibility of the manager (AIFM)?

AIFMD

In accordance with AIFMD, the AIFM must implement a robust governance framework for the production and approval of the valuations of the underlying assets held by the REIF. The AIFM must first establish, maintain and implement formal procedures that address the competence and independence of the person(s) performing the valuation and describe the controls over the valuation input criteria and sources. These policies must be reviewed regularly (at least annually) and amended accordingly (see Articles 67 – 71 of the Level 2. Measures for detailed information on what is to be included in the valuation policies and procedures). More specifically, Article 68 of the Level 2 Measures states that in the case where specific models are implemented these must be reviewed by professionals with sufficient expertise and which have not been involved in the design of the valuation model. These models must also be officially approved by the AIFM valuation committee and/or by senior management.

The AIFM is responsible to ensure that the valuation function is independent from the portfolio management function and must document the approval and escalation process of the valuations. To assist the AIFM to perform this function, the AIFM may appoint independent appraiser(s) who can provide certain input on the valuation of the underlying assets.

However, any such appointed appraisers are simply providing guidance and cannot be held liable for the valuation function.

The AIFM is also responsible for performing the initial and on-going due diligence on any appointed independent appraiser or in the case of a full delegation to the external valuer and maintain policies and procedures to be followed outlining the supervisory functions.

1.9 Oversight responsibilities of the depository in relation to the valuation process?

AIFMD

As part of the obligations of the oversight duties of the depository under Article 21(9) of the AIFMD (and more specifically Article 92 of the Level 2 Measures), the oversight obligations imposed on depositories in regards to valuation is to ensure that the valuation is calculated in accordance with the AIF applicable rules and the principles which are outlined in the Directive. In order to do so, the depository must ensure that upon commencement of its duties, appropriate communication channels have been put in place between the depository and all appointed service providers of the AIF and that appropriate procedures have been established for the valuation of the assets. The depository must also obtain comfort that such policies and procedures are effectively implemented and periodically reviewed. In the case that an external valuer has been appointed the same rules are applicable.

In the following sections, references have been made to INREV guidelines. These guidelines do not consist in an accounting framework but provide with adjustments, enabling managers and investors comparing vehicles performance with a more economic view.

2. Accounting

2.1 Determining whether a REIF is an investment entity

2.1.1 What is the definition of an investment entity?

Luxembourg GAAP

Investment entity is a term within IFRS. Luxembourg GAAP has exemptions to consolidation within the SIF and SICAR Laws.

IFRS

The management of a REIF needs to assess whether it meets the definition of "investment entity" in accordance with IFRS 10.

An investment entity is an entity that:

- Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- Measures and evaluates the performance of substantially all of its investments on a fair value basis.

The following characteristics, set out in paragraph 28 IFRS 10, are also considered when assessing whether a REIF meets the definition of an investment entity, having:

- More than one investment;
- More than one investor;
- Investors that are not related parties of the entity; and
- Ownership interests in the form of equity or similar interests.

The definition and characteristics are subject to interpretation and require a significant amount of judgment.

2.1.2 What are the consequences when a REIF is an investment entity?

IFRS

Investment entities shall not consolidate its subsidiaries. It should measure them at fair value through profit or loss in accordance with IFRS 13. If an investment entity has a subsidiary that provides services that relate to the investment entity's investment activities, it shall consolidate that subsidiary.

2.2 Accounting for investment properties

2.2.1 What is the accounting treatment for property acquisition costs?

Luxembourg GAAP

Property acquisition costs are initially capitalised with its purchase cost. 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 into account potential disposal costs of the seller. Effectively they are therefore written off through the profit and loss account at the next NAV determination date.

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 (when permissible) to adjust the Accounting NAV into a Fund NAV offered to new investors to add an adjustment to cover transaction costs borne by existing investors. Any impact as part of a pricing scheme is recorded directly in equity.

IFRS

Treatment under IFRS is similar to Luxembourg GAAP.

Other

INREV guidelines provide alternative treatment for spreading the impact of acquisition costs. Acquisition costs are amortised over five years. When a property is sold before the amortisation period expires, the unamortised portion of acquisition costs are expensed.

2.2.2 How is revenue recognised in a REIF?

Luxembourg GAAP

Revenue recognition under Luxembourg GAAP allows other methods of income recognition in addition to straight-lining if these are more appropriate based on the fund style.

IFRS

Rental income including rent incentives are recognised 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 in which the REIF's derives its benefit from the property.

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 comes from the fact that 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 by the fair value model.

Other

One of the issues of applying straight line method of accounting is that revenue and cash flows from revenues do not match. This means that definitions of distributable income often need to be adapted accordingly. This is however a common practice in many countries from a tax perspective.

2.2.3 How are service charges treated by a REIF?

Generally service charges are levied on the tenants to recover expenditures to be supported by lessees as set out in the tenant's lease or tenancy agreement. They normally cover costs such as general maintenance and repairs, insurance of the building and, where the services are provided, central heating, lifts, porterage, lighting and cleaning of common areas etc.

The charges may also include the costs of management by the property owner or property managers acting as agent and for contributions to a reserve fund.

The REIF, or, sometimes, a management company or a property manager that is party to the lease, provides or contracts for the services on behalf of the tenants.

Luxembourg GAAP

Luxembourg GAAP provides no specific guidelines regarding service charges and therefore should follow the same accounting principles as the ones existing under IFRS.

IFRS

The accounting of service charges depends on the fact whether the REIF is acting as a principal or an agent for these service charges. Determining whether a REIF is acting as a principal or as an agent requires judgement and consideration of all relevant facts and circumstances. An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the service charges. A REIF is acting as an agent when it does not have exposure to the significant risks and rewards associated with the service charges and uses the services of a third party provider. One feature indicating that a REIF is acting as an agent is that service charges are collected by the REIF on behalf of third parties.
When the REIF is acting as a principal, service charges are recognised and recorded in the profit and loss account and the balance sheet in the accounting period in which the services are rendered. When the REIF is acting as an agent, the service charges are recorded on the balance sheet and does not form part of the income and expenses of the REIF.

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

Luxembourg GAAP

Properties held for trading as part of a purchase, development and sales programme should be treated as inventory when the developer takes the sales risk. For valuation, please refer to guidelines in Chapter II - 1. Valuation.

IFRS

Similar to Luxembourg GAAP properties held for trading are considered to be inventory. Under IAS 2, however, they should be carried at the lower of cost and Net Realisable Value (NRV).
The methodology for calculating the NRV of property under construction classified as inventory is typically determined as the planned selling price of the completed asset less remaining construction costs to be incurred and a provision for selling costs. Key differences with the fair value include:

- The NRV includes a deduction for the estimated selling costs which the fair value does not; and

- The fair value of a property under construction, may include a deduction for the anticipated profit to be achieved on development which is not the case for the NRV of inventory where no such margin is deducted.

Other

Under the INREV guidelines, inventory is measured at the net realisable value (fair value less disposal costs).

Where the likely disposal date is more than one year from the date of the NAV computation, disposal costs should not be deducted from fair value in calculating this adjustment.

2.2.5 How should a fund treat development property not categorised as inventory?

Luxembourg GAAP

Property being developed as an investment property should be carried at fair value or other method as foreseen in the prospectus. Luxembourg GAAP provides no specific guidance as to the valuation of properties under development.

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 of IAS 40 is applied under IFRS 13, 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.

IAS 40 in connection with IFRS 13 provides no further specific guidance as to the valuation of properties under development.

Other

Under INREV guidelines, property being developed as an investment property should be carried at fair value similar to properties being developed for trading purposes.

As mentioned above, neither Luxembourg GAAP nor IAS 40 in connection with IFRS 13 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 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 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.

Where few key project milestones have been met (such as during the early stages of a development project) it may be that Fund management assesses that it is not appropriate to recognise a gain above the cost of development in a 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.

2.3 Accounting for funding, borrowing and derivatives

2.3.1 How should a fund treat debt and is there a requirement to carry debt at fair value?

Luxembourg GAAP

Fair-value and nominal value are permissible if not contracted by the fund documentation.
For fixed rate debts, if economically justifiable, the fund documentation may provide a derogation from using fair-value so that fixed rate debts can be recorded at cost 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 planned to be held until maturity, the liabilities may be valued at their cost to avoid the impact of unrealised changes in the fair value of the instrument on the NAV during the life of the fund;

- For open-ended funds where, again, the fixed rate debts are planned to be held till maturity and Fund management, therefore, does not believe that it is appropriate that the NAV of the fund is impacted by the changes 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. 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.

Normally, the carrying value of variable interest debt arrangements approximates its fair value and such debt should be carried at amortised cost using the effective interest rate method.

IFRS

Debts can either be carried at fair value or amortised cost depending on the classification of the financial liability per IAS 39. Mortgages typically do not meet the criteria to be measured at fair value. If the cost model is adopted, the fair value should be disclosed in the notes to the financial statements. If fixed rate debt is carried at amortised cost, a reconciling item to arrive to the Fund NAV may be necessary.

Other

INREV requires debts to be carried at fair value.

2.3.2 How should a fund treat interest rate swaps and interest related derivatives?

Luxembourg GAAP

Interest rate swaps are derivative financial instruments that are commonly entered into to reduce the Fund's exposure to the volatility in future cash out-flows resulting from the variable interest rate of loans. Derivatives are not defined in Luxembourg GAAP, thus IFRS definition is used as reference. Derivatives follow the recognition rules of any financial instruments. They are recognised only when the entity becomes contractually obligated. Derivatives are initially recognised at fair value and acquisition cost. These interests related derivatives are re-measured to fair value on each subsequent NAV date with changes in fair value through profit and loss.

IFRS

Derivative is defined as a financial instrument:

- Whose value changes in response to the change in a specified interest rate, financial instrument price, commodity price foreign exchange rate, index of prices or credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the "underlying");

- Which requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors;
- Which is settled at a future date;

- Which follow the recognition rules as stated under IAS 39. They are recognised only when the entity becomes contractually obligated. All derivatives are initially recognised at fair value.

Derivatives subsequent measurements follow the following rules:

- Derivatives classified as held for trading are measured at fair value through profit or loss;
- Derivatives that are designated as hedging instruments under a hedge accounting relationships follow the hedge accounting rule described in Chapter II - 2.3.3 below;
- Derivative liabilities that are linked to and which are required to be settled by delivery of an unquoted equity instrument whose fair value cannot reliably be determined is measured at cost.

Other

In seeking to achieve the investment objective for each Fund or property company, Fund Managers may enter into OTC derivative arrangements for hedging purposes to mitigate interest rate risks, which bring these Funds or property companies within the scope of the European Markets Infrastructure Regulation (EMIR).

2.3.3 How should a fund treat currency or interest rate hedges?

Luxembourg GAAP

Interest rate hedges are recorded at fair value through profit and loss. If currency swaps are being used to hedge specific balance sheet positions, they are recorded at fair value through the profit and loss account, when they offset movements in the carrying value of the corresponding asset or liability.

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 recognised in other comprehensive income, and the ineffective portion of the gain or loss is recognised in the statement of profit or loss. For interest rate hedges not meeting the conditions for hedge accounting, the gain or loss is recognised in the statement of profit and loss.

Currency hedges are typically classified as fair value hedges. If the currency hedge qualifies for hedge accounting, changes in the fair value of the hedging instrument are recognised in the statement of profit and loss together with any changes in fair value of the underlying hedged item.

Other

Interest rate hedges are recorded at fair value based on the INREV Guidelines.

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 statements treatment by taking into account their intended purpose. For instance, for closed ended funds where hedges are almost certainly held till maturity, the value of these hedges at the end of the life time of the fund is nil and therefore an adjustment to derecognise the hedges may be specified to avoid impacting the Fund NAV during the life of the fund.

The assessment of the intended purpose of the interest rate hedges should be documented and be re-considered at each Fund NAV date to substantiate the derecognition adjustment to the Fund NAV. Management should consider the facts and circumstances at each Fund NAV date, and particularly whether the disposal is expected in a foreseeable future. The documentation should include:

- A statement that the derivative contracts have been subscribed to reduce the interest rate risk;

- A description of the mortgage variable interest rate cash outflows that are hedged (the mortgage can either be a loan which is currently granted by a financial institution or a firm commitment to grant the loan);
- The identification of the interest rate risk

cash outflows hedged; and

- A description of the changes in the value of the hedged item that are attributable to a hedged interest rate risk.

It is expected that this hedging relationship, and related documentation, is implemented when the derivative is contracted.

It is also expected that the hedge accounting strategy, and related documentation, defined at Fund level is consistent with the one at the property company level.

2.3.4 What levels of leverage/gearing are allowed for Luxembourg REIFs?

Luxembourg GAAP

Luxembourg GAAP as an accounting framework does not prescribe any specific levels of allowed leverage/gearing for Luxembourg REIFs.

IFRS

IFRS as an accounting framework does not prescribe any specific levels of allowed leverage/ gearing for Luxembourg REIFs.

Other

Under CSSF Circular 91/75, gearing ratios are limited to 50% for part II funds of the law of 17 December 2010 as amended 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.

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. 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.

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.

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.

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 the going concern assumption and potential contingencies, and in their audit of the presentation of borrowings in the balance sheet.

2.4 How do Luxembourg REIFs treat deferred taxes liabilities?

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 crystallise in the foreseeable future or resulting from a planned transaction, under the general provisions requiring the application of fair value principles in determining the Luxembourg GAAP NAV of Luxembourg funds.

As well as providing for specific tax liabilities, there will be some deferred taxation impacts (e.g. latent capital gain 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 the Fund NAV calculation if it is likely to crystallise in the foreseeable future.

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.

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. There is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale if measured at fair value. Accordingly, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset shall reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.

Other

For many Luxembourg REIFs which prepare IFRS financial statements, adjustments are made to the NAV to adjust the amount of the recorded deferred tax. 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 Chapter II - 3.1 in this paper.

INREV guidelines 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 guidelines states that the calculation 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 crystallise on the disposal transaction should be taken into account when calculating the fair value of deferred tax liabilities. INREV is consistent with Luxembourg GAAP with regards to the calculation of the deferred tax liabilities.

On an ongoing basis, Fund management should make comparisons with current market practice and information to ensure that their deferred tax estimates remain realistic.

2.5 Special considerations regarding acquisition of property owning vehicles

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

Luxembourg GAAP

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. If under Luxembourg GAAP, consolidated accounts are prepared, there is no 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.

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 recognised based upon their relative fair values, and no goodwill is recognised. 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.

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.

2.5.2 How do funds account for joint ventures or minority investments?

Luxembourg GAAP

It is common practice in the real estate industry to acquire properties in share deals (i.e. purchasing a SPV owning a property), but only as a minority shareholder or as a joint venture partner. Under Luxembourg GAAP the shareholding in these investments is typically recorded at fair value with any changes in fair value accounted for in the statement of profit and loss.

IFRS

Under IFRS the REIF will need to classify its joint venture or minority investment into the following categories:

a. Joint Venture
   A joint venture is characterised by the fact that the involved investors will only be able to take decision on a joint basis, i.e. they need to act in unison to take decision. This is usually specified in the joint venture agreement. If an investment qualifies as a joint venture the accounting treatment is the same as for an associate.

b. Associate
   An associate is typically an investment in which the REIF owns between 20%-50% and the REIF exercises significant influence over the investment without obtaining control. The investment is accounted for using the "at-equity method", i.e. revaluing the investment with the pro-rata share of the REIF in the underlying equity, however by ensuring that the accounting policies used by the associate are similar to the REIF's ones, especially regarding the valuation of investment property.

c. Financial asset at fair value through profit and loss
   Investments below 20% are typically classified as financial asset at fair value through profit and loss in accordance with IAS 39, i.e. the investments are recorded at fair value with fair valued changes being recorded through profit and loss.

If an REIF is an investment entity, its joint ventures and associates have to be measured at fair value (please refer to Chapter II - 2.1).

2.6 Other accounting considerations

2.6.1 What is the recommended treatment of fund formation costs?

Luxembourg GAAP

Fund formation costs can be capitalised and amortised over a period not exceeding 5 years.

IFRS

General fund launch costs must be written off immediately through the income statement.

Other

Costs directly associated with raising equity must be shown as a deduction to the proceeds raised from capital formation. Adjustments 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) is in line with INREV guidelines.

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

Luxembourg GAAP

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.

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.

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.

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.

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.

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.

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.

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.

IFRS

The treatment described above under Luxembourg GAAP is consistent with IFRS treatment in regard that the performance fee as a contingent liability should not be recognised, it should be disclosed as a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Other

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.

In open ended funds, where investors enter or leave the fund at different times, there are mechanisms to issuing of series of share classes with different terms with respect to performance fees, or performance fee equalisation mechanisms used whenever capital enters or leaves the fund.

2.6.3 What are the typical accounting treatments for dividends?

Luxembourg GAAP

For some REIFs their Fund Documentation might foresee an automatic dividend distribution so that dividends are in substance, a contractual liability of a REIF and therefore recognised as accruals in the period in which they are earned. For 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.

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.

IFRS

The treatment described above under Luxembourg GAAP is consistent with IFRS treatment. A dividend as a contractual liability is recognised as accruals in the period in which it is earned subject to certain approvals in the Fund Documentation.

Other

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 realise cash as well as accounting profits, and should also allow the accumulation of cash at the fund level in the structure.

In addition, normal corporate law rules on dividends and distributions may apply, depending on the choice of vehicle.

3. Net Asset Values

3.1 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?

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.

As already mentioned in various sections of this document, depending on the Fund GAAP the following adjustments (reconciling items) could be made to the fund GAAP NAV, as non-exhaustive list, e.g. based on INREV guidelines:

- Effect of reclassifying shareholder loans and hybrid capital instruments (including convertible bonds) that represent shareholder long term interest in a vehicle;
- Revaluation to fair value of investment properties, self-constructed or developed investment properties, properties intended for sale and property that is leased to tenants under a finance lease;
- Adjustment of property fair values to reflect the best estimate of realisable transfer taxes and purchasers costs;
- Measurement of deferred tax liabilities and assets at fair value (adjustment to take into account the manner of disposal of the properties and tax structuring);
- Adjustment to bring the carrying value of fixed rate debt to its fair value;
- Adjustment to derivative financial instruments held for hedging purposes;
- Adjustment for formation costs;
- Tax effects and minority interest effect of the adjustments above;
- Effect of subsidiaries having negative equity where there is neither a legal nor a constructive obligation to fund the accumulated losses in situations where the financing of the subsidiaries is non-recourse to the vehicle; and
- Other adjustments which would present fairer the Fund NAV in accordance with the Fund reporting objectives and investors requirements. Please, refer to INREV guidelines for further information related to these adjustments."

In addition, the fund documentation may require that the NAV based price offered to new investors include adjustments for property acquisition costs to reflect a fairer spreading of such costs between investors over certain period of time.

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.

Reconciling adjustments made between the financial GAAP NAV and the NAV used for Unit/ Share Pricing calculation may contain some adjustments in order to bring the Fund 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.

In some cases, REIF may also define several NAVs to be used in different circumstances, such as NAV for subscriptions, NAV for redemption, etc.

3.2 If fund NAV is different from accounting NAV, what disclosures are necessary to assist users of NAV? More generally, what are the required NAV disclosures?

For any differences between fund NAV and Accounting NAV such as those referred above, it is recommended to disclose the reconciliation between the two NAVs and it is expected to explain the material adjustments which includes key assumptions and methods used.

3.3 Tolerance limit for NAV calculation errors for real estate funds

Tolerance limits for NAV calculation errors are set out in the *Commission de Surveillance du Secteur Financier* (CSSF) circular 02/77, which relates to the protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment (Circular 02/77). This circular scopes, among others, real estate Part II funds (law of 17 December 2010 on undertakings for collective investment in transferable securities, as amended).

Circular 02/77 does not apply to SIFs and SICARs. However, with respect to SIFs, the CSSF has included additional guidance on tolerance limits for NAV calculation errors in the Annual Report 2014, page 160 point 4.5.3, as follows: "Circular CSSF 02/77 on the protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules in principle does not apply to SIFs.

Nevertheless, the CSSF considers that SIFs apply Circular CSSF 02/77 in the aforementioned cases unless they have other internal rules. It goes without saying that these rules must remain within reasonable limits with respect to the SIF's investment policy."

As a result, the governing body of the SIF (the board of managers, board of directors or governing body of the management company, as the case maybe) should determine its own tolerance limits which are to be used on a consistent basis. It is best practice to document such limits in the minutes of the relevant meetings of the governing body of the SIF.

According to the CSSF Annual Report 2008, in the event that no internal rules have been defined or documented at the SIF level in respect of tolerance limits, the tolerance limits set out in Circular 02/77 shall apply.

Real estate investments of a SIF qualify as "shares and other financial assets" as per Circular 02/77. As a result, the threshold of 1% of NAV (as set by Circular 02/77 for such type of asset) would then be used as tolerance limit for NAV calculation errors, in the event the governing body of a SIF has not set its own internal rules/ tolerance limits.

In addition, it is to be noted that Circular 02/77 provides a zero tolerance limit for losses arising from non-compliance with investment restrictions and investment policies. In many circumstances, the limits contained in Circular 02/77 (as mentioned above) can be considered as too low for real estate assets. Therefore it is recommended that the governing body of the SIF sets its own tolerance limits for the SIF and each of its sub-funds.

Factors to be considered when determining such tolerance limits are a matter of judgment and should be based on the particularities of each SIF. The following factors may be considered when setting tolerance limits for NAV calculation errors:

- Investment strategy;
- Type of asset;
- Closed-ended or open-ended; and
- Leverage.

Such tolerance limits are to be calculated for each sub-fund.

4. Disclosures

4.1 What financial reporting disclosures related to the portfolio and the valuation should management consider?

Luxembourg GAAP

Funds typically 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 related 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 summarised 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.

In addition, the methodology used to determine the fair value of the portfolio should be included as well as the key assumptions made when determining this fair value. Such assumptions include for instance the yield, vacancy rates, ERV, rental growth, discount rate, etc.

There is also a general requirement to disclose the names and location of significant subsidiaries, joint ventures and associated companies in consolidated accounts, which would include some details on the property owning entities.

IFRS

In addition, under IFRS, there is a requirement to consider the disclosure of segmental information if the fund is listed.

Other

There may also be other situations where additional disclosures are required, e.g. under the Prospectus Directive.

4.2 If a REIF is an Investment entity, what are the disclosures?

Luxembourg GAAP

Investment entity is not defined in Lux GAAP.

IFRS

A REIF that is an investment entity as defined in accordance with IFRS 10, is prevented to prepare consolidated IFRS financial statements and therefore cannot include the real estate portfolio activities in the primary statements.

Other

However, in order to provide relevant information to the investors and to other readers of the financial statements, the management of the REIF may wish to present additional information on the core business of the REIF such as the composition of the underlying portfolio, acquisitions and disposals, fair value of properties, etc. but also details on the financing of these activities. Preferably, management can present this information in the management report. Alternatively, this information can also be included as a description of the assumptions used to determine the fair value of the investments owned by the REIF.

4.3 Swap disclosures

Luxembourg GAAP

As described in section A.2.3, a fund and its SPVs may enter into derivatives to hedge foreign currency and interest rate exposures. The Fund should disclose:

- Its hedging strategy for each nature of risk being hedged;
- To which extend this hedging strategy has been actually complied with;
- A description of each type of hedge; and
- The fair value of the hedge instruments.

IFRS

In addition to the disclosures applying to Luxembourg GAAP, additional disclosure requirements have to be considered as per IFRS 7.

4.4 What are the typical contents of the fee disclosure note?

Transparent disclosures on the terms and conditions of the fees incurred by the Fund need to be provided 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. Such fees for a real estate fund are typically fees paid to the promoter, asset managers, joint venture partners, key service providers such as custodians, officers and management etc. More specifically, these fees include:

- Performance fees (if any);
- Management fee/Asset management fees;
- Administrative fees (if self-administered);
- Distributors fees;
- Acquisition costs paid to the asset manager ;
- Fees paid to co-investment of the promoter in the fund.

In addition to the description of the terms and conditions, it is expected that the financial statements include the costs incurred by the REIF during the year as well as the balance of unpaid fees at year-end.

A.4.5 What are the requirements for risk disclosures?

Luxembourg GAAP

The fund may be exposed to market and financial risks. Common market and financial risks for a real estate fund include:

- Property market related risks;
- Operational risk;
- Interest rate risk;
- Financial leverage risk;
- Credit and counterparty risk;
- Liquidity risks;
- Currency risks.

Funds are expected to provide qualitative information on the exposure to financial risks, how these risks are managed and policies and procedures to monitor and mitigate these exposures. Then, Funds typically describe the level of compliance with these policies and procedures. In addition, some quantitative analysis are provided, such as for liquidity, credit and market risks (including sensitivity analysis) as well as capital management disclosures.

IFRS

REIF require additional disclosures for financial instruments, and particularly quantitative sensitivity and liquidity risk analysis as per IFRS 7.

However, IFRS does not require disclosures of any information and policies for non-financial risks, such as property market risks and operational risks.

A.4.6 AIFM disclosure

ALFI has issued guidance on AIFMD reporting to investors and annual reports (available on the ALFI website www.alfi.lu). These guidances have been prepared on the basis of the two most common accounting frameworks used in Luxembourg (Luxembourg GAAP and IFRS).

A.4.7 Interim reporting

It is best practice to provide on a quarterly basis investors with an interim reporting. This reporting can either be abridged or full. INREV also provides guidance on the content of the interim reports. Ultimately, the fund manager and investors should agree on the frequency and content of interim reporting.

fund of real estate investment funds

1. Fund of Funds

In general, a Fund of Real Estate Funds (FOREF) invests in illiquid and/or hard-to-price assets where valuation information is infrequent and where it may be necessary to make significant judgments in arriving at a fair valuation of individual assets. As a result, Management of a FOREF should ensure that a robust valuation process is designed and clearly documented, with appropriate controls embedded to avoid or resolve conflicts of interest, if any.

1.1 Valuation of the Investee Funds

1.1.1 What are the acceptable valuation methods for Investee Funds?

As a general principle, FOREF NAVs must take into account 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 FOREF including any estimates provided by or discussions with the Investee Fund manager.

Generally, Management of FOREF assumes that the fair value of their investment corresponds to the NAV per share/unit provided by the Investee Fund without further adjustment. Indeed fair value is generally estimated as being the NAV of the target investment in case such NAV can be used for actual subscriptions/redemptions. However, certain attributes of the investment (such as restrictions on redemption, transaction on secondary market, specific investee's risks identified by the FOREF, etc.) may indicate that it is necessary to make adjustments to the NAV per share/unit to estimate the fair value of the Investee Fund.

The Management of a FOREF can only place reliance on the reported net asset values provided by the Investee Fund to the extent that there is sufficient evidence that the reported net asset value is appropriately derived using proper fair value principles as part of a robust reporting process.
Typically, evidence related to the fair value approach, procedures and consistency of application is gathered via initial due diligence, on-going monitoring, and review of financial reporting and governance of the Investee Fund by Management of the FOREF.

This should also include an understanding of the valuation method(s) used to value the Investee Fund assets and check whether this/these method(s) is/are acceptable under the applicable GAAP and laws and regulations and/or contractual arrangements (e.g. the fund documentation).

1.2 What are the best practices in terms of information available and diligence to be conducted for valuing Investee Funds?

These best practices will typically include a mixture of analysing/reviewing direct source of information and additional supporting information. The information should be addressed to the fund manager of the FOREF, 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.

Direct source of information

- 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.
- Details of all capital calls made to/distributions received from the Investee Funds since the last valuation of the Investee Funds;
- Details of significant subsequent events since the last date of the NAV calculation of Investee;
- Investee Funds quarterly reports;
- Discussion with the asset managers.

Additional supporting information

Additional financial information might include:

- Operational information received from the FOREF under the terms of side letter arrangements with the Investee Funds;
- 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 ISAE 3402 (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;
- Analyses of historical accuracy of provisional NAVs released by Investee Funds by comparison to those contained in audited accounts;
- Independent valuers' reports for the real estate portfolio of the Investee Fund;
- Analyst or valuer reports regarding market conditions and valuations of the geographical and sector markets in which the Investee Funds have invested;
- Meeting minutes or call logs between the FOREF and the Investee Fund;
- Minutes of any meetings of supervisory bodies of the Investee Fund in which the FOREF is represented – e.g. investor advisory committees;
- Confirmations from management/ administrators of the Investee Funds in respect of their valuations/NAV.

Use of information received from Investee Funds

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 the FOREF NAV and financial statements, whether the FOREF's governing body, a pricing committee or a third-party administrator, need to have full access to this monitoring information.

Consideration also needs to be given to the process (and its formalisation) of how this information is utilised 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, utilise, and challenge the information received to enable this information to be used when determining the FOREF NAV. When 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.

Timing matter

There may be a difference between the NAV published by the Investee Fund at the relevant NAV cut-off date and the valuations in the financial statements published by this Investee Fund subsequent to this date, as a result of further information being received.

Consideration of the timing of receipt of Investee Fund NAV's and release of FOREF'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.

1.3 What are the NAV considerations for Investee Funds?

Appropriate considerations will have to be made regarding the NAV to be used as a basis for fair valuing Investee Funds. In fact a FOREF can receive from Investee Funds different NAV including:

- An “accounting NAV” which is the NAV prepared in accordance with the accounting framework followed by the Investee Fund (IFRS, Luxembourg GAAP, US GAAP , etc.);

- A “trading NAV” (for open-ended funds)/ “adjusted NAV” which is the NAV applied for the purpose of subscriptions and redemptions to achieve equitable treatment for all investors. The base of the trading NAV is generally the accounting with some adjustments. Compared to an IFRS NAV, a trading NAV generally includes adjustments for capitalised transaction costs, formation costs, deferred tax and unpaid dividends;

- An INREV NAV which is a NAV prepared in accordance with INREV guidelines.

1.4 What are the adjustments considerations to the NAV of Investee Funds?

The net asset value of Investee Funds is based on the valuation methods as defined in the prospectus/by the Management of such Investee Funds. Management of the FOREF has to consider whether the NAV reported by the Investee Fund is an appropriate estimate for the retained value of the Investee Fund or whether adjustments are required.

The following factors might result in an adjustment to the reported NAV by Management of the FOREF:

- If the Investee Funds assets do not follow the same valuation policy as the one applied at the FOREF level (for instance the assets portfolio of the Investee Fund are valued at cost vs fair-value followed as valuation policy at the FOREF level);

- If the Investee Funds units/shares are actively traded on a secondary market, fair value would be the actively traded prices;

- If Management has made the decision to sell Investee Funds units/shares for an amount other than NAV, the fair value would be the expected sales price;

- Appropriate recognition in the Investee Fund retained NAV of potential performance fee, carried interest or any other features which may have a dilutive impact;

- Appropriate consideration of the tax impact for the FOREF in relation to future disposals of underlying assets made at the Investee Fund level;

- Suspension of net asset value calculation or restrictions on redemptions;

- Specific investee’s risks identified by the entity.

1.5 How does increased valuation uncertainty affect FOREF NAV production?

With respect to Investee Fund property portfolios

Some valuations of real estate are particularly 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 Fund’s valuations may impact the reliability of the NAVs reported by these Investee Funds on which FOREFs base the valuation of their investments.

With respect to financial position of Investee Funds

As well as the additional increased inherent uncertainties in respect of property valuations under certain circumstances, some market conditions may have 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.

FOREFs themselves, as well as Investee Fund 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.

With respect to delayed information from Investee Funds

The inherent valuation uncertainty is further exacerbated by the fact that there may be a time lag between the reporting date of the FOREF NAV and the receipt of information relevant to that date from Investee Funds. For some assets, if valuations of Investee Fund's investments are not based on up to date information there is a risk that these will be unreliable and potentially materially misstated given the volatility of pricing inherent to some markets.

What options do FOREFs have in respect of the issues identified above?

The above factors may negatively impact the ability to calculate an accurate NAV for a FOREF. Broadly speaking, Management of such FOREFs has three main options in respect of dealing with this:

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

In some cases, Management should strongly consider delaying reporting in order to collect as much as 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 by the Investee Funds.
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.

Suspend issuance of the FOREF NAV

Management may choose to suspend issuance of the FOREF NAV until such time that Management believes that the NAV can be produced with an appropriate level of accuracy.

If Management judges that, due to some market conditions, it is not possible to calculate a reliable NAV then consideration may need to be given to suspending the FOREFs NAV.
This is particularly important with regard to open-ended funds where NAVs not only are used for information purposes but are also used for subscriptions and redemptions.

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:

- Deferring subscriptions and redemptions until the NAV can be reliably calculated. However, this may be not commercially viable - the FOREF 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;

- Arranging short term funding in order to finance operations, to avoid the need to price new issues of units/shares;

- Issuing/redeeming shares/units but delaying pricing of these transactions until a more reliable NAV is available. This is a possible solution, subject to the regulatory framework of the FOREF, where Management wants to draw capital from investors and also provide them with liquidity.

Continue to produce Fund NAVs/financial statements within normal timeframes

If Management does not wish to delay the issue of NAVs/financial statements then consideration will have to be given to the adequacy of the information received as regards to producing accurate reporting.

Where this is not sufficient, given some 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 and face problems.

It is the primary responsibility of Management to ensure that sufficient, reliable data is available and has been used in calculating the FOREF NAV. Considering market volatility compounded by time lags in receiving information in a FOREF environment, and especially if the NAV is used for subscriptions and redemptions, and thus affects the distribution of value 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.

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:

- 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
- Uncertainty in respect of the property types and geographical markets that the Investee Fund is exposed to.

FOREF structured as a SIF should refer to the SIF law requiring appropriate information (qualitative

2. Disclosures

and quantitative) to be provided on the Investee Funds portfolio for an investor to allow making judgements on the activities and results of the FOREF.

Appropriate information should be also given in the notes to the accounts on the methodology used and assumption followed to value Investee Funds and in particular if fair-value is followed as valuation policy. This point is particularly tricky in case of different valuation policies are applied across the Investee Funds in portfolio.

real estate debt funds

What is a Real Estate Debt Fund?
A Real Estate Debt fund is a vehicle which invests directly or indirectly, in loans financing real estate assets. The investments are made through the acquisition of existing loans (from a bank for example) or through the origination of the loans. The loans range from senior loans (first rank guarantee) to mezzanine loans (other than first rank guarantee).

1. Valuation

1.1 What are acceptable valuation methods for investment in loans?

Luxembourg GAAP

The loans should be valued in accordance with the method described in the issuing document (i.e. basically fair value or amortised cost or any other method as long as it is adequately described in the issuing document).

IFRS

Under IAS 39, subject to certain conditions, the loans can be classified into the following categories:

a. Loans at fair value through profit or loss;
b. Held-to-maturity investments at amortised cost;
c. Loans and receivables at amortised cost; or
d. Available-for-sale loans at fair value through other comprehensive income.

Under IAS 39, when the loan is recognised initially, the Fund measures it at fair value plus transaction costs, except in the case of a loan at fair value through profit or loss.

The introduction of IFRS 9 may require the re-examination of these categories due to the changes in the definitions

1.2 What are the generally accepted methods for determining fair value for debts?

The method usually applied to determine the fair value of a loan is a discounted cash-flow model, where the fair value of the loan is defined as the discounted sum of expected future cash-flows. The main steps for the valuation of a loan are as follows:

a. Estimation of the expected future cash-flows over the life of the loan, taking into account the probability of default and the extension risk;
b. Determination of an appropriate discount rate reflecting the risks associated with the above cash-flows; computation of the net present value of the estimated cash-flows.

1.3 What is the amortised cost of a loan?

The amortised cost of a loan is the amount at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (using the effective interest rate), and minus any impairment.

The effective interest is the rate that discounts the future expected cash flows through the life of the loan to the net carrying amount of the loan.

1.4 What are the fees to be included in the cost when calculating the amortised cost?

All the fees and transaction costs are included in calculating the amortised cost. This means that, in effect, they are amortised through profit and loss of the Fund over the loan's life.

1.5 Impairment

For loans valued at amortised costs, potential impairments have also to be considered based on assessments performed by Management. Events that might lead to impair loans include payments default from the borrower, deterioration of the LTV and ICR ratios, etc.

2. Accounting

2.1 How are origination fees/up-front fees accounted?

Origination fees are those paid by the borrower to the lender (i.e. the Real Estate Debt Fund) as compensation of the time spent in the due diligences performed by the lender for originating the loan or as compensation for granting a complex loan including guarantee and collateral arrangements, preparing and processing documents.

Luxembourg GAAP

Origination fees are booked in full as an income in the profit and loss account on an accrual basis.

IFRS

a. If the loans are measured at amortised cost, the origination fees should be added to the initial fair value;
b. If the loans are measured at fair value through profit or loss, the origination fees are recognised in profit or loss on initial recognition.

3. Disclosures

3.1 Disclosure of the fair value of the loans

IFRS require that, if the amortised cost model is used, the fair value of each of the loan must be disclosed in the notes to the Financial Statements.

This being said, if the management of the Fund can demonstrate that the amortised cost is an acceptable approximation of the fair value, no further disclose is required.

3.2 What are the characteristics of the loan to be disclosed in the notes?

There are no specific disclosures required in Luxembourg GAAP for loans held at amortiSed cost. However, in the event where the Fund is structured as a SIF, qualitative and/or information on the investment portfolio enabling investors to make an informed judgment on the development of the activities and the results of the SIF should be disclosed in the financial statements.

reporting for liquidation of REIF

I. introduction

This chapter is intended to provide guidance to the real estate investment fund industry and as such may not be suitable in all circumstances. This chapter seeks to outline key reporting considerations for situations where a fund manager liquidates a real estate investment fund. The considerations hereunder shall not be seen as legal advice. Readers should always seek the advice of qualified professionals of the Luxembourg investment fund industry.

Scope

These chapter applies to all Luxembourg Real Estate Investment Funds (hereafter "REIF" or "REIFs") that fall under the following Luxembourg laws irrespective of the legal form the respective REIF may take:

- Undertakings for Collective Investment ("UCI") governed by Part II of the law of 17 December 2010, as amended;
- Specialised Investment Funds ("SIFs") governed by the law of 13 February 2007, as amended;
- Investment companies in risk capital ("SICARs") governed by the law of 15 June 2004, as amended
- Reserved Alternative Investment Funds ("RAIFs") governed by the law of 23 July 2016, as amended;
- any other AIFs managed by an alternative investment fund manager under the supervision of a European regulator and governed by the law of 10 August 1915, as amended, on commercial companies (the "Company Law").

For any REIF, of the corporate type governed by the Company Law, regard must be given to the specific provisions of the said law on the liquidation of such vehicles. The liquidation of sub-funds of any REIF qualifying as an umbrella fund (which is not possible for REIFs under (5) above), is further governed by the administrative practice of the Luxembourg financial markets supervisory authority, the *Commission de surveillance du secteur financier, the CSSF*. In that respect, some accounting and reporting considerations mentioned hereafter may apply to the liquidation of a sub-fund but other legal and regulatory considerations are not covered unless specifically indicated.

This chapter does not cover the liquidation of REIFs under the contractual form of common funds ("FCP"). The procedure and principal terms for the liquidation process for an FCP are disclosed in its management regulations.

General points of consideration

For REIFs of the corporate type, the precise steps for the liquidation process depend on a number of factors including the liquidation mode (i.e. voluntary or legally required), the legal form and regulation of the entity and any specific items relating to liquidation included in the entity's governing documents. The duration of the liquidation process also depends on what assets at the opening of the liquidation procedure the REIF owns and how those assets should best be disposed of (share deal vs asset deal).

The Company Law recognizes two different voluntary liquidation procedures for corporate REIFs, i.e. (i) the so-called "simplified liquidation" (when all the shares of the company are held by one single investor/shareholder) and (ii) the classic liquidation procedure by way of shareholder/s meetings.

Simplified Liquidation

In the case of a simplified liquidation, the investor who has come to hold all the shares of a company may dissolve that company at any time. If so, the dissolution shall entail the universal transmission of the assets and liabilities of the company to the sole member without formal liquidation. In other words, the Company will be dissolved without a formal liquidation and all its assets and liabilities will be legally transferred to the sole investor. The dissolution of the company without liquidation can be proceeded by means of a single deed to be

* For REIFs subject to a product law, the CSSF has accepted that the second and third EGM may be held concurrently

enacted in the presence of a notary. The simplified liquidation procedure does not require the appointment of a liquidator. It should however be noted that the Company Law requires the dissolution to be accompanied by different certificates issued by:

1. The Centre d'informatique, d'affiliation et de perception des cotisations commun aux institutions de sécurité sociale (the Central Social Security Office);
2. The Administration des contributions directes (Luxembourg Inland Revenue);
3. The Administration de l'enregistrement et des domaines (Registration Duties, Estates and VAT Authority).

These certificates confirm that the Company complies with its obligations relating to the payment of social security contributions, taxes and duties as at a date, which may not be earlier than three months before the date of the instrument of dissolution nor later than the instrument of dissolution.

It is to be noted that the time needed for the administrations to issue these different certificates is uncertain as it will depend on their reactivity. Thus, waiting time can be of several weeks depending on the reactivity of the relevant administrations and Company compliance with its above-mentioned obligations.
Creditors may, within a period of 30 days from the publication of the act of dissolution, obtain securities.

Classic Liquidation Procedure

The most common procedure used for the voluntary liquidation of REIFs is the holding of extraordinary shareholder/s meetings deciding on the liquidation of the company. A first extraordinary general meeting ('EGM') of the investors (shareholders, partners hereafter "Investors") is held in advance of (preferably), or on maturity date of the REIF. At the first EGM, the decision is made to dissolve the REIF, to open the liquidation period and to appoint a liquidator. For all the REIFs under the corporate form, except the simple limited partnership (société en commandite simple or "SCS") or special limited partnership (société en commandite spéciale or "SCSp"), and having been set up for an indefinite period of time, the first EGM shall be held before a notary as the EGM sets a term to the life of the company and thus entails a change to the articles of incorporation. For REIFs having a fixed term, the first EGM will be limited to acknowledging the term and appointing a liquidator. This EGM may be held under private seal, and no notary will be required.

The liquidation of the SCS and SCSp falls within the competence of the partners. The conditions and procedure for the dissolution and/or liquidation of the partnership may be freely established in the partnership agreement.

When the liquidation is completed, the liquidator's report to the partners regarding the use of the assets and present supporting accounts and documents. The partners subsequently appoint auditors to examine the documents and issue a report. Following the auditor's report, the partners then fix a meeting in order to deliberate on the management of the liquidators.
Notice of the completion of the liquidation of the REIF is published after the final meeting.

While not expressly required by law, it is generally recommended that the governing bodies of the REIF prepare pro forma accounts as of the day of the start of the liquidation procedure.

As a result of the liquidation, the roles and responsibilities of the governing bodies will be taken over by the liquidator as of the opening of the liquidation procedure. Third party service providers including the administrator, the depositary bank and the transfer agent, etc. will, in principle, remain in place until the closing of the liquidation procedure.

II. Appointment of liquidator and liquidation period

For entities under the direct supervision of the CSSF, the liquidator/(s) appointment requires the prior approval by the CSSF before it is ratified in the extraordinary general meeting. A liquidator may be a former member of the board of directors/managers of the REIF or an external individual. The liquidator may be the general partner of a partnership limited by shares, *société en commandite par actions*) or of an SCS or SCSp. A company may have more than one liquidator.

The liquidation period is defined as the period from the first extraordinary general meeting opening the liquidation up to the extraordinary general meeting where the liquidator and the auditor to the liquidation (*commissaire*) will present their reports to the Investors, during a final EGM.

1. Reporting requirements

a) From the last year-end to the start of the liquidation period (Period 1)

The governing body of the relevant REIF is responsible for the preparation of the financial statements in accordance with applicable accounting principles stated in its constitutive documents and adjusted for preparation on a liquidation basis. The financial statements are required to be audited by a *réviseurs d'entreprise agréé* in accordance with the normal audit requirements for the specific form of the REIF.

REIFs under the direct supervision of the CSSF should submit the liquidation accounts to the CSSF. The liquidation accounts should be dated as of the date the relevant REIF is entering officially in liquidation and they are audited.

b) From the start of the liquidation period until final EGM* (period 2)

In addition to financial statements prepared (i) for the last financial year and (ii) from the last (financial) year-end to the start of the liquidation period described above, the liquidator in charge of the REIF is (iii) required to prepare a liquidation report to the Investors. The report is required to be reviewed by an auditor to the liquidation (*commissaire*), which for all REIFs under the direct supervision of the CSSF as well as for RAIFs and any AIF having appointed an authorised AIFM must be the *réviseur d'entreprises agréé* of the REIF. The liquidation report shall include information on the disposal of the remaining assets, if any, as well as supporting information and documents.

After the start of the liquidation period, the REIF is no longer required to prepare a net asset value (NAV) in line with the frequency stated in its constitutive documents. The REIF, however, must continue to prepare (on a liquidation basis) financial statements for every financial year that follows the start of the liquidation. These financial statements are not legally required to be audited but, in practice, often continue to be audited on a voluntary basis. Furthermore, the annual financial statements are not required to be prepared in compliance with the full disclosure framework specified by the applicable (Luxembourg) GAAP or IFRS – i.e. the liquidator is permitted to prepare the financial statements on a summary basis. In practice, however, the liquidator may choose to continue to have the annual financial statements audited – for example, if the REIF still holds significant assets pending disposal. This, in turn, would necessitate the preparation to be in full compliance with the REIF financial reporting framework, accounting principles stated in the prospectus and adjusted for preparation on a liquidation basis.

In addition, investors may be provided with additional communication when appropriate. The liquidator may decide, for example, to provide financial information to the Investors in line with the previously applicable NAV frequency on a voluntary basis.

The CSSF requires an annual transactional update on the status of the liquidation for those REIFs under its direct supervision. Such transactional update shall include, among others, information on the disposal of any remaining assets. The liquidator will most likely satisfy part of this requirement by providing the CSSF with the annual financial statements described above.

Finally, the liquidator must prepare the closing liquidation accounts and the liquidator's report.

2nd EGM:
During the 2nd EGM, which may be held under private seal, the shareholders of the relevant REIF shall review and approve the liquidator's report and shall appoint an auditor to the liquidation, in charge of reviewing the liquidator's report and the way the liquidator settled the assets and the liabilities during the liquidation period. The auditor to the liquidation shall be appointed among the list of *Réviseurs d'entreprises agréé* in Luxembourg in the case the REIF is subject to the direct supervision of the CSSF or the applicable product or AIFM law so requires. In the case the REIF is not

* For REIFs subject to a product law, the CSSF has accepted that the second and third EGM may be held concurrently

subject to the direct supervision of the CSSF or the product or AIFM law and/or the constitutive documents do not so require, a *commissaire à la liquidation* is appointed which does not require to be a *réviseur d'entreprises agréé*. In practice, the auditor to the liquidation will in principle be the original auditor of the relevant REIF.

The auditor shall then issue a report.

3rd EGM:
During the 3rd EGM, (which shall be held under private seal) the shareholders shall hear the auditor's report and resolve upon it.

The liquidation accounts shall be provided for such EGM. The EGM shall determine the payment of final liquidation proceeds to the shareholders (if any). It should be noted that Investors can only receive their final distribution (or indeed any prior distributions) if they are in compliance with all relevant KYC / AML requirements.

This EGM shall discharge the liquidator from its mandate and may discharge the auditor to the liquidation, and shall provide for the address where the books of the REIF will be kept (in Luxembourg) for a period of five (5) years. The REIF ceases to exist as from the date of the EGM which closes the liquidation and may then be deregistered from the commercial register.

For REIFs subject to a product law, the CSSF has accepted that the second and third EGM may be held concurrently. In such case, the first EGM needs also adapt certain decisions of the second EGM.

2. Accounting and Reporting

Preparation of the Financial Statements until the liquidation decision

The non-going concern basis of accounting should be used for the preparation of financial statements of REIFs in liquidation during the period preceding the approval of the liquidation.
Financial statements prepared and issued prior to the commencement of the liquidation period may also be prepared on a basis other than going concern in the following circumstances:

- The governing body of the relevant REIF intends to liquidate or close the entity but the formal decision has not been taken yet. This intention must be firm and substantiated in a written document.
- The governing body of the relevant REIF considers the use of the going concern basis of accounting not appropriate due to circumstances that cast significant doubt on the entity's ability to continue as a going concern.

The laws governing reporting for Luxembourg REIFs provide limited guidance in respect of the non-going concern basis of accounting.

Main changes in accounting policies commonly applied in practice between the going concern and non-going concern basis of accounting under Luxembourg GAAP are as follows:

- Non-current assets and liabilities should be classified as current;
- A provision for liquidation expenses - covering items such as liquidator fees, notary fees, publication costs, service providers etc. - should be recognized where these expenses can be reliably estimated;
- Investments (including investment properties) should be valued at net realisable value rather than fair value; and
- Any unamortised formation costs should be fully depreciated.

IFRS provides limited guidance, within I*AS 1 Presentation of Financial Statements*, in respect of the non-going concern basis of accounting. Preparers of financial statements should give careful consideration to the impact of adopting the non-going concern basis of accounting on accounting policies including the accrual of liquidation expenses, the valuation of investments, the measurement of other assets, the measurement of deferred tax assets and liabilities and the treatment of contingencies and guarantees.

IFRS requires management to constantly assess an entity's ability to continue as a going concern. When management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties (IAS 1.25).

Such disclosures might arise well before the last reporting period preceding the commencement of liquidation of the REIF, as management is required to take into account all available information about the future, which is at least twelve months from the end of the reporting period (IAS 1.26).

In addition, *IAS 10 Events after the Reporting Period* states that if the going concern assumption is no longer appropriate, the effect would be so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting" (IAS 10.15). This implies that in case of a non-going concern, an alternative basis of accounting should be adopted.

However, neither IAS 1 nor IAS 10 provide details of any alternative basis and how it might differ from the going concern basis. Accordingly, entities will need to consider carefully their individual circumstances to arrive at an appropriate basis.

Regardless of whether the relevant REIF is applying Luxembourg GAAP or IFRS, the notes to the annual financial statements should disclose the basis of preparation under which the financial statements have been prepared. The following should be addressed:

- The fact that the financial statements are not prepared on a going concern basis;
- The reason why the financial statements are not prepared on a going concern basis – i.e. because the REIF is in liquidation or the governing body of the relevant REIF intends to liquidate the REIF;
- Relevant details of the liquidation such as the estimate timeline;
- A detailed description of the changes in the presentation of the financial statements and the REIF's accounting policies arising from the basis of preparation; and
- The mention "(*en liquidation / in liquidation)*" should be added after each reference of the REIF's name when the decision to liquidate has been formally made prior to the issuance of the financial statements.

3. Preparation of the financial statements after the liquidation decision

a. The interim liquidation accounts

In the case where the liquidation process lasts more than one financial year, the liquidator is responsible for preparing interim liquidation accounts at each financial year end with a report on the operations of the liquidation. These interim liquidation accounts are not required to follow the full accounting framework described above, but should contain at least:

» A balance sheet showing an inventory of the outstanding assets and liabilities presented at their net realizable values at balance sheet date;
» A statement showing the result of the operations of liquidation;
» Notes to the interim liquidation accounts summarizing:
  • The accounting principles used to pre pare the accounts
  • Details of key captions composing the balance sheet and liquidation account.

b. The final liquidation accounts

The final liquidation accounts and the liquidation report are the responsibility of the liquidator. They must be prepared once the liquidation is finalized and provided at the 3rd EGM. The applicable law does not specify the exact content of these documents but the liquidated accounts must be prepared under regular accounting rules and allow a professional to understand the liquidation transactions. Main liquidation entries relate to:

- Investment realization and receivables collection;
- Payment of the creditors and any expenses related to the liquidation;
- Determination of the liquidation result.

The liquidation report must summarize the transactions realized as part of the liquidation process.

4. Other Regulatory Reporting

The REIF being placed in liquidation also impacts its reporting requirements to the CSSF and the Banque Centrale du Luxembourg ('BCL') for those REIF, which are CSSF supervised. The impact is as follows:

- No further U1.1 reporting files are requested by CSSF after the reference month that relates to the closing date - the closing date being reference month for which the REIF transmits its final U 1.1 reporting; and
- The reporting obligation to the BCL stops in the month of liquidation – i.e. the REIF is not required to provide statistical reports in the month in which it is placed into liquidation (and subsequent to this month).

glossary

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
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
CSSF circular 02/77	Protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compli- ance with the investment rules applicable to undertakings for collective investment
CSSF	Commission de Surveillance du Secteur Financier (the Luxembourg Financial Authority)
DCF	Discounted Cash Flow
DCF method	Analysis is a method of valuing a project, company, or asset using the concepts of the time value of money
EMIR	European Markets Infrastructure Regulation
EPRA	European Public Real Estate Association
ERV	Estimated Recovery Value
EVCA	European Venture Capital Association
FOREF	Fund Of Real Estate Funds
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 NAV	The NAV of the Fund, calculated in accordance with the provisions of the Fund documentation
Gross Asset Value	The gross value of the assets of the Fund, mainly property, cash and other investment securities
GAV	Gross Asset Value
IAS	
ICR	Interest Coverage Ratio
IFRS	International Financial Reporting Standards

IFRS NAV	The NAV of the Fund, calculated in accordance with the provisions of the International Financial Reporting Standards
INREV	European Association of Investors in Non-listed Real Estate Vehicles
IRR	Internal Rate of Return
ISA	International Standards on Auditing
ISRE	International Standards on Review Engagements
IVSB	International Valuation Standards Board
IVSC	International Valuation Standards Committee
LTV	Loan to Value
Luxembourg GAAP/ LuxGAAP	Luxembourg Generally Accepted Accounting Principles is 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)
LuxGAAP NAV	The NAV of the Fund, calculated in accordance with the provisions of Lux GAAP
MD & A	Management Discussion and Analysis
NAV	Net asset value
NRV	Net Realisable Value
OTC	
REIF	Real Estate Investment Fund (In Luxembourg, this would typically include SICAR SICAV, FCP, SIF, SICAV PART II)
REIF	Where this capitalised 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)
RICS	Royal Institution of Chartered Surveyors
SICAR	*Société d'Investissement en Capital à Risque*
SIF	Specialised Investment Fund

SPV	Special Purpose Vehicle
TEGOVA	The European Group of Valuation Association

about alfi

The Association of the Luxembourg Fund Industry (ALFI), the representative body for the Luxembourg investment fund community, was founded in 1988. Today it represents more than 1 300 Luxembourg-domiciled investment funds, asset management companies and a wide variety of service providers including depositary banks, fund administrators, transfer agents, distributors, law firms, consultants, tax advisers, auditors and accountants, specialist IT providers and communications agencies.

Luxembourg is the largest fund domicile in Europe and its investment fund industry is a worldwide leader in cross-border fund distribution. Luxembourg-domiciled investment structures are distributed in more than 70 countries around the globe, with a particular focus on Europe, Asia, Latin America and the Middle East.

ALFI defines its mission as to "Lead industry efforts to make Luxembourg the most attractive international centre".

Its main objectives are to:

Help members capitalise on industry trends
ALFI's many technical committees and working groups constantly review and analyse developments worldwide, as well as legal and regulatory changes in Luxembourg, the EU and beyond, to identify threats and opportunities for the Luxembourg fund industry.

Shape regulation
An up-to-date, innovative legal and fiscal environment is critical to defend and improve Luxembourg's competitive position as a centre for the domiciliation, administration and distribution of investment funds. Strong relationships with regulatory authorities, the government and the legislative body enable ALFI to make an effective contribution to decision-making through relevant input for changes to the regulatory framework, implementation of European directives and regulation of new products or services.

Foster dedication to professional standards, integrity and quality
Investor trust is essential for success in collective investment services and ALFI thus does all it can to promote high professional standards, quality products and services, and integrity. Action in this area includes organising training at all levels, defining codes of conduct, transparency and good corporate governance, and supporting initiatives to combat money laundering.

Promote the Luxembourg investment fund industry
ALFI actively promotes the Luxembourg investment fund industry, its products and its services. It represents the sector in financial and in economic missions organised by the Luxembourg government around the world and takes an active part in meetings of the global fund industry.

ALFI is an active member of the European Fund and Asset Management Association, of the European Federation for Retirement and of the International Investment Funds Association.

To keep up to date with all the news from the association and the fund industry in Luxembourg, join us on LinkedIn (The Luxembourg Fund Industry Group by ALFI), Twitter (@ALFIfunds), Youtube, Vimeo or visit our website at www.alfi.lu.

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Real Estate Investment Funds Financial Reporting

guidelines