

Real Estate Fund Valuations: Understanding Auditors' Expectations and Avoiding Pitfalls in the Process

November 5, 2021



As you look to begin your real estate fund, keep in mind that the valuation of investments held by the fund comprise a key component of the annual financial statement requirements pursuant to generally accepted accounting principles (GAAP). is. These valuations are more than just an audit compliance responsibility; they are a way to provide investors with confidence in their investments and serve as an indicator of the fund's performance. As you navigate the valuation process, it is important to manage expectations with your auditors in order to avoid many of the common valuation process pitfalls which can hinder the audit process, increase costs and delay the release of financial statements. Here are some expectations along with items to watch out for as you begin the asset valuation process.

Valuation Expectations:

Timing: Investment valuations should be performed timely, considering the legal and compliance requirements of your partnership or operating agreement. If the legal

documents provide for a December 31st year-end audit, initial/draft valuations should be prepared in November of that year and reviewed by you and your auditors shortly thereafter. Once the significant valuation assumptions have been agreed upon, the valuation model can then be promptly rolled forward to December 31st.

Internal versus external valuations: Establish whether the property and investment-level valuations will be performed by a third-party appraiser or an internal professional and discuss this with your auditors. Consider the following when making your decision:

- If the valuations are to be prepared internally, do the individuals performing them have the proper qualifications? Do they have a professional certification or license (i.e., Certified General Appraiser)? Do they have experience in real estate valuations, specifically those involving financial reporting?
- If valuations are to be prepared externally, do the third-party appraisers have the necessary skills and qualifications? Do they meet the requirements to be considered a Member Appraisal Institute (MAI) and do they have experience with the asset class and geographic area of your fund's assets?

Understanding property versus investment valuations: Your valuation policy should explain that property valuations will be performed in accordance with GAAP, ASC 820 – Fair Value Measurements and Disclosures (ASC 820). Once a property's value has been determined, in order to value the investment, the formula would generally be as follows: property value plus realizable assets minus realizable liabilities, including preferred return, promote fees payable to third parties, mortgage payables and other realizable liabilities. Please note that your auditors may not accept property-level appraisals that are not prepared in accordance with ASC 820.

Third-party data: Valuations should be based on appropriate available third-party data that is both verifiable and supportable. Be prepared to provide your auditors with the third-party support used by your internal valuation experts or third-party appraisers, noting that this information will likely be disclosed in the footnotes of the audited financial statements.

Valuation Pitfalls:

Here are some common pitfalls and what to watch out for:

1. Using unverifiable inputs - The investment valuation models used to value investments will utilize assumptions for various inputs to the models. It is important that these inputs and assumptions be based on verifiable third-party data. These include, but are not limited to, terminal capitalization rates, discount rates, expense and revenue growth rates, leasing commissions and lease-up periods, reserves, etc. The use of unverifiable inputs will lead to increased audit scrutiny and a more difficult audit process overall.
2. Using the valuation method that is not most applicable to the investment or not taking into consideration various valuation methods - There are several ways to value an investment, such as: the cost approach, sales comparable approach and discounted cash flow method. When determining the appropriate method to use, you should consider maximizing the use of observable inputs while minimizing the use of unobservable inputs. Whichever inputs you use, make sure to explain how it was determined that they were the right fit for your fund.
3. Having an over-reliance on past information - The value of an investment is based on its expected future performance. While historical data can help you determine trends and predict future results, one must not blindly extrapolate this data assuming these trends will continue. It is important to consider whether there have been any changes in operations or previous nonrecurring events that could affect future revenue and expense expectations, further impacting the valuation of the real estate investment.
4. Ignoring cash flows and focusing on profitability - Profitability is a key part of valuing an investment, but it's not the only part. Non-core operations, non-operating assets and abnormal historical events could also have an impact on the valuation. Your valuation should be based on cash flows and not just profitability.

5. Making overly optimistic revenue forecasts – When looking into the future, it's easy to imagine everything going well. But this can lead to revenue forecasts that are overly optimistic, expense projections that are too low, unrealistically short lease-up periods or unrealistic terminal capitalization and discount rates, throwing off your valuation. Thus, it is important to consider potential negative events, like growth constraints and changes in the competitive landscape.
6. Ignoring transactions costs – Transactions costs to acquire a property, such as title searches, attorney fees, commissions and other costs can be considerable. While these costs are built into the cost-basis of the investment, they have no value and should be treated as a sunk cost when valuing an investment.
7. Not accounting for preferred equity – Remember not to overlook promote payable to third parties at the investment level and preferred equity as part of the valuation process, as these factors generally reduce the value of the investment.
8. Accounting based on book value instead of market value – It is important to understand that the book value of an investment does not represent the actual market value of the investment. For example, the balance sheet would not reflect any unrecorded assets or liabilities, such as goodwill or environmental claims. Be diligent in determining the true market value of your investment.
9. Using simple rules of thumb instead of proper valuation methods – There are certain valuation rules of thumb, such as setting the value of the underlying property based on a multiple of revenues. While these shortcuts may save time, they will most likely not be acceptable for audit purposes.

These valuation pitfalls can result in you losing the trust of your investors and can even lead to compliance and auditing issues. However, they can be avoided.

Hiring a qualified MAI, an expert in the asset class and geographic location, to perform the valuations will help mitigate many of the pitfalls discussed above. The money you spend on the proper valuation guidance could pay for itself by containing

audit cost expenditures. Make sure to work with an accounting firm that understands the nuances of the valuation process and can provide valuable input before valuations are finalized.

For more information on how to best avoid valuation pitfalls, please contact Anchin's [Emerging Manager Platform team](#), or your Anchin Relationship Partner.