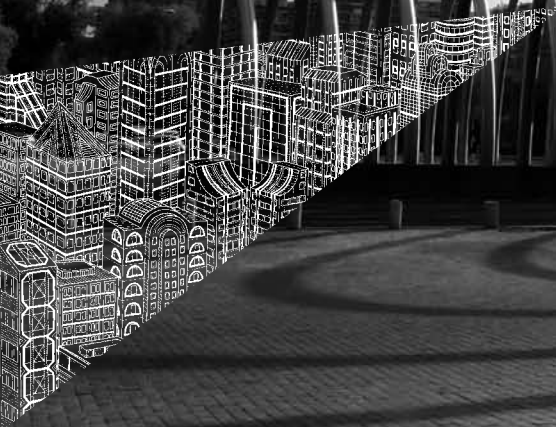


Caution: fair values in progress

Accounting for Investment property
under construction



Accounting for investment property under construction



“In May 2008, as part of its annual improvement process, the IASB approved changes that brought investment property under construction into the scope of IAS 40 for annual periods beginning on or after 1 January 2009.”

What's happened?

In December 2007 we published *Real Estate IFRS Financial Statements Survey – 2007*, our review of the financial statements of twenty five of the largest real estate companies reporting under International Financial Reporting Standards (IFRS). The survey showed that there was general consensus on the policy adopted for measuring development properties – the majority of those companies that included a policy for investment property under construction chose to measure them at cost.

However, five companies chose to measure these assets by applying the revaluation option they believe that IAS 16 – *Property, Plant and Equipment* offers. Four of these were based in the UK and one in Australia. For example, the UK group, Liberty International plc, stated, perhaps with a nod towards the observation in IAS 40 – *Investment Property* which opines that it may be difficult to estimate fair value reliably for investment property under construction, that it had elected to use the revaluation option in IAS 16 as “*reliable estimates are available*”. Figure 1 provides an overview of the current model for accounting for investment property.

Fig 1 – Existing model for accounting for investment property

| IAS 40 | | IAS 16 | |
|--|--|---|---|
| Completed investment property and those being redeveloped. | | Investment property being constructed. | |
| | | | |
| Same cost model as in IAS 16. | Fair value with changes in fair value taken to profit or loss. | Historical cost. | Fair value with any revaluation changes taken directly to equity, not profit or loss. |
| | | After completion of construction, the asset is reclassified into the scope of IAS 40 and, at that point, the difference between fair value and carrying value is taken to profit or loss. | After completion of construction, the asset is reclassified into the scope of IAS 40 and, at that point, the difference between fair value and carrying value is taken to profit or loss. |



But the question of whether the revaluation option was actually available under IAS 16 for development properties was raised with the International Financial Reporting Interpretation Committee (IFRIC) during 2006. The IFRIC noted that whilst the Basis for Conclusions on IAS 40 implies that investment property under construction may not be revalued, IAS 16 does not preclude accounting for such property using the revaluation model. The IFRIC also noted that since IAS 40 was written, the use of fair values in accounting has become more widespread and valuation techniques have become more robust.

The IFRIC therefore considered that the requirement that investment property under construction be accounted for under IAS 16 may no longer be necessary and referred the issue to the International Accounting Standards Board (IASB).

The IASB noted that:

- ▶ investment property being redeveloped remained within the scope of IAS 40 and that the exclusion of investment property under construction gave rise to a perceived inconsistency; and
- ▶ with increasing experience of the use of fair value measures since IAS 40 was issued, entities were more able to measure reliably the fair value of investment property under construction.

Consequently, in May 2008, as part of its annual improvement process, the IASB approved changes that brought investment property under construction into the scope of IAS 40 for annual periods beginning on or after 1 January 2009.

However, the persistent concern remains that, in some situations, the fair value of investment property under construction cannot be measured reliably. Therefore, the IASB concluded that it would, for those entities that chose the fair value model for completed investment property, allow investment property under construction to be measured at cost if fair value cannot be measured reliably until such time as the fair value becomes reliably determinable or construction is completed (whichever comes earlier). Figure 2 provides an overview of the revised model for accounting for investment property.

Fig 2 – Revised model for accounting for investment property from 2009

| IAS 40 | | |
|--|---|--|
| <p>Completed investment property and those being redeveloped <i>plus</i> investment property being constructed for which fair value can be reliably estimated.</p> | | <p>Investment property being constructed for which fair value cannot be reliably estimated.</p> |
| <p>Same historical cost model as IAS 16.</p> | <p>Fair value with changes in fair value taken to profit or loss.</p> | <p>Cost in accordance with IAS 16 until either its fair value becomes reliably determinable or construction is completed (whichever comes earlier) after which it is measured at fair value.</p> |

Accounting for investment property under construction continued



So, what does this mean in practice?

From 2009, entities reporting under IFRS will be required to re-classify investment property under construction as investment property.

This means that any entities who wish to measure their completed investment property at fair value – and our 2007 survey of real estate companies found that this is almost universal practice – will also need to measure their investment property under construction at fair value (subject to fair value being reliably determinable). IAS 40 does not allow an inconsistent application of its fair value model.

In fact, even if an entity measured its investment property using the cost model (the other measurement option available in IAS 40) it would still need to obtain the fair value of the investment property under construction (unless it was for the reason that a fair value is not reliably available), since IAS 40 requires the disclosure of the fair value.

The IASB has, however, allowed that entities apply these changes prospectively for annual periods beginning on or after 1 January 2009. An entity is permitted to apply the amendments to investment property under construction from any date before 1 January 2009 provided that the fair values of investment properties under construction were determined at those dates. Earlier application is permitted. So the first entities to mandatorily report under the revised IAS 40 will be those entities that provide quarterly information for the period to 31 March 2009.

But how can a property that is not yet built be valued?

The general lack of current (or recent) transaction prices of similar properties under construction usually requires the use of estimation models. IAS 40 does not contain any specific guidance as to the valuation of investment properties under construction and reference is often made to International Valuation Standards (IVS) but the extent of IVS guidance in this area is quite limited. Looking further, in the United Kingdom, The Royal Institution of Chartered Surveyors has issued Valuation Information Paper 12 – *Valuation of Development Land*, but this specifically excludes land in the course of development.

Of course, all valuations of real estate involve forecasting revenues and costs, but the risks and uncertainties associated with a development are much higher than those associated with an acquisition of a completed building. For example, risks during the development phase that are not (or, at least, are less) present in a valuation of an existing building may include:

- ▶ contaminated land or otherwise unexpected rectification costs
- ▶ an extended planning horizon (changes during the planning phase, licensing problems as a result of protest)
- ▶ construction risk (additional works being required)
- ▶ changes in the economic environment during the gestation period. In particular, speculative developments may face reduced rental demand when completed
- ▶ changes in prices of raw materials.



However, existing guidance may not be sufficient in dealing with uncertainties, for example:

- ▶ Should a certain amount of construction be completed before (and, therefore uncertainties be sufficiently reduced) before fair value can be reliably determined? Perhaps, at a minimum, zoning and other necessary licensing should be in place, but the importance of these *vis-à-vis* other elements such as the provision of essential infrastructure has to be judged on a market-by-market basis.
- ▶ How are the remaining uncertainties after this point to be dealt with? If this means the use of higher discount rates, then how much higher?
- ▶ Is a discounted cash flow (DCF) or 'residual' method appropriate or are there superior methods? For example Real Options Methodology is currently applied in valuing oil fields and mines, but it is occasionally used in the Real Estate Industry as well.

In any event, it is vital for investors to have transparent and comprehensive disclosure of the critical valuation parameters and IAS 40 does require disclosures about the valuer and valuation methods and judgments. In particular, the methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors because of the nature of the property and lack of comparable market data.

What do we think?

In our view, the changes proposed by the IASB are likely to be welcomed because:

- ▶ they overcome an existing inconsistency within IAS 40 whereby properties under redevelopment are measured under that standard, whilst properties being constructed are not; and
- ▶ they will require most properties under construction to be either carried at fair value or have the fair value disclosed, thereby providing investors with additional information on the profit potential of investment properties under construction.

Some may argue that, as a valuation of investment projects involves an essentially higher uncertainty factor than a valuation of completed property, the income statement will become increasingly volatile. However, this view does not take into account existing accounting under the cost model where there is significant volatility caused by recognising the entirety of development gains or profits in the year of completion.

But of course, the results of investors/ developers will depend more than ever on the valuations made by real estate appraisers – and the assumptions made by such appraisers have a significant impact on the valuation. So, for the investor, appropriate and transparent disclosure of such methodologies and assumptions will continue to be vital.

We believe there is a need for more detailed guidelines on valuing property under construction and we have started a dialogue with the valuation standard setters on this matter. We are following developments closely.

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