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Real Estate IFRS Financial Statements Survey – 2007

Key Findings

- Almost unanimous adoption of the fair value option in IAS 40 for investment property
- Only UK and Australian companies in the survey utilised the revaluation option in IAS 16 for investment property under construction
- Universal use of external valuers, but few examples of disclosure of numerical assumptions underlying valuations
- Mixed approach to goodwill—some companies impaired goodwill immediately, but most carried it forward on their balance sheets to some extent
- Difficult to determine the potential impact that IFRIC D21 will have on the sector as revenue recognition policies tend not to address the area of pre-completion sales
- Despite the many real estate deferred taxation issues arising from IAS 12, accounting policies do not always describe how complex problems—such as how to interpret ‘manner of recovery’ and deferred tax relating to single asset entities—are dealt with
- Most companies use the alternative approach in IAS 23 and capitalise interest into the cost of qualifying assets
- Most companies apply cash flow hedge accounting
- A small majority use a proportionate consolidation approach for joint arrangement accounting, rather than the equity approach, even though the former option may be eliminated in the future

The real estate industry and International Financial Reporting Standards (IFRS)

The real estate industry encompasses a range of activities from property development to construction, management and maintenance. Clearly, IFRS are applicable to all of these, but this analysis focuses on the use of IFRS in the property investment industry. The key standard for that sector — IAS 40 *Investment Property* — appears relatively straightforward at first glance. However, the relationships between IAS 40 and other standards such as IAS 16 *Property, Plant & Equipment*, IAS 17 *Leases*, IAS 18 *Revenue* and IAS 12 *Income Taxes* and sharply varying customs and legislation in different real estate markets have led to various interpretation issues in practice.

In September 2006, in the Ernst & Young publication, *‘Observations on the Implementation of IFRS’*, we compared certain accounting policies of nine property companies. This year, we have selected a larger sample of twenty five major listed property companies and looked in more detail at the complex areas of accounting that are prevalent in this sector. The companies selected are set out in the table below:

Company	Location	Financial year-end
Westfield Group (Westfield Holdings Limited & controlled entities) (Westfield)	Australia	31 December 2006
The GPT Group (GPT)	Australia	31 December 2006
Investa Property Group (Investa)	Australia	30 June 2007
Stockland Trust (Stockland)	Australia	30 June 2007
Confinimmo SA (Confinimmo)	Belgium	31 December 2006
Foncière des Régions SA (Fonciere)	France	31 December 2006
GECINA (GECINA)	France	31 December 2006
Unibail Holding (Unibail)	France	31 December 2006
Klépierre SA (Klepierre)	France	31 December 2006
Deutsche Annington Immobilien GmbH (Deutsche Annington)	Germany	31 December 2006
IVG Immobilien AG (IVG)	Germany	31 December 2006
Hong Kong Land Limited (Hong Kong Land)	Hong Kong	31 December 2006
Beni Stabili S.p.A (Beni Stabili)	Italy	31 December 2006
Corio NV (Corio)	Netherlands	31 December 2006
Rodamco Europe, NV (Rodamco)	Netherlands	31 December 2006
Fortune Real Estate Investment Trust (Fortune)	Singapore	31 December 2006
Inmobiliaria Colonial, S.A (Inmobiliaria)	Spain	31 December 2006
Castellum AB (Castellum)	Sweden	31 December 2006
Fabege AG (Fabege)	Sweden	31 December 2006
PSP Swiss Property Group Ltd (Swiss Property)	Switzerland	31 December 2006
Land Securities Group PLC (Land Securities)	UK	31 March 2007
The British Land Company PLC (British Land)	UK	31 March 2007
Liberty International PLC (Liberty)	UK	31 December 2006
Hammerson PLC (Hammerson)	UK	31 December 2006
Mapeley Limited (Mapeley)	UK	31 December 2006

Measurement of investment and development property

The fair value option for investment property

Not surprisingly, given the sector's focus on net asset values, almost all of the companies in our survey have adopted the fair value option in IAS 40 for the measurement of their investment property.

However, **IVG** and **Klepierre** are the notable exceptions to this rule. **IVG** adopted the cost model and included the following explanation in its 2005 financial statements:

“Investment properties are carried at depreciated cost in accordance with IAS 40.56 and not at market value. As industry standards with regard to choice of accounting policy for investment property are still evolving, IVG opted to apply the cost model in its consolidated financial statements from 2004. This has the advantage that it is possible to change to the fair value model should this be adopted as best practice by the capital markets. A switch in the other direction from the fair value model to the cost model is not permitted.”

However, this policy choice will be short-lived as can be seen from the following announcement in their 2006 financial statements:

“2006 is the last year in which investment properties will be carried at depreciated cost and depreciated on a flat-line basis according to IAS 40.56. The fair value of investment properties is given separately in the notes. It is calculated using internationally recognized valuation methods.

As the fair value method is now accepted by the capital markets as best practice for measuring investment properties, IVG will switch to the fair value method in 2007. In future, this will mean that fluctuations in the market value of these properties will be recognized in income.”

Since the cost model was applied, **IVG** disclosed, in accordance with IAS 40 paragraph 79(e), that the fair value of Investment Property at 31 December 2006 was €2,908m – some €709m more than the carrying amount.

The other user of the cost model, **Klepierre**, perhaps recognising the needs of the market, has provided *pro forma* financial data that restates its investment property on a fair value basis in order that it may “... produce financial reporting that is both complete and comparable”.

The revaluation option for investment property under construction

There is also a degree of consensus about the policy that has been adopted for measuring development properties: the majority of those companies that included a policy for investment property under construction are choosing to measure them at cost.

However, it is noteworthy that, of the five companies that chose to measure such assets by applying the revaluation option in IAS 16, four of these were based in the UK (the fifth being in Australia). This dichotomy may reflect previous practices under national GAAP. In the UK, investment property under construction was widely carried at fair value prior to the adoption of IFRS. **Liberty**, for example, stated, perhaps with a nod towards the observation in IAS 40 paragraph B17 (in which the IASB indicated that it may be difficult to estimate fair value reliably for investment property under construction), that the group elected to use the fair value model as “reliable estimates are available.”

British Land points out that:

“Any surplus or deficit arising on revaluing investment properties or investment properties being redeveloped is recognised in the income statement”, whilst “Valuation surpluses arising on other development properties, those not previously classified as investment properties, are reflected in the statement of recognised income and expense”.

This reflects the current notion in IAS 40 that a previously recognised investment property under development continues to be accounted for under IAS 40, whereas a new property that has not been accounted for as an investment property is properly dealt with under IAS 16.

The question of whether the revaluation option is even available for development properties under IAS 16 was raised with the IFRIC during 2006. The IFRIC noted that, whilst the Basis for Conclusions to 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 noted that there may be ‘practical issues’ in applying the revaluation model to investment property under construction.

In any event, the IFRIC deferred its discussion on these potential issues and 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 to account for investment property under construction under IAS 16 might no longer be necessary. Consequently, in their October 2006 meeting, the IASB tentatively decided to amend IAS 40 and IAS 16 to include investment property under construction within the scope of IAS 40. In October 2007, the IASB issued an Exposure Draft which would, if finalised as drafted, bring such a change into effect from 1 January 2009.

Presentation of investment property valuations to avoid 'double counting'

Paragraph 50 of IAS 40 requires that, "In determining the fair value of investment property, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities."

We reviewed the companies in our survey to ascertain how this requirement is interpreted in respect of balances arising from:

- SIC-15 *Operating Leases – Incentives*: when an entity offers an initial rent-free period to the lessee, it will recognise an asset and amortise it over the lease term, thereby spreading the reduction in rental income over the duration of the lease; and
- IAS 17: in particular, finance lease balances relating to the properties in question.

Our survey showed that, when disclosed, this requirement in IAS 40 not to double count assets or liabilities recognised separately is usually interpreted as a requirement to adjust the carrying value of an investment property from its fair value to the extent that an asset or liability arises as a result of the application of SIC-15 or IAS 17.

This can lead to some significant presentation adjustments; **Land Securities**, for example, disclosed (as required by paragraph 77 in IAS 40) that the appraised market value for its property portfolio at 31 March 2007 was £11,619m, which was then adjusted to arrive at a book value of £11,440m for

financial statement purposes. However, no adjustments to fair values were disclosed except in the UK and Australian companies. This difference may reflect that long leasehold interests (and, perhaps, even lease incentives) are a more common feature of some real estate markets than others.

Therefore, it can be seen that, despite the requirement of paragraph 33 in IAS 40 for an entity to "measure all of its investment property at fair value", often the disclosed book value of an investment property portfolio will not be the same as the appraised market value of that portfolio.

Valuation methods

The valuer

IFRS does not mandate the use of an independent valuer. However it is encouraged and our survey found that, to some extent, all of these companies used an independent valuer each year.

IFRS requires disclosures about the valuer. Paragraph 75(e) of IAS 40 requires disclosure of whether the estimate of fair value is based on a valuation by an independent valuer who holds a relevant qualification. The disclosures found in our survey were of varying length.

IVG, for example, referred to their fair value disclosures being "predominantly based on valuations performed by reputable neutral appraisers" whilst others named the valuers that were used.

It is interesting to note that **Westfield's** property investments are carried at the directors' determination of fair value based on annual independent valuations where appropriate. Their financial statements explain that a full independent valuation of each shopping centre is obtained at least every three years with independent updates in the intervening periods.

Methodology and assumptions

Paragraph 75(d) of IAS 40 requires the disclosure of:

"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 (which the entity shall disclose) because of the nature of the property and lack of comparable market data."

Perhaps the most comprehensive explanation of their valuation methodology was provided by **Castellum** whose narrative continues for three pages. But typically, disclosures were restricted to far less expansive descriptions. In general, the companies in our survey briefly described the valuation methodologies utilised. **Westfield** was typical in its comment:

“In determining the fair value, the capitalisation of net income method and the discounting of future cash flows to their present value have been used, which are based upon assumptions including future rental income, anticipated maintenance costs, appropriate discount rate and make reference to market evidence of transaction prices for similar properties.”

Other companies went further and disclosed that the appraisal was carried out in accordance with certain valuation standards, for example, **Rodamco** referred to the fifth edition of the “*Appraisal and Valuation Standards*” (the “*Red Book*”), published by the Royal Institution of Chartered Surveyors (RICS) and the seventh edition of “*International Valuation Standards*” published by the International Valuation Standards Committee (IVSC).

Some companies gave details on how different segments were dealt with — **Unibail** gave an explanation of how its valuation methodology differed between offices, shopping centres and convention-exhibitions buildings and in some cases the names of the external valuers were given.

Few of the companies in our survey gave a quantification of the assumptions underlying the valuations in the financial statements — although information is often provided elsewhere in the annual report as well. The European Public Real Estate Association (EPRA) recommends in its November 2006 “*Best Practices Policy Recommendations*” that:

“... real estate companies should disclose the valuation methodology applied (eg, open market value existing use, net of purchasers costs), and specify (on an average basis for each sector of the portfolio) the quantitative elements and assumptions applied in valuing the investments property. For instance, when a DCF approach is used, the average growth rates, costs, discount rates and exit yields should be quoted.”

But, of course, the preparers of financial statements must make a judgement about what constitutes a ‘significant assumption’ and that will be a matter of interpretation.

As already noted, **Castellum** gave considerable detail and fellow Swedish company **Fabege** disclosed its assumptions for annual inflation, weighted cost of capital, weighted yield requirement, residual value, average long-term vacancies, and operation and maintenance cost per square metre.

It may be that the recent market uncertainty arising from the credit crunch in late summer 2007 will prompt the preparers of accounts to give more numerical information about the critical assumptions in their estimates of fair value in their forthcoming financial statements.

Disposals of complete and incomplete investment property

Paragraph 9 of the Appendix to IAS 18 states that:

“Revenue is normally recognised when legal title passes to the buyer. However, in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue.”

We found considerable variety in the way that the industry has addressed this issue.

Whilst “equitable interest” is not defined in IFRS (and, consequently, interpretations may vary), companies are required to judge when it is most appropriate to recognise a disposal. As noted in our 2006 survey, not all entities explicitly state how this issue is interpreted, but in practice, some companies delay profit recognition until legal completion, whilst others recognise profit before that point when the significant risks and returns have been transferred to the buyer. The two approaches are illustrated in the following extracts:

Mapeley’s policy is described as,

“Income earned from property trading consists of proceeds from the sale of trading properties. Sales are recognised on completion of sale contracts.”

Whilst **Liberty** takes a slightly different approach in that,

“Where revenue is obtained by the sale of properties, it is recognised when the significant risks and returns have been transferred to the buyer. This will normally take place on exchange of contracts unless there are conditions attached. For conditional exchanges sales are recognised when these conditions are satisfied.”

The recognition of revenue on real estate sales becomes more complex in the case of real estate developments where the asset has been forward sold to the ultimate buyer prior to the completion of construction. Such forward sale contracts are common in areas such as multiple-unit real estate developments (for example, residential apartment blocks)

and commercial property developments that the developer has decided not to build speculatively and where agreements for sale are reached before construction is complete. In these situations, the developers start marketing the development before construction is complete — or even before construction has started — and buyers enter into agreements to acquire either the entire building or a specific unit within the building upon completion of the construction. The contracts may require the buyer to pay a deposit and progress payments, which are refundable only if the developer fails to complete and deliver the unit. The balance of the purchase price may be payable only when the buyer gains possession, which often coincides with the point at which legal title is transferred to the buyer. However, legal title may transfer at different times, depending on national laws and practices.

The majority of the companies in our survey did not provide an explicit accounting policy for this issue but **IVG** and **Immobiliaria** demonstrate the different methods that are currently used.


IVG stated that its turnover includes,

“Revenue from project development, either in the form of construction contracts accounted for using the percentage of completion method if its criteria are met, or with revenue recognition on completion and transfer of economic ownership.”

Conversely, **Immobiliaria’s** policy states that:

“Under IFRS, revenues from sales of developments are recognised by the Group when ownership of the goods is transferred. Until then, expenses incurred in connection with the development construction work are accrued in inventories and down payments received against the total sale price are recorded under “Customer pre-payments” on the accompanying balance sheet.”

In determining the appropriate revenue recognition policy for pre-completion contracts, the first issue that needs to be resolved is which standard is applicable: IAS 18 or IAS 11? This matter was the subject of an IFRIC Draft Interpretation, D21 – *Real Estate Sales*, which was issued in July 2007.



D21 provides guidance about when the selling entity should recognise revenue from the sale of real estate. Specifically, D21:

- clarifies whether sale agreements entered into before construction is complete should be regarded as construction contracts within the scope of IAS 11 or agreements for the sale of goods within the scope of IAS 18; and
- revises guidance on applying IAS 18 to real estate sales in general.

In terms of the Draft Consensus set out in D21, IAS 11 applies if the sale agreement meets the definition of a construction contract in IAS 11. IAS 18 applies if the sale agreement is instead an agreement for the sale of goods (completed real estate).

IAS 11 defines a construction contract as “a contract specifically negotiated for the construction of an asset or a combination of assets.” Consequently, a sale agreement meets this definition if it is an agreement for the seller to provide construction services to the buyer’s specifications.

D21 identifies features that, individually, or in combination, may indicate that: (i) an agreement is for the seller to provide construction services to the buyer’s specifications; or (ii) an agreement is for the sale of goods (completed real estate).

If a sale agreement is for the sale of goods, revenue is recognised when all the conditions in IAS 18 have been satisfied.

In the event that D21 is converted to a final Interpretation, then paragraph 9 of the appendix to IAS 18 (Real estate sales) will be deleted in its entirety. Such final Interpretation is likely to be effective for annual periods beginning on or after mid-2008.

Goodwill

Goodwill can only arise on a business combination; it is important to note that the acquisition of a subsidiary is not automatically a business combination as defined in IFRS 3 *Business Combinations*. In many cases, the acquisition of an entity owning just a few properties is not a business combination — rather, it is often an asset purchase. Even the acquisition of a company owning a large portfolio of properties may constitute an asset purchase. Each transaction must be judged on its own merits.

It is sometimes argued that investment property companies that carry their property at fair value cannot have goodwill on their balance sheets since goodwill needs to be justified by future cash flows – and a property investor’s future cash flows are already built into the fair value of the investment property.

Under IFRS, the issue has become more acute. On a business combination, deferred taxation is provided in accordance with IAS 12 and this is usually far in excess of the fair value of the expected liability to taxation. As it is the fair value of the liability that is generally considered in setting the price for the business acquired, such an approach tends to increase the amount of goodwill arising.

This issue is highlighted by **Land Securities** when referring to an acquisition in 2006:

“During the prior year, the Group acquired 100% of Tops Estates PLC. The fair value exercise gave rise to goodwill of £64.5m. The goodwill arises primarily from the difference between how deferred tax was calculated for accounting purposes and the value ascribed to it in negotiations. The former was based on the difference between the values of the assets and liabilities concerned for accounts purposes and those applying for taxation.

The latter was based on tax payments likely to be made. In the Group’s opinion, the carrying amount of this goodwill could not be justified by reference to future cash flows and it was accordingly impaired.”

Whilst IAS 36 *Impairment of Assets* explicitly requires tax to be excluded from the estimate of future cash flows used to calculate any impairment, it is our view that it cannot have been the intention of IAS 36 to require an immediate impairment of goodwill generated by the recognition of deferred taxation liabilities in excess of their fair value — although this is often the practical approach that is adopted.

Our survey found a wide range of practices. Of those companies that recorded goodwill in their financial statements on the acquisition of a business, three (**Westfield**, **Land Securities** and **GPT**) impaired that goodwill immediately for various stated reasons. Somewhat unusually, two companies (**Swiss Property** and **Hong Kong Land**) actually reported negative goodwill that had been released to income.

However, ten companies carried goodwill in their balance sheets and, in this situation, IFRS 3 mandates an annual impairment test of goodwill in accordance with IAS 36. In so doing IAS 36 requires, amongst other things, a description of the key assumptions used by management — for example, in the case of a ‘value in use’ calculation, the assumptions on which management based cash flow projections for the period covered by the most recent budgets and forecasts.

In respect of its value in use calculations, **Investa** discloses its assumptions for gross margin, growth rates and the discount rates applied. **Fonciere** discloses its assumptions for growth rates and discount rates.

Taxation

Seventeen of the companies in our survey qualify for special tax regimes (Real Estate Investment Trusts (REITs)). Broadly, REITs benefit from tax exemptions in relation to profits from a qualifying property letting business and an exemption for qualifying chargeable gains. There are national characteristics specific to each, but the fact that, generally, REITs are not subject to taxation means that few taxation issues arise.

However, for the entities that do not have the benefit of such exemptions, there are numerous issues arising from the application of IAS 12, especially in the calculation of deferred taxation. Below we consider two of these: dual tax base assets and single assets entities.

Dual tax base assets

Under IAS 12 *Income Taxes*, deferred tax must be measured by reference to the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the asset or liability to which it relates.

IAS 12 notes that, in some jurisdictions, the manner in which an entity recovers the carrying amount of an asset may affect either or both of:

- the tax rate applicable when the entity recovers the carrying amount of the asset ; and
- the tax base of the asset.

In such cases, an entity should measure deferred tax assets and liabilities using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

We believe that, in determining the expected manner of recovery of an asset for the purposes of IAS 12, an entity should assume that, in the case of an asset accounted for under IAS 16, it will recover the residual value of the asset through sale and the depreciable amount through use.

But, of course, IAS 40 allows a fair value treatment for investment properties, so for *these* purposes, no residual amount need be calculated. SIC 21 clarifies that, where a non-depreciable asset is revalued, any deferred tax on the revaluation must be calculated by reference to the tax consequences that would arise if the asset were sold at book value. This applies irrespective of the basis on which the value is measured, or the manner in which the economic benefits

of the asset are expected to be realised. The rationale for this treatment is that, in accounting terms, the asset is never recovered through use, as it is not depreciated.

SIC 21 also clarifies that it is to be applied to investment properties only to the extent that they would be considered non-depreciable if IAS 16 were applied. Thus, where an investment property is accounted for using the fair value model in IAS 40, the fact that the asset is not depreciated for financial reporting purposes does not imply that it is intrinsically not depreciable and, as a result, entirely within the scope of SIC 21. Rather, SIC 21 applies only to that part of the carrying amount of the asset that would not be depreciated if it were accounted for under IAS 16.

The practical effect of this is that deferred tax relating to that portion of the carrying amount of an investment property that would be depreciated under IAS 16 (taking into account appropriate management intent) should be measured on an ‘in use’ basis, as opposed to an ‘on sale’, basis.

An investment property will typically comprise land together with one or more buildings erected on the land. The element of the total carrying amount represented by the land would be considered non-depreciable under IAS 16, and any deferred tax relating to the land element of the property should, under SIC 21, be measured at the tax rate applicable on sale.

Some companies in our survey explained how this issue was interpreted. **Rodamco** notes that:

“In the real estate business, different tax rates and taxable bases exist for capital gains arising from investment property transactions (‘asset transactions’) or capital gains arising from share transactions of property investment companies. The Group uses the corporate income tax rate or the capital gain tax rate as the basis for the deferred tax calculation depending on how the temporary difference can be recovered (through use of the investment property or sale of the investment property or a combination of both). The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantially enacted at the balance sheet date.”

More specifically, in its 2005 financial statements (prior to entry into the UK REIT regime), **Hammerson** offered the following explanation:

“Under IAS 12, deferred tax provisions are made for the tax that would potentially be payable on the realisation of investment properties and other assets at book value. For UK investment properties, deferred tax is calculated on the basis that properties will be realised predominantly through sale so that capital gains are reduced by indexation.”

On the other hand, in its 2005 financial statements prior to its entry into the UK REIT regime, **Liberty** took the view that,

“Under IAS 12 (Income Taxes) provision is made for the deferred tax liability associated with the revaluation of investment properties. The group does not provide for deferred tax on investment properties by reference to the tax that would be due on the sale of the investment properties as the group has no current intention to dispose of these properties. Instead, the group treats the value of the investment properties as being recovered through use, and so provides for deferred tax on the revaluation of investment properties by applying the corporation tax rate of 30 per cent to the revaluation surplus without indexation allowance.”

It should be noted that the IASB has indicated its desire to eliminate the guidance that management’s intent as to the manner in which an entity will recover or settle the carrying amount of an asset or liability can affect the tax base of that asset or liability. This evolution may potentially be troublesome for real estate companies because, in order to determine whether a temporary difference ‘... will result in taxable or deductible amounts when the reported amount of the asset ... is recovered’, it is surely necessary to have regard to the manner in which that asset is going to be recovered, and the timing of that recovery.

Single asset entities

In many jurisdictions it is common for properties to be bought and sold by transferring ownership of a separate legal entity formed to hold the property (a ‘single asset’ entity) rather than the property itself.

A ‘single asset’ entity may be formed for a number of reasons. For example, where the true owner of the property is a natural person, the insertion of a ‘single asset’ entity between that individual and the property may limit the individual’s personal liability for obligations arising from ownership of the property. More pertinently, it may also provide shelter from tax liabilities arising on disposal of the property since, in many jurisdictions, the sale of shares is taxed at a lower rate than the sale of property.

This raises the question whether, in determining the expected manner of recovery of an asset for the purposes of IAS 12, an entity may have regard to the fact that an asset held by a ‘single asset’ entity can be disposed of by disposing of the shares of the entity rather than the asset itself. Few companies in our survey explicitly indicated whether this issue was significant to them.

A natural reading of IAS 12 could suggest that, where the reporting entity prepares consolidated financial statements (such that the asset held by the ‘single asset’ entity is included in those financial statements), it is not appropriate to have regard to the possible tax effects of disposing the shares in the ‘single asset’ entity rather than the asset itself. This is because paragraph 51 of IAS 12 requires an entity to have regard to the expected manner of recovery or settlement of ‘the carrying amount of its assets and liabilities’. Where consolidated financial statements are prepared, the asset recognised in the balance sheet is the property held by — rather than the shares in — the ‘single asset’ entity (which are eliminated on consolidation).

However, the IASB apparently regards the position as at least ambiguous since in July 2005 it indicated that the revised version of IAS 12 will contain guidance on determining the tax base of an asset when different deductions are available depending on whether an asset is sold separately or in a ‘single asset’ entity.

Consequently, we believe that there could be specific limited circumstances where the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities at the balance sheet date may also include the sale of a ‘single asset’ entity. These could include situations where a property that is clearly not a business is already held by such an entity.

Other issues

Finance costs

Of the 23 companies that disclosed accounting policies in relation to finance costs, only two companies (**IVG** and **Fortune**) did not adopt the allowed alternative in IAS 23 to capitalise finance costs that are directly attributable to the construction of qualifying assets.

This is another area where change is coming. The IASB has reconsidered capitalisation of interest as part of its short-term convergence project with US GAAP and, as a result, has changed direction. In March 2007, it issued a revised version of IAS 23, effective from 1 January 2009, this time mandating capitalisation.

Nevertheless, the revised IAS 23 does not require companies to capitalise interest in respect of assets that are measured at fair value. If the assets are held under a full fair value model with all changes going to the income statement, then capitalisation of interest does not affect measurement in the balance sheet and is no more than a reallocation between finance costs and the fair value movement in the income statement. However, the exemption is not restricted to assets where the fair value movement is taken to the income statement. Other assets measured at fair value, for example, properties in the course of construction that fall under IAS 16's revaluation model, are also eligible for this scope exemption even though the revaluation goes to equity rather than income. Most such properties will be investment properties in the course of construction and are currently not within scope of IAS 40. As a result, this will cease to be an issue if and when the proposed amendment to IAS 40 enables them to be classified as investment properties.

Cash flow hedge accounting

Our survey shows that only one company, **Deutsche Annington**, utilised fixed rate borrowings for all of their debt requirements. Whilst, unsurprisingly, none of the companies are entirely financed by equity, eight companies had only variable rate borrowings. The remaining companies used a mixture of fixed and variable rate debt.

All of the companies that used either all variable rate debt or a blend of fixed and variable rate borrowings used interest rate swaps to manage the consequent interest rate risk. The interest risk management policies of these companies varied from the aim of converting all of their variable interest bearing borrowings into fixed rate debt interest to achieving a target ratio between fixed and variable rate borrowings predetermined by the management.

Liberty, for example, states that:

“Group debt carries both fixed and floating interest rates. Bank debt is typically at floating rates linked to LIBOR for the relevant currency. Bond debt and other capital markets debt is generally at fixed rates. The group's policy is to eliminate substantially all exposure to interest rate fluctuations in order to establish certainty over long-term cash flows.”

Whilst **Investa's** policy is that:

“The Group uses a combination of fixed rate debt and interest rate derivatives to ensure that the rate of interest on debt is predominantly fixed.”

And,

“**Corio's** policy is to finance between 1/3 and 2/3 of its borrowing requirements at fixed rates and to aim for an average financing term of at least five years.”

Our survey shows that twenty companies using derivatives also applied cash flow hedge accounting to account for their positions in such derivative instruments. Consequently changes in the fair value of those derivatives that were determined to be effective hedges were recognised directly in equity. Only four companies using derivatives did not use hedge accounting for these instruments. Instead, they classified their derivatives as trading instruments with all changes in the fair value of those instruments being reported in the income statement.

It seems clear that the industry strongly prefers to actively manage its interest rate risk by making use of derivatives rather than locking into fixed rate debt. This is, perhaps, not surprising in an industry which commonly has a highly leveraged capital structure but future cash inflows that are fixed for relatively short periods only, due to rent reviews or short leases.

Accounting for joint arrangements

It is very common for property investors to enter into joint arrangements to facilitate investment in real estate assets. Often these arrangements take the form of an interest in another legal entity and, as such, are classified by IAS 31 *Interests in Joint Ventures* as Jointly Controlled Entities (JCEs). Currently, IAS 31 provides two options for accounting for such JCEs — proportionate consolidation and the equity method.

Our survey shows a very mixed approach. Of the twenty five companies studied, seven used equity accounting and ten used proportionate consolidation, whilst the remaining eight did not disclose a policy choice. However, once again, there are certain national characteristics — six of the seven companies using equity accounting are either Australian or part of a UK group. The seventh, **Hong Kong Land**, explains that “Joint ventures are included on the equity basis of accounting”.

In any event, the option to proportionately consolidate JCEs may soon be removed by the IASB. The IASB Exposure Draft (ED) 9 *Joint Arrangements* is intended to replace the existing requirements of IAS 31 and is another step in the short-term conversion project with US GAAP.

The ED establishes the core principle that parties in a joint arrangement are to recognise their contractual rights and obligations arising from an arrangement. ‘Joint Venture’ will replace the term ‘JCE’ — in a Joint Venture the parties do not have rights to individual assets or obligations for expenses of the venture. Instead, each party shares in the outcome (e.g., profit or loss) of the activity. Such arrangements will be accounted for using the equity method and proportionate consolidation will no longer be available.

Therefore, groups that currently account for JCEs using proportionate consolidation will, if ED 9 is adopted, need to change their policies. However, rather than simply switch to equity accounting, the contractual arrangements will need to be examined to ascertain whether the parties have rights or obligations relating to the individual assets and liabilities of the joint arrangement. If so, those assets and liabilities will have to be recognised directly in the financial statements.

EPRA recommendations

The latest version of the European Public Real Estate Association’s (EPRA) best practice recommendations regarding financial statements were published in November 2006 by EPRA’s Best Practices Committee. As set out in the introduction to that publication, the main objective of EPRA was to foster widely accepted industry-specific best practices to enhance the transparency and comparability in the financial reporting of real estate companies in Europe. The recommendations cover a wide range of subjects in the accounting policy and financial reporting area from performance review by management, calculation of earnings and net asset value per share (NAV) to measurement methods to be applied by companies in the industry. For the purpose of this analysis, only the implementation of recommendations on the NAV per share calculation is considered.

Whilst the majority of the companies (sixteen) disclosed NAV per share information in the annual reports, only four (one Nordic, one French and two UK companies) explicitly stated that information was prepared in accordance with the EPRA’s best practice recommendations.

Two of these companies (**Hammerson** and **British Land**) claim compliance with EPRA recommendations only for the purpose of NAV per share calculation and **Rodamco** stated partial compliance. Only **Unibail** explicitly stated full compliance with all the EPRA recommendations.

Conclusion

The real estate industry is a good example of the differences that can arise from the application, and, more importantly, the interpretation, of apparently straightforward standards.

Clearly, there are different measurement options available to the real estate industry and these are widely understood. Whilst, for example, there is almost uniformity amongst the companies in our survey in the application of the fair value method for investment property under IAS 40, there is a clear divide in respect of the use of the revaluation option for development properties accounted for under IAS 16.

Perhaps of more interest is the varied level of detail in the disclosures in the financial statements regarding, for example, the assumptions applied in determining fair values, and the varied explanations about the judgments on other issues, for example, goodwill.

Given the differing customs and legislation across national markets, full disclosure of assumptions and judgments made is vital for investors who wish to compare companies' performance across borders. It will be interesting to see how companies in this sector tackle the disclosure requirements of IFRS 7 which is mandatory from 1 January 2007.

If you would like to discuss accounting for real estate in more detail, please contact your regular Ernst & Young representative or one of the people below:

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Appendix – Summary of findings

Company	Investment property	Investment property under construction	Adjustments to valuations disclosed?	External valuer used?	Proportionate Consolidation (% or Equity for JOEs?)	Capitalization of interest in qualifying assets?	Treatment of goodwill	Real Estate Investment Trust (REIT)?	Disclosed NAV per share?	Use of cash flow hedge accounting?
Westfield	Fair Value	Fair Value	Yes	Yes	Equity	Yes	Impaired	REIT	No	Yes
GPT	Fair Value	Cost	Yes	Yes	Equity	Yes	Carried	REIT	No	Yes
Investa	Fair Value	Cost	Yes	Yes	Equity	Yes	Impaired	REIT	No	Yes
Stockland	Fair Value	Cost	Yes	Yes	Equity	Yes	Carried	REIT	No	Yes
Confinimmo	Fair Value	Cost	No	Yes	n/a	Yes	n/a	SICAFI - REIT	Yes	Yes
Foncière	Fair Value	Cost	No	Yes	n/a	Yes	Carried	SIIC - REIT	Yes	Yes
GECINA	Fair Value	Cost	No	Yes	%	Yes	n/a	SIIC - REIT	Yes	Yes
Unibail	Fair Value	Cost	No	Yes	%	Yes	Carried	SIIC - REIT	Yes	Yes
Klépierre	Cost	Cost	n/a	Yes	%	Yes	Carried	SIIC - REIT	No	Yes
Deutsche Annington	Fair Value	n/a	No	Yes	n/a	n/a	n/a	No	No	No
IVG	Cost	Cost	n/a	Yes	n/a	No	Carried	part REIT	Yes	Yes
Hong Kong Land	Fair Value	n/a	No	Yes	Equity	Yes	Negative	No	No	Yes
Beni Stabili	Fair Value	Cost	No	Yes	%	Yes	n/a	No	Yes	Yes
Corio	Fair Value	Cost	No	Yes	%	Yes	Carried	No	No	Yes
Rodamco	Fair Value	Cost	No	Yes	%	Yes	Carried	REIT	Yes	Yes
Fortune	Fair Value	n/a	No	Yes	n/a	No	n/a	REIT	No	Yes
Immobiliaria	Fair Value	Cost	No	Yes	%	Yes	Carried	SIIC - REIT	Yes	Yes
Castellum	Fair Value	n/a	No	Yes	n/a	Yes	n/a	No	Yes	No
Fabege	Fair Value	n/a	No	Yes	%	Yes	n/a	No	Yes	No
Swiss Property	Fair Value	Cost	No	Yes	n/a	Yes	Negative	No	Yes	Yes
Land Securities	Fair Value	Fair Value	Yes	Yes	Equity	Yes	Impaired	REIT	Yes	Yes
British Land	Fair Value	Fair Value	Yes	Yes	Equity	Yes	n/a	REIT	Yes	Yes
Liberty	Fair Value	Fair Value	No	Yes	%	Yes	n/a	REIT	Yes	No
Hammerson	Fair Value	Fair Value	No	Yes	%	Yes	n/a	REIT	Yes	No
Mapeley	N/a	Fair Value	No	Yes	n/a	n/a	n/a	No	Yes	Yes

SICAFI = Société d'investissement à capital fixe immobilier

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