

# *Applying IFRS for the real estate industry*

*November 2017*

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# *Introduction to applying IFRS for the real estate industry*

## *What is the focus of this publication?*

This publication considers the main accounting issues encountered by real estate entities and the practices adopted in the industry under International Financial Reporting Standards (IFRS).

## *Who should use this publication?*

This publication is intended for real estate entities that construct and manage real estate property. Activities such as the construction of properties on behalf of third parties, and holding or developing properties principally for sale or otherwise own use, are not considered in this publication.

This publication is intended for:

- audit committees, executives and financial managers in the real estate industry;
- investors and other users of real estate industry financial statements, so they can identify some of the accounting practices adopted to reflect features unique to the industry; and
- accounting bodies, standard-setting agencies and governments throughout the world that are interested in accounting and reporting practices and responsible for establishing financial reporting requirements.

## *What is included?*

This publication covers issues that we believe are of financial reporting interest due to their particular relevance to real estate entities and/or historical varying international practice.

This publication has a number of sections designed to cover the main issues raised.

This publication is based on the experience gained from the worldwide leadership position of PwC in the provision of services to the real estate industry. This leadership enables PwC's Real Estate Industry Group to make recommendations and lead discussions on international standards and practice.

We hope you find this publication helpful.

# 1. Real estate value chain

## 1.1. Overview of the investment property industry

The investment property or real estate industry comprises entities that hold real estate (land and buildings) to earn rentals and/or for capital appreciation.

Real estate properties are usually held through a variety of structures that include listed and privately held corporations, investment funds, partnerships and trusts.

## 1.2. Real estate life cycle

The life cycle of real estate that is accounted for as investment property typically includes the following stages:



### 1.2.1. Step 1: Acquisition and construction of real estate

Control of real estate can be obtained through:

- direct acquisition of real estate;
- construction of real estate; or
- leasing of real estate, under either operating or finance leases.

Entities normally perform strategic planning before the acquisition, construction or leasing, to assess the feasibility of the project.

Entities might incur costs attributable to the acquisition, construction or leasing of real estate, during this first step of the cycle. Entities might also enter into financing arrangements to secure the liquidity required for the acquisition and construction of real estate.

### 1.2.2. Step 2: Leasing or subleasing of real estate

Most real estate entities primarily hold real estate for own use or for the purpose of earning rentals.

For entities holding real estate for the purpose of earning rentals, lease agreements might contain a variety of terms. The most common terms that will feature in all leases include matters such as the agreed lease term (and any options to extend that term), as well as the agreed rental payments due. Additional items that might feature include payments for maintenance services, insurance, property taxes and terms of lease incentives provided to the tenant.

### 1.2.3. Step 3: Management of real estate

Real estate entities often provide management services to tenants who occupy the real estate that they hold, to ensure that the property is in good condition and to preserve the value of the real estate. These services might be performed by the real estate owners themselves, or they might be outsourced to other entities that are designed to provide these services. Services might include maintenance of common areas, cleaning and security.

### 1.2.4. Step 4: Sale or demolition of real estate

Real estate entities might sell the real estate that they hold at the end of the life cycle to benefit from capital appreciation. Alternatively, entities might proceed with demolition of the property, potentially with a view to construction of a new property.

### 1.3. *Relevant accounting standards*

Acquisition and construction of real estate that is accounted for as investment property is governed by the requirements of IAS 40, 'Investment property', IAS 16, 'Property, plant and equipment', and IAS 23, 'Borrowing costs'.

The requirements of IAS 17, 'Leases', apply when an entity leases out the real estate property or an entity does not elect to classify its property interest under an operating lease as investment property. The requirements of IAS 18, 'Revenue', apply for revenue generated by a real estate entity other than lease income.

This publication is based on accounting standards that are effective for periods beginning on or after 1 January 2017.

There are a number of new standards, interpretations or amendments to existing standards issued as of the date of this publication that are not yet effective. Their impact is presented in separate sections under each relevant area or otherwise referred to specifically in the guide. The standards, interpretations or amendments are as follows:

- IFRS 9, 'Financial Instruments', which replaces guidance of IAS 39 on classification and measurement of financial instruments ('IFRS 9');
- IFRS 15, 'Revenue from contracts with customers', which replaces the guidance in IAS 18, IAS 11, IFRIC 13, IFRIC 15, IFRIC 18 and SIC 31 ('IFRS 15');
- IFRS 16, 'Leases', which replaces IAS 17, IFRIC 4, SIC 15 and SIC 27 ('IFRS 16');
- 'Transfers of investment property' amendments to IAS 40, 'Investment Property';
- IFRIC 22, 'Foreign currency transactions and advance consideration' ('IFRIC 22'); and
- IFRIC 23, 'Uncertainty over income tax treatments' ('IFRIC 23').

The following standards, effective as at the date of this publication, are referred to in the guide:

- IFRS 3, 'Business combinations' ('IFRS 3');
- IFRS 5, 'Non-current assets held for sale and discontinued operations' ('IFRS 5');
- IFRS 7, 'Financial instruments: disclosures' ('IFRS 7');
- IFRS 8, 'Operating segments' ('IFRS 8');
- IFRS 10, 'Consolidated financial statements' ('IFRS 10');
- IFRS 11, 'Joint arrangements' ('IFRS 11');
- IFRS 13, 'Fair value measurement' ('IFRS 13');
- IAS 1, 'Presentation of financial statements' ('IAS 1');
- IAS 2, 'Inventories' ('IAS 2');
- IAS 7, 'Statement of cash flows' ('IAS 7');
- IAS 8, 'Accounting policies, changes in accounting estimates and errors' ('IAS 8');
- IAS 11, 'Construction contracts' ('IAS 11');
- IAS 12, 'Income taxes' ('IAS 12');
- IAS 16, 'Property, plant and equipment' ('IAS 16');
- IAS 17, 'Leases' ('IAS 17');
- IAS 18, 'Revenue' ('IAS 18');
- IAS 21, 'The effects of changes in foreign exchange rates' ('IAS 21');
- IAS 23, 'Borrowing costs' ('IAS 23');

- IAS 27, 'Separate financial statements' ('IAS 27');
- IAS 28, 'Investments in associates and joint ventures' ('IAS 28');
- IAS 36, 'Impairment of assets' ('IAS 36');
- IAS 37, 'Provisions, contingent liabilities and contingent assets' ('IAS 37');
- IAS 38, 'Intangible assets' ('IAS 38');
- IAS 39, 'Financial instruments: recognition and measurement' ('IAS 39');
- IAS 40, 'Investment property' ('IAS 40');
- IFRIC 4, 'Determining whether an arrangement contains a lease' ('IFRIC 4');
- IFRIC 13, 'Customer loyalty programmes' ('IFRIC 13');
- IFRIC 15, 'Agreements for construction of real estate' ('IFRIC 15');
- IFRIC 18, 'Transfers of assets to customers' ('IFRIC 18');
- SIC 27, 'Evaluating the substance of transactions involving the legal form of a lease' ('SIC 27'); and
- SIC 31, 'Revenue – barter transactions involving advertising services' ('SIC 31').

## 2. Acquisition and construction of real estate

### 2.1. Overview

Real estate entities obtain real estate either by acquiring, constructing or leasing property. Property used for the purpose of earning rentals is classified as investment property under IAS 40.

### 2.2. Definition and classification

#### 2.2.1. Principles

IAS 40 defines investment property as property that is held to earn rentals or capital appreciation or both. [IAS 40 para 5]. The property might be land or a building (part of a building) or both.

Investment property does not include:

- Property intended for sale in the ordinary course of business or for development and resale.
- Owner-occupied property, including property held for such use or for redevelopment prior to such use.
- Property occupied by employees.
- Owner-occupied property awaiting disposal.
- Property that is leased to another entity under a finance lease.

[IAS 40 para 9].

Owner-occupied property is property that is used in the production or supply of goods or services or for administrative purposes. [IAS 40 para 5]. A factory or the corporate headquarters of an entity would qualify as owner-occupied property. During the life cycle of a property, real estate entities might choose to redevelop property for the purposes of onward sale. Property held for sale in the ordinary course of business is classified as inventory rather than investment property. [IAS 40 para 9(a)]. Transfers between investment property and both owner-occupied property and inventory are dealt with in section 3.7.

Classification as investment property is not always straightforward. Factors to consider, when determining the classification of a property, include but are not limited to:

- the extent of ancillary services provided (see section 2.2.2);
- the extent of use of the property in running an underlying business;
- whether the property has dual use (see section 2.2.6);
- the strategic plans of the entity for the property; and
- previous use of the property.



### **Example – Property leased out to hotel management entity**

#### **Background**

Entity A owns property which it leases out under an operating lease to a hotel management entity. Entity A has no involvement in the running of the hotel or any decisions made; these decisions are all undertaken by the hotel management entity.

Does the property meet the definition of ‘investment property’ for entity A?

#### **Solution**

Yes. Although the property is used as a hotel by the lessee, entity A uses the property to earn rentals, and so the property meets the definition of ‘investment property’.

Where an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property. [IAS 40 para 58]. The property will continue to be classified as investment property until it meets the criteria to be classified as a non-current asset held for sale in accordance with IFRS 5 (see section 6).

### **2.2.2. Ancillary services**

Where an entity provides insignificant ancillary services, such as maintenance, to the third party occupants of the property, this does not affect the classification of the property as an investment property. [IAS 40 para 11].

Where ancillary services provided are more than insignificant, the property is regarded as owner-occupied, because it is being used to a significant extent for the supply of goods and services. For example, in a hotel, significant ancillary services such as a restaurant, fitness facilities or spa are often provided. IAS 40 provides no application guidance as to what ‘insignificant’ means. Accordingly, entities should consider both qualitative and quantitative factors in determining whether services are insignificant.

### **Example – Serviced apartments**

#### **Background**

An entity owns a number of apartments which it leases out to tenants under short-term leases. The entity is also responsible for providing in-house cleaning services, and it undertakes to provide internet, telephone and cable television to the tenants for an additional monthly fee. The additional fee charged for the services is approximately 20% of the monthly rental.

Does the property meet the definition of ‘investment property’?

#### **Solution**

No. The entity provides ancillary services to the tenants other than the right to use the property. The value of these services represents around 20% of the rental income. Therefore, these services cannot be viewed as insignificant. The property is classified as property, plant and equipment in the financial statements of the entity.

### **2.2.3. Properties under construction or development**

Real estate that meets the definition of ‘investment property’ is accounted for in accordance with IAS 40, even during the period when it is under construction. Further, an investment property under redevelopment for continued future use as investment property also continues to be recognised as investment property.

### **2.2.4. Properties held to be leased out as investment property**

Real estate entities might hold investment properties that are vacant for a period of time. Where these properties are held to be leased out under an operating lease, they are classified as investment property.

### 2.2.5. *Properties with undetermined use*

Land with undetermined use is accounted for as investment property. This is due to the fact that an entity's decision around how it might use that land (be it as an investment property, inventory or as owner-occupied property) is, of itself, an investment decision. In turn, the most appropriate classification for such property is as investment property. [IAS 40 para B67 (b) (ii)].

### 2.2.6. *Properties with dual use*

A property might be partially owner-occupied, with the rest being held for rental income or capital appreciation.

If each of these portions can be sold separately (or separately leased out under a finance lease), the entity should account for the portions separately. [IAS 40 para 10]. That is, the portion that is owner-occupied is accounted for under IAS 16, and the portion that is held for rental income or capital appreciation, or both, is treated as investment property under IAS 40.

If the portions cannot be sold or leased out separately under a finance lease, the property is investment property only if an insignificant portion is owner-occupied, in which case the entire property is accounted for as investment property. If more than an insignificant portion is owner-occupied, the entire property is accounted for as property, plant and equipment. There is no guidance under the standards as to what 'insignificant' means; accordingly, entities should consider both qualitative and quantitative factors in determining whether the portion of the property is insignificant.

#### **Example – Hotel resort with a casino**

##### **Background**

Entity A owns a hotel resort which includes a casino, housed in a separate building.

The entity operates the hotel and other facilities on the hotel resort, with the exception of the casino, which can be sold or leased out under a finance lease. The casino is leased to an independent operator. Entity A has no further involvement in the casino. The casino operator will only operate the casino with the existence of the hotel and other facilities.

Does the casino meet the definition of 'investment property'?

##### **Solution**

Yes. Management should classify the casino as investment property. The casino can be sold separately or leased out under a finance lease. The hotel and other facilities would be classified as property, plant and equipment.

If the casino could not be sold or leased out separately on a finance lease, the whole property would be treated as property, plant and equipment.

### 2.2.7. *Group situations*

Within a group of entities, one group entity might lease property to another group entity for its occupation and use. In the consolidated financial statements, such property is not treated as investment property, because from the group's point of view the property is owner-occupied. In the separate financial statements of the entity that owns the property or holds it under a finance lease, the property will be treated as investment property if it meets the definition. [IAS 40 para 15].

In contrast, property owned or held under a finance lease by a group entity and leased to an associate or a joint venture should be accounted for as investment property in both the consolidated financial statements and any separate financial statements prepared. Associates and joint ventures are not considered part of the group for consolidation purposes.

### 2.2.8. Properties held under operating leases

An entity might choose to treat a property interest that is held by a lessee under an operating lease as an investment property if:

- the rest of the definition of investment property is met (see section 2.2); and
- the lessee uses the fair value model in IAS 40 (see section 3.5).

This choice is available on a property-by-property basis. The initial cost of a property interest held under an operating lease and classified as an investment property is as prescribed for a finance lease (that is, an asset should be recognised at the lower of the fair value of the property and the present value of the minimum lease payments). [IAS 40 para 25].

#### Impact of IFRS 16

IFRS 16 brings almost all leases on the balance sheet of the lessee. The lessee recognises a right-of-use asset and a corresponding liability at the lease commencement date. [IFRS 16 para 22].

As a result, under IFRS 16, property currently held under operating leases will be recognised on the balance sheet. If this property meets the definition of investment property, it is initially recognised in accordance with IFRS 16, and it is subsequently accounted for as investment property in accordance with IAS 40.

The right-of-use asset might subsequently be carried at cost or fair value, depending on the accounting policy of the entity for investment properties.

#### **Example – Recognition of property held under an operating lease as investment property**

##### **Background**

An entity owns a hotel that it leases out (as lessor) under an operating lease to a hotel management group. The hotel is situated on land leased by the government to the entity (as lessee) for a period of 99 years, with no transfer of title to the entity at the end of the lease. The hotel building's useful life is expected to be approximately 40 years. There are no provisions in the lease to return the land with the building intact at the end of the 99-year lease. At inception of the lease, the present value of the minimum lease payments is significantly lower than the fair value of the land. On considering the lease classification guidance in IAS 17, it has been determined that the land lease meets the definition of an 'operating lease'.

Can the hotel be classified as investment property?

##### **Solution**

###### *Building:*

Yes. The building meets the definition of 'investment property' and should be accounted for under IAS 40.

###### *Land:*

The land meets the definition of 'investment property' and is recognised on the balance sheet as an investment property only if the entity has chosen the fair value model for investment property. [IAS 40 para 6]. Otherwise, it is recognised and accounted for as operating lease under IAS 17.

#### Impact of IFRS 16

Under IFRS 16, the entity will need to recognise a right-of-use asset relating to the leased land.

The right-of-use asset relating to the leased land should be accounted for as investment property, given that it meets the definition. The policy that the entity applies for subsequent measurement of investment property will not affect the classification of the land as investment property.

## 2.3. Acquisition of investment properties: asset acquisition or business combination

Entities might acquire investment properties that meet the definition of an asset or investment properties, together with processes and outputs that meet the definition of a business under IFRS 3.

It is also common in the real estate industry to structure property acquisitions and disposals in a tax-efficient manner. This often involves the transfer of a company, frequently referred to as a 'corporate wrapper', which holds one or more properties.

The accounting treatment for an acquisition depends on whether it is a business combination or an asset acquisition.

A 'business' is defined as an *"integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants"*. [IFRS 3 App A].

The legal form of the acquisition is not a determining factor when assessing whether a transaction is a business combination or an asset acquisition. For example, the acquisition of a single vacant investment property is not a business combination simply because it is effected using a corporate wrapper. Similarly, a transaction is not an asset acquisition simply because the acquiring entity purchases a series of assets rather than a company.

A transaction will qualify as a business combination only where the assets purchased constitute a business. Significant judgement is required in the determination of whether the definition of a business is met.

A business is a group of assets that includes inputs, outputs and processes that are capable of being managed together for providing a return to investors or other economic benefits. Not all of the elements need to be present for the group of assets to be considered a business:

- Outputs are not required for an integrated set to qualify as a business. [IFRS 3 para B10].
- A business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs (for example, by integrating the business with their own inputs and processes). [IFRS 3 para B8].

Different properties might fall on a spectrum ranging from asset acquisition to business combination, depending on the facts and circumstances involved in the transaction. At one end of the spectrum is the acquisition of a vacant parcel of land; at the other end is the acquisition of a full service, fully operational shopping mall.

The purchase of a vacant parcel of land is typically viewed as an asset acquisition, because the land itself is an input, but there are no significant processes in place. The acquisition of the full service shopping mall is typically viewed as a business combination, because the shopping mall has inputs (the building), processes (the strategic management, employees and procedures currently operating) and outputs (store rentals).

All other acquisitions fall somewhere in between these two on the spectrum. There is no bright line that indicates whether the acquisition is that of a business or an asset. Each acquisition will be unique, and the facts and circumstances of each will have to be examined, with significant judgement being required.

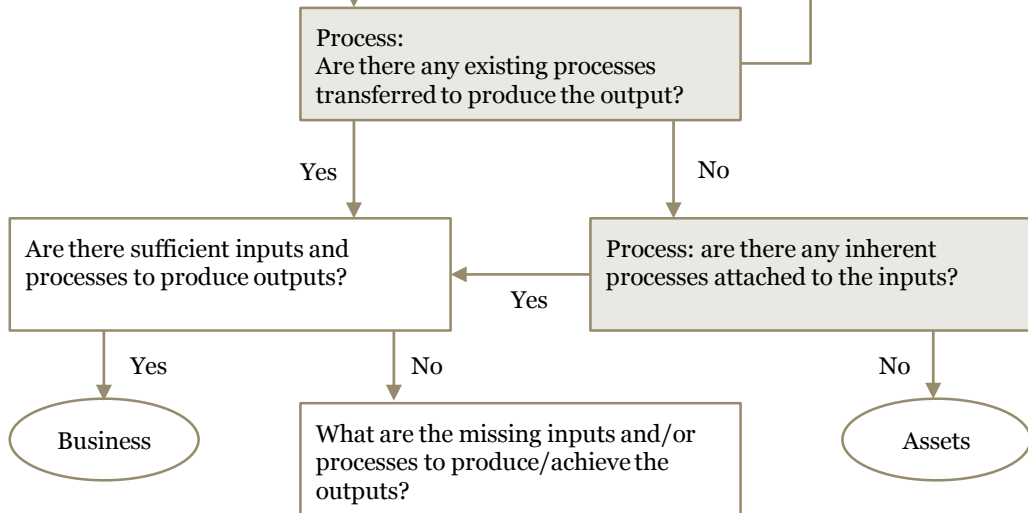
Each property type has its own considerations as to how it is operated and managed. In general, the more actively managed a property is, the more likely it is to be considered a business.

The following diagram summarises the requirements of IFRS 3:

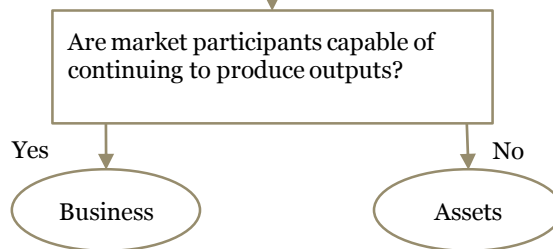
**Step 1:** Identify the element of the acquired group



**Step 2:** Assess capability of the group to produce outputs



**Step 3:** Assess market participant's ability to produce outputs



Inputs and outputs alone (for example, the acquisition of a single-tenant property) would not lead to a business combination. Furthermore, if the 'processes' are insignificant to the arrangement as a whole, this should not in isolation cause the transaction to be a business combination (for example, the provision of a caretaker who is responsible for security and basic maintenance).

An example of acquisition of significant processes would be the acquisition of the management team of a shopping mall which is responsible for strategy around tenant mix, tenant selection, rent reviews, management of communal areas and marketing of the centre to shoppers. This sort of strategic management would suggest that the transaction is a business combination rather than an asset acquisition.

The table below sets out the types of process that can be viewed as purely administrative and those that are more strategic and might indicate that a business has been acquired. The items in the table are not an exhaustive list of factors, and the facts and circumstances of each transaction must be carefully assessed on a case-by-case basis.

Indicators of business combinations	Not necessarily indicators of business combination on their own
Substantive processes and/or services acquired/provided:	Administrative processes and/or ancillary services acquired/provided:
<ul style="list-style-type: none"> <li>Lease management (rent reviews, negotiation of terms)</li> </ul>	<ul style="list-style-type: none"> <li>Security</li> </ul>
<ul style="list-style-type: none"> <li>Management of common areas to promote increased footfall (for example, themed evenings, marketing)</li> </ul>	<ul style="list-style-type: none"> <li>Cleaning</li> </ul>
<ul style="list-style-type: none"> <li>Selection of tenants</li> </ul>	<ul style="list-style-type: none"> <li>Rent collection/invoicing</li> </ul>
<ul style="list-style-type: none"> <li>Investment decisions</li> </ul>	<ul style="list-style-type: none"> <li>Caretaker</li> </ul>
<ul style="list-style-type: none"> <li>Marketing decisions</li> </ul>	

The criteria set out above could be applied to the acquisition of more than one investment property.

For example, if the acquirer acquired one property, or a small number of properties, from a seller’s asset portfolio which is managed centrally, the acquirer is unlikely to have acquired the benefit of the seller’s strategic activities, and so the acquisition is unlikely to be viewed as a business combination. However, if the acquirer buys almost all of the portfolio, including the portfolio management, the acquirer will be getting the benefit of the seller’s portfolio management, which is indicative of a business combination.

It is necessary to look at what has been acquired, rather than the acquirer’s subsequent intentions. An entity might buy a business solely for the assets within that business, with the intention of disregarding the processes and management within that business. The intention to disregard the acquired processes does not mean that the acquisition should not be treated as a business combination.

### Impact of proposed amendment to IFRS 3

The requirements of IFRS 3 in relation to whether a transaction meets the definition of a business combination are currently under review. The IASB has issued an exposure draft that proposes clarifications to the definition of a business, as well as additional illustrative examples, including those relevant to the real estate industry.

A significant change in the proposed amendment is the requirement for an entity to assess whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. If such a concentration exists, the transaction is not viewed as an acquisition of a business.

In the context of real estate, this will be relevant where the value of the acquired entity is concentrated in one property, or a group of similar properties.

#### *Example – Acquisition of a group of commercial office properties 1*

##### **Background**

Entity W owns and manages a group of commercial real estate investment properties. It purchases a commercial office property in a large city. The purchased property is 90% occupied, and entity W will become a party to the lease agreements on acquisition. Entity W will replace existing security, cleaning and maintenance contracts with new contracts. In addition, the existing property management agreement will be terminated, and entity W will undertake all property management functions, such as collecting rent and supervising work. In connection with the transaction, entity W will also hire the current leasing and other key strategic management personnel involved with the operations of the property.

Is the acquired group a business?

**Solution**

Yes. It is likely that the acquired group is a business.

Step 1: Identify the elements of the acquired group:

<b>Inputs</b>	<ul style="list-style-type: none"> <li>• Tangible items: commercial property</li> <li>• Intangible items: lease agreements</li> <li>• Other items not necessarily recognised in the financial statements: key leasing and management personnel</li> </ul>
<b>Processes</b>	<ul style="list-style-type: none"> <li>• Strategic management team processes</li> <li>• Personnel with requisite skills and experience</li> </ul>
<b>Outputs</b>	<ul style="list-style-type: none"> <li>• The right to receive cash flows in the form of rental income</li> <li>• Potential capital growth in the property</li> </ul>

Step 2: Assess the capability of the group to produce outputs

Rental income (that is, an output) is present immediately after the acquisition.

Step 3: Assess the capability of a market participant to produce outputs if missing elements exist

In this case, entity W has acquired all processes and key personnel associated with the property, even though it subsequently chooses to replace some non-strategic processes with its own. In entity W’s case, it was able to easily replace the elements that it chose not to take on from the seller. This assessment requires judgement and is based on facts and circumstances in each situation. In particular, judgement is required in determining whether any missing elements would prevent the acquired group from being a business.

**Example – Acquisition of a group of commercial office properties 2**

**Background**

Entity X is an owner and manager of commercial office towers across the east coast of Australia.

Entity X has purchased a portfolio of commercial properties on Australia’s west coast. Entity X has no existing operations in this location, and it has limited local market knowledge and experience.

The acquired portfolio of commercial property has 85% occupancy on average, with leases being executed between the tenants and the property’s freeholder. Entity X becomes a party to these lease agreements on acquisition of the freehold title to the commercial properties.

Existing security, cleaning and maintenance contracts are novated to entity X on acquisition of the property. The existing property management agreement will be terminated. Entity X will undertake all property management functions: tenant management, collection of rent, and supervision of contract work at the commercial properties.

Entity X will employ a number of the seller’s employees, including the regional leasing managers and other key strategic management personnel. These employees will be responsible for:

- the property’s leasing profile and tenant mix;
- capital expenditure on the property (for example, decisions to repair, renovate, redevelop and expand);
- additional investment and divestment decisions (for example, to buy or sell additional properties); and
- other decisions concerning the strategic positioning of the west coast portfolio.

The acquisition price has been based on an independent valuation of the commercial properties individually, using discounted net cash flows, and taking into consideration rental returns less cash outflows on property outgoings, over a 10-year period.

Is the acquired group of assets a business?

**Solution**

Yes. The acquired portfolio is a business.

Step 1: Identify the elements of the acquired group:

<b>Outputs</b>	<ul style="list-style-type: none"> <li>• Tangible items: the commercial office towers</li> <li>• Intangible items: existing lease agreements with tenants, security, cleaning and maintenance contracts</li> <li>• Other items not necessarily recognised in the financial statements: management team, management knowledge of the west coast Australian market and portfolio</li> </ul>
<b>Processes</b>	<ul style="list-style-type: none"> <li>• Strategic management team processes</li> <li>• Expertise</li> <li>• Industry knowledge</li> </ul>
<b>Outputs</b>	<ul style="list-style-type: none"> <li>• The right to receive cash flows in the form of rental income</li> <li>• Potential capital growth in the property</li> </ul>

Step 2: Assess the capability of the group to produce outputs

Entity X has acquired processes in the strategic management of the commercial properties. These processes will allow entity X to realise the value of the commercial properties and generate outputs, through both rental returns and future growth in the valuation of the properties.

Step 3: Assess the capability of a market participant to produce outputs if missing elements exist

Entity X acquired inputs and processes that allow the generation of outputs. No further analysis concerning the capability of a market participant to produce outputs is required.

**Example – Acquisition of an empty building**

**Background**

Entity Y has acquired an empty building during the year. The building has no tenants on acquisition. The building contains no furniture. Entity Y will undertake the day-to-day property management. Entity Y did not hire any existing employees.

Is the acquired group of assets a business?

**Solution**

No. The acquired portfolio is not a business.

Step 1: Identify the elements of the acquired group:

<b>Outputs</b>	<ul style="list-style-type: none"> <li>• Tangible items: the building</li> <li>• Intangible items: none</li> <li>• Other items not necessarily recognised in the financial statements: none</li> </ul>
<b>Processes</b>	<ul style="list-style-type: none"> <li>• None</li> </ul>
<b>Outputs</b>	<ul style="list-style-type: none"> <li>• Access to economic benefits arising from future leases</li> </ul>



**Step 2: Assess the capability of the group to produce outputs**

Processes that allow entity Y to find tenants, run the day-to-day operations and strategically position the property in order to secure future tenants are missing. These would include:

- marketing to new tenants;
- management of the property’s leasing profile and tenant mix;
- management of capital expenditure on the property (for example, decisions to repair, renovate, redevelop and/or expand the commercial office tower); and
- management of the initial and continued funding of the property.

Entity Y will not be able to produce outputs without these processes.

**Step 3: Assess the capability of a market participant to produce outputs if missing elements exist**

Entity Y is an owner and manager of real estate. No tenants or management of the building were acquired. The building will form part of its larger portfolio going forward; entity Y’s management will perform this role.

**2.3.1. Accounting treatment for business combinations and asset acquisitions**

The accounting treatment for an acquisition that is a business combination differs from the accounting when acquiring a group of assets that does not meet the definition of a business (that is, an asset acquisition).

The key considerations are explained below:

	Asset acquisition	Business combination
<b>Standard</b>	IFRS 3 – apply scope exemption explained in paragraph 2(b) <sup>1</sup>	IFRS 3
<b>Assets and liabilities</b>	Allocate the purchase price to the individual identifiable assets and liabilities on the basis of their relative fair values	Recognise and measure the identifiable assets and liabilities at their acquisition-date fair values
<b>Deferred tax</b>	No deferred tax is recognised under IAS 12, given the initial recognition exception [IAS 12 para 15(b)]	Deferred tax is recognised in accordance with IAS 12
<b>Goodwill</b>	Not recognised	Recognise any related goodwill or negative goodwill
<b>Contingent liabilities</b>	Not recognised, although the presence of contingent liabilities might impact transaction price and asset valuation	Contingent liabilities that are a present obligation arising from past events and can be reliably measured should be recognised at fair value. This is the case even if it is not probable that a future outflow of economic benefits will occur
<b>Transaction costs</b>	Form part of the cost of the asset	Expensed in the period incurred

<sup>1</sup> Paragraph 2(b) of IFRS 3 scopes out the acquisition of an asset or a group of assets that does not meet the definition of a business. In such cases, the acquirer recognises the acquired assets and assumed liabilities in accordance with the relevant standards. The cost should be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the purchase date.

	Asset acquisition	Business combination
<b>Subsequent measurement implications</b>	Follow relevant standards for each asset	<p>Follow relevant standards for each asset</p> <p>For contingent liabilities, these should be measured at the higher of:</p> <ul style="list-style-type: none"> <li>a the amount that would be recognised under IAS 37; and</li> <li>b the amount initially recognised less, if appropriate, the cumulative income recognised</li> </ul> <p>Annual impairment test for any recognised goodwill is required (see section 3.4.5)</p>

### 2.3.2. Accounting for portfolio premiums/discounts

Entities acquire real estate properties either individually or in a portfolio. The price paid to acquire a portfolio of properties in a single transaction could differ from the sum of the fair values of the individual properties.

Portfolio premiums (discounts) are the excess (shortfall) of the market value of a portfolio of properties over the aggregate market value of the properties taken individually. Such premiums (discounts) affect the allocation of consideration.

Portfolio premiums could arise as a result of a purchaser’s ability to build a portfolio immediately rather than over a period of time, short supply in the market, or because of saved transaction costs. In some instances, (expected) portfolio synergies might also result in portfolio premiums. In such a case, it is important to consider whether the existence of a portfolio premium is an indicator of a business combination as opposed to the acquisition of a group of assets.

Portfolio discounts could be granted by a seller in order to encourage a single buyer to purchase a large number of properties, and thereby avoid future marketing and other administrative costs associated with selling properties one-by-one.

The accounting for such portfolio premiums (discounts) at initial recognition differs, depending on whether the transaction qualifies as a business combination or not.

The following table summarises the principles of accounting for portfolio premiums and discounts paid when acquiring a portfolio of real estate properties:

Portfolio premiums	Business combination	Asset deal
<b>Initial measurement</b>	<p>The assets and liabilities acquired are recognised at fair value, so any premiums or discounts affect the amount of goodwill arising from acquisition accounting.</p> <p>If the discount results in negative goodwill (bargain purchase), the gain is recognised in profit or loss.</p>	<p>The consideration is allocated to the underlying assets proportionately to their fair value. Premiums (discounts) might result in a higher (lower) amount being allocated to the investment property when compared to its fair value.</p>

## 2.4. Asset acquisitions: Measurement at initial recognition

The rules for recognition of real estate that meets the definition of investment property are similar to those for all other assets. Investment properties are initially recognised at cost, including transaction costs. [IAS 40 para 20].

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction. [IAS 40 para 5].

An entity might acquire investment property for an initial payment plus agreed additional payments contingent on future events, outcomes or the ultimate sale of the acquired asset at a threshold price. The entity will usually be contractually or statutorily obligated to make the additional payment if the future event or condition occurs. This is often described as variable or contingent consideration for an asset. The accounting for contingent consideration of an asset has been discussed by the IFRS Interpretations Committee (IC), although the IC has not currently concluded on this issue.

There is diversity in practice in accounting for contingent consideration of an asset, with two approaches observed in practice. The first is a cost accumulation model, whereby contingent consideration is not taken into account on initial recognition of the asset, but it is added to the cost of the asset initially recorded, when incurred, or when a related liability is remeasured for changes in cash flows. The second approach is a financial liability model, whereby the estimated future amounts payable for contingent consideration are recorded on initial recognition of the asset, with a corresponding liability. Any remeasurements of the related liability and any additional payments are either recognised in the income statement or capitalised. The cost accumulation model is more common in practice. Both approaches to accounting for contingent consideration of an asset acquisition are acceptable. This is a policy choice that should be applied consistently to all similar transactions and appropriately disclosed.

#### *2.4.1. Accounting for transaction costs, start-up costs and subsequent costs shortly after acquisition*

Cost is the purchase price, including directly attributable expenditures. Such expenditures include transaction costs (such as legal fees and property transfer taxes) and, for properties under construction, borrowing costs in accordance with IAS 23.

Except for transaction costs relating to acquisitions meeting the definition of a business combination, external transaction costs are included in the cost of acquisition of the investment property.

The cost of acquired investment property excludes internal transaction costs (for example, the cost of an entity's in-house lawyer who spends a substantial amount of time drafting the purchase agreement and negotiating legal terms with the seller's lawyers). The entity cannot apportion the in-house lawyer's salary and include an estimated amount related to the work on the acquisition of a property into the cost of that property. The in-house lawyer's employment-related costs are internal costs that relate to 'general and administrative costs', and they are not directly attributable to the acquisition of the property.

#### **Example – Market study research costs**

##### **Background**

Entity Y purchased an investment property in Lisbon. It performed a study of the real estate market in Portugal before it purchased the property. Management proposes to capitalise the costs of this study.

Can management capitalise the real estate study costs?

##### **Solution**

No. The costs cannot be capitalised, since the costs of the market study are not directly related to the acquired property. Such costs are pre-acquisition costs, and they are expensed as incurred.

#### **Example – Determining fair value: treatment of transaction costs**

##### **Background**

Entity A has a 31 December year end, and it adopts the fair value model for its investment properties (see section 3.5).

Entity A acquired a property in December 20X5 at a cost of CU100, and it incurred transaction costs amounting to CU5. There is no movement in the underlying market value of the property between the acquisition date and the year-end date, so the fair value of the investment property at 31 December 20X5 is CU100.

How should the entity account for the transaction costs incurred?

**Solution**

Investment property is initially measured at the cost of CU100, including transaction costs of CU5. [IAS 40 para 20]. Transaction costs include legal fees, property transfer taxes, etc., that are directly attributable to the acquisition of the property. [IAS 40 para 21]. However, investment property measured subsequently at fair value cannot be stated at an amount that exceeds its fair value. At 31 December 20X5, entity A should report its investment property at the fair value of CU100 and recognise a loss of CU5 in its income statement.

The cost of an investment property excludes items such as:

- start-up costs, unless they are necessary to bring the property to its working condition;
- initial operating losses incurred before the investment property achieves the planned level of occupancy; and
- abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

Such costs, incurred in the period after the acquisition or completion of an investment property, do not form part of the investment property's carrying amount, and they should be expensed as incurred. [IAS 40 paras 21–23].

An entity might incur costs subsequent to completion of a property but before it can be put to its intended use (for example, where a regulatory approval must be obtained first).

Costs incurred subsequent to the completion of the property as explained above are:

- expensed where they relate to maintenance of the building and attracting new tenants; or
- capitalised where they enhance the value of the asset or where they help to bringing the asset to an operational condition.

**Example – Costs incurred subsequent to completion: prior to being fully let**

**Background**

Entity M develops an office building for rental. Subsequent to completion of the building, it incurs expenses (such as security, utilities and marketing) before the building has secured a reasonable level of occupancy. The time between the building's completion and securing a reasonable number of tenants is three months. Management considers capitalising these operating costs that are incurred in this period.

Can entity M capitalise costs that are incurred after the date of completion of the property and prior to it being fully let?

**Solution**

No. The costs should be expensed as incurred. These costs relate to maintaining the building and attracting tenants. They are not necessary in bringing the asset to an operational condition.

**Example – Costs incurred subsequent to completion and prior to approval by relevant government agency**

**Background**

Entity N develops an office building for rental and incurs expenses (such as security and utilities) subsequent to completion. The building was physically completed on 31 March, but the local health and safety regulator did not clear the property for use until 30 June, when the security system met the required conditions. The delay of three months in receiving health and safety approval is standard for the type and location of the building. Entity N incurred CU100,000 security expenses in the period between 31 March and 30 June. These costs were necessary in order to ensure that the required conditions for health and safety approval could be satisfied.

Can entity N capitalise those costs in the period between the date of completion and the date when the building receives approval for use from the relevant government agency?

**Solution**

Yes. The security expenses incurred during the period from 31 March to 30 June should be capitalised. The legal requirement to receive the regulatory clearance meant that the building could not be put to its intended use, although construction was completed on 31 March.

## **2.5. Accounting for forward contracts and options to acquire real estate**

Entities might enter into forward contracts or options for purchasing investment property. Contracts to buy a non-financial asset (such as property) that are entered into for the purposes of receipt of that non-financial asset are outside the scope of IAS 39/IFRS 9. [IAS 32 para 8]. Since the contract will be settled by physical delivery of property (typically land) rather than by delivery of a financial asset or exchange of financial instruments, it is not accounted for as a derivative ('own use exemption').

Entities usually make a small initial payment to enter into these contracts. This initial payment is recognised in the balance sheet if it meets the definition of an asset. The cost can be measured reliably, since it is the amount paid. If it is probable that the acquisition of the property will occur in the future, or economic benefits could be derived from this option in some other way (for example, if it is possible to sell the option to a third party), the recognition criteria for an asset are met.

The contract does not meet the definition of investment property, since it has not yet represented a current interest in property. In substance, it is the first payment to secure the future acquisition of the property. If the property is subsequently acquired, the amount paid for the option would form part of the cost of that property.

The amount paid to the owner of the property for the option or forward is recognised as a non-financial asset. If future economic benefits are no longer expected to occur (for example, if acquisition of the property is no longer probable and economic benefits cannot be derived from the option in any other way, such as the absence of the ability to sell the option to another party or obtain a refund), the asset is derecognised. The asset would also need to be assessed for indicators of impairment in accordance with IAS 36.

Where the asset is denominated in a foreign currency, an entity will need to determine whether the asset is monetary or non-monetary in the context of IAS 21. For example, if the asset is non-refundable, it will be treated as a non-monetary item; whereas, if the amount is fully refundable, it will be treated as a monetary item. On initial recognition, the asset should be translated to the entity's functional currency using the spot rate at the date of the transaction. If the asset is a monetary item, it will need to be remeasured at each reporting date, using the closing rate. If it is a non-monetary item, no remeasurement should be performed.

## Impact of IFRIC 22

IFRIC 22, effective for periods beginning on or after 1 January 2018, has confirmed the current accounting practice for assets arising from advance payments to purchase non-monetary assets.

IFRIC 22 applies where an entity either pays or receives consideration in advance for foreign currency-denominated contracts.

The Interpretation states that the date of the transaction, for the purpose of determining the exchange rate to use on initial recognition of the related item, should be the date on which an entity initially recognises the non-monetary asset or liability arising from the advance consideration.

If there are multiple payments or receipts in advance of recognising the related item, the entity should determine the date of the transaction for each payment or receipt.

### *Example – Land options*

#### **Background**

Entity A made a one-off payment to entity B for the option to buy entity B's land within the next 10 years, subject to planning permission for development being achieved. The price of the land will be based on market value at the time of exercise, less the initial one-off payment already made. The initial one-off payment for the option is non-refundable. Entity A plans to develop the land into investment property when it is acquired. Entity A has a high expectation of purchasing the underlying land.

How should the initial payment for the land option be accounted for?

#### **Solution**

Provided that it is probable that entity A can derive future economic benefits from the land option, the one-off payment is recognised as a non-financial asset in the statement of financial position.

### *Example – Purchase of an investment property: share deal*

#### **Background**

Entity A enters into a forward contract to purchase 100% of the outstanding shares of entity X in six months' time. Entity X holds a property that is currently rented out to a single lessee on a long-term lease contract.

The final purchase price is calculated as the pro rata share of the equity presented in the balance sheet of entity X at the settlement date. The investment property held is accounted for under the fair value model in entity X's financial statements. The contract does not contain any net settlement provisions.

Entity A will be required to consolidate entity X when control is transferred (see section 5.1). Entity A intends to use the property as investment property.

Should entity A account for the forward purchase contract as a derivative within the scope of IAS 39/IFRS 9?

#### **Solution**

There are two permissible accounting approaches in this case. Entity A should select an accounting policy approach and apply that approach consistently.

*Accounting policy 1 – Forward purchase contract is accounted for as the purchase of an investment property, based on the economic substance of the contract*

The forward purchase contract has the economic substance of a contract to purchase investment property and is outside the scope of IAS 39/IFRS 9 as a result of the own use exemption. [IAS 39 para 5; IFRS 9 para 2.4]. The economic substance needs to be considered; this is because the legal form of the purchase contract, being a contract to purchase shares rather than an asset, should not impact the accounting.

*Accounting policy 2 – Forward purchase contract is accounted for as a derivative, based on the legal structure of the contract*

Entity A intends to purchase the outstanding shares of an entity. Therefore, the forward purchase contract is within the scope of IAS 39/IFRS 9. Entity A has the right to receive 100% of the shares of entity X, and it has the obligation to pay the purchase price at the settlement date. Accordingly, the forward purchase contract is within the scope of IAS 39/IFRS 9.

### **Example – Purchase of an investment property: asset deal**

#### **Background**

Entity A enters into a contract to purchase a property in six months' time. Entity A is required to pay the fixed purchase price for the property, and the counterparty is required to transfer all rights attached to the property at the future settlement date. The contract does not contain any net settlement provision. Entity A pays a small signing fee to the seller in order to enter into the purchase contract. The fee is deductible from the final amount that entity A pays at the settlement date, and it is considered by the entity as a down payment.

Entity A intends to use the property, which is rented out to a single lessee on a long-term lease contract, as an investment property in accordance with IAS 40.

Should entity A account for the forward purchase contract to buy an investment property as a derivative within the scope of IAS 39/IFRS 9?

#### **Solution**

Entity A enters into a contract to purchase a non-financial instrument which cannot be settled net in cash and which has been entered into and is held for the purpose of delivery of the investment property for its own use. The fee should be recognised as a deposit on the balance sheet.

## **2.6. Special considerations: investment properties under construction**

An entity might enter into a binding forward purchase agreement to purchase a completed property after construction is completed. Where the contract requires the entity to pay a fixed purchase price, the entity will need to consider whether the contract is onerous. A provision for onerous contracts is recognised if the unavoidable costs of meeting the obligations under the contract or exiting from it exceed the economic benefits expected to be received under it. [IAS 37 paras 66–69].

For example, if this fixed price had a net present value of CU100 million at the reporting date, and the estimated economic benefits of the completed investment property at the reporting date is below that (say, CU80 million), a loss of CU20 million is recognised immediately in the income statement. The resulting provision is recognised on the balance sheet.

If there is an onerous contract as defined above, an impairment test is performed on any asset dedicated to the contract (for example, prepayments made in relation to the purchase). Such assets relating to an onerous contract are written down to the recoverable amount (see section 3.4 for further guidance on impairment), if this is less than the carrying amount. [IAS 37 para 69]. A provision is recognised only after such asset is reduced to zero.

Regardless of the assessment as to whether or not there is an onerous contract, contractual obligations to purchase, construct or develop investment property, or for repairs, maintenance or enhancements, should be disclosed. [IAS 40 para 75(h)].

## 2.7. Accounting for rental guarantees

Sellers of real estate might provide guarantees to the potential buyers. A typical rental guarantee contract usually has the following characteristics:

- The seller guarantees a minimum tenancy level of the building.
- The buyer does not need to meet certain requirements to be eligible to receive payment.
- The payments under the guarantee do not change based on market yields, but rather they represent a percentage of the initial purchase price of the building.

From the buyers' perspective, contracts with the above characteristics are classified as available-for-sale financial assets measured in accordance with IAS 39. The fair value of the contract is separated from the purchase price on initial recognition of the property.

Subsequently, the rental guarantee asset is measured at fair value at each reporting date. Any changes in amounts recognised as part of amortised cost are recognised in profit or loss. Any other difference between the amortised cost and fair value is recognised in other comprehensive income.

Debt instruments for which the expected cash flows have changed are subject to the provisions of paragraph AG8 of IAS 39 as follows:

- The entity should revise its estimates of receipts by adjusting the carrying amount of the financial asset.
- The difference between the carrying value and the revised amount, using the revised cash flows discounted at the original effective rate, is recognised in profit or loss.

The accounting for contracts that contain additional guarantees beyond those for tenancy levels might differ from that noted above. Entities should carefully examine the terms of the contract.

### Impact of IFRS 9

Accounting for rental guarantees will change under IFRS 9. Under IFRS 9, the rental guarantee financial asset would be classified as at fair value through profit or loss, since payments do not comprise payments of solely principal and interest.

#### *Example – Rental guarantees*

##### **Background**

On 1 January 20X1, entity A acquired an investment property from entity B, a property developer, for CU100. Entity B provided a rental guarantee to entity A as follows:

- Entity B guarantees to entity A that if the property is not fully rented during the first three years post acquisition, B will compensate entity A.
- The maximum amount of compensation payable to entity A is 5% of the total purchase price paid by entity A; if entity A is unable to rent the building to any tenants and the building remains vacant for each of the first three years, entity B will pay CU5 (being 5% of the purchase price) to entity A.
- Compensation for part occupancy of the building is calculated as the proportionate amount of the maximum guarantee; for example, for 20% vacancy, the guarantee amount to be paid would be CU1 (that is, 20% of CU5).

The fair value of the property, without the guarantee, at the acquisition date is CU97. On 31 December 20X1, the fair value of the property without the guarantee is CU95. There are no transaction costs, no VAT and no transfer tax. Entity A has an accounting policy to measure investment property at fair value.

At the acquisition date, the property is partially rented out (80%). Entity A expects the vacancy rates to be constant over the next three years. Accordingly, entity A expects to receive CU3 over the next three years



(CU1 per year). The fair value of the rental guarantee has been determined to be CU3 (for simplicity, the time value of money has been ignored).

On 31 December 20X1, entity A received payment of CU1 compensation for the first year. Due to a change in market conditions, the estimated vacancy rate for the second year increased to 40%. Entity A expects that this will also be the case for the third year. The new cash flow projection estimates a payment of CU2 per year for the next two years, resulting in a fair value of the rental guarantee at 31 December 20X1 of CU4.

How should entity A account for a rental guarantee provided by the seller of a property?

### Solution

Entity A recognises the property and a rental guarantee financial asset on initial recognition. The financial guarantee is recognised at fair value on initial recognition (CU3), and the remaining amount is allocated to the investment property.

On initial recognition, the following is recorded:

	Dr (CU)	Cr (CU)
Investment property (allocated cost)	97	-
Rental guarantee financial asset at fair value	3	-
Cash	-	100

As at 31 December 20X1, the investment property is measured at fair value, and fair value changes are recognised in profit or loss.

	Dr (CU)	Cr (CU)
Profit or loss	2	-
Investment property	-	2

Entity A receives a payment of CU1 from entity B, since the vacancy rate for the first year was 80%.

	Dr (CU)	Cr (CU)
Cash	1	-
Rental guarantee financial asset at fair value	-	1

The carrying value of the rental guarantee financial asset (CU2) is then remeasured to fair value. To estimate the fair value, entity A revises its estimates of the cash flows to be received from entity B over the next two years. Entity A recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate.

The fair value of the available-for-sale asset would be CU4 (ignoring discounting). Since the change in carrying amount is due to a change in expected cash flows calculated in accordance with paragraph AG8 of IAS 39, the resulting increase in carrying value is recorded through profit or loss. In the event that there were any further fair value changes beyond changes in expected future cash flows (for example, a change in market rates that would have an impact on the discount rate used to measure the fair value), these would have been recorded in other comprehensive income.

	Dr (CU)	Cr (CU)
Rental guarantee financial asset	2	-
Profit or loss	-	2

## 2.8. Development properties: accounting for the costs of construction

### 2.8.1. Capitalisation of construction costs

Investment property under construction is initially measured at cost. Cost is usually the price paid to the developer to construct the property, together with any directly attributable costs of bringing the asset to the condition necessary for it to be capable of operating in the manner intended by management.

Costs that are eligible for capitalisation include, but are not limited to:

- contract costs with the developer;
- architecture fees;
- civil engineer fees; and
- staff costs for employees employed specifically for the construction process.

Costs that are not eligible for capitalisation include, but are not limited to:

- feasibility studies in identifying development opportunities; and
- staff costs for project management if these would be incurred irrespective of any development.

### 2.8.2. Demolition costs

An entity might acquire a property and demolish some of the existing buildings in order to construct new buildings. Demolition costs are capitalised as part of the investment property if they are directly attributable to bringing the asset to the location and condition for its intended use, [IAS 16 paras 16, 17(b)]. Depending on the condition of the acquired property, these costs might be recognised as part of the cost of the land or the cost of the building. Correct classification will impact future depreciation where the cost model is applied and the land and building are subject to different depreciation rates.

#### **Example – Demolition of a building: Scenario 1**

##### **Background**

Entity A acquires a property for CU100 million.

The fair value of the property (land and building) is represented by the value of the land only, because the current building on the land is derelict and unusable.

The building is demolished after purchase, in order to construct a new building in its place. Entity A incurs demolition costs of CU3 million.

How should entity A account for the acquisition cost of the property and the costs of demolition?

##### **Solution**

Entity A should recognise CU100 million as the cost of the land, and it should not allocate any part of the purchase price to the building. The purchased building is derelict and does not have stand-alone value, since no market participant would be willing to pay consideration for an unusable building. [IAS 16 para 7]. The economic rationale behind the purchase was to acquire land rather than land and a building. The sole purpose of the demolition was to bring the land to its intended use, because it would not be available for use until the building was demolished. Therefore, all consideration paid (CU100 million) should be allocated to the land.

The demolition costs of CU3 million are capitalised as part of the cost of the land. In accordance with paragraphs 16 and 17(b) of IAS 16, this represents costs directly attributable to bringing the land to the condition necessary for it to be capable of being developed. Without demolishing the existing building, the intended use of the land cannot be realised.

Cost of:	Land (CU million)	Building (CU million)
Initial acquisition costs	100	-
Demolition	3	-
Cost – post demolition	103	-

### Example – Demolition of a building: Scenario 2

#### Background

Entity B purchases land together with a building. The purchase price is CU200 million. The fair value of the property is CU190 million for the land and CU10 million for the building. The building has value, because a market participant would normally use the building rather than demolish it.

Entity B plans to demolish the building immediately after purchase, in order to construct a new building in its place. The costs of demolishing the old building will be CU3 million.

How should entity B account for the acquisition cost of the property and the demolition costs?

#### Solution

Entity B should recognise CU190 million as the cost of the land and CU10 million as the cost of the purchased building. This is because the purchased building has value, based on the fact that a market participant would normally use the building rather than demolish it. The intended use of the land has already been achieved – in contrast to the previous example, where the intended use had not been achieved because of the presence of the derelict building on the land. On demolition, the carrying value of the building is derecognised and expensed to the income statement.

The demolition costs of CU3 million are capitalised as part of the cost of the new building. In line with paragraphs 16 and 17(b) of IAS 16, this represents costs directly attributable to constructing the new building, and they are capitalised when incurred.

Cost of:	Land (CU million)	Building (CU million)
Initial acquisition costs	190	10
Demolition of old building		(10)
Demolition costs – part of new building		3
Cost – post demolition	190	3

### 2.8.3. Borrowing costs for properties under construction

The cost of investment property might include borrowing costs incurred during the period of construction.

Under IAS 23, borrowing costs are capitalised if an asset takes a substantial period of time to get ready for its intended use. Capitalisation of borrowing costs is optional for qualifying assets that are measured at fair value (for example, investment property under IAS 40). [IAS 23 para 4(a)].

Borrowing costs include, but are not limited to:

1. Interest expense calculated using the effective interest method, as described in IFRS 9/IAS 39;
2. Finance charges in respect of finance leases; and
3. Exchange differences arising from foreign currency borrowings, to the extent that they are regarded as an adjustment to interest costs.

Borrowing costs should be capitalised while construction is actively underway.

These costs include the costs of:

1. specific funds borrowed for the purpose of financing the construction of the asset; and
2. general borrowings, being all borrowings that are not specific borrowings for the purpose of obtaining a qualifying asset. The general borrowing costs attributable to an asset's construction should be calculated by reference to the entity's weighted average cost of general borrowings.

Capitalisation starts when all three of the following conditions are met:

1. expenditures for the asset are incurred;
2. borrowing costs are incurred, and
3. the activities necessary to prepare the asset for its intended use are in progress.

Capitalisation of borrowing costs in respect of real estate developments can commence before the physical construction of the property (for example, when obtaining permits, completing architectural drawings, or other activities necessary to prepare the property for its intended use.

### **Example – Capitalisation of borrowing costs**

#### **Background**

Entity A contracts a third party for the construction of a building. Entity A will make progress payments to the third party over the construction period of the building.

Entity A obtains a loan from the bank to finance the progress payments made to the third party, and it incurs borrowings costs on this loan.

How should entity A account for the borrowing costs incurred?

#### **Solution**

The borrowing costs incurred by entity A to finance prepayments made to a third party to construct the property are capitalised on the same basis as the borrowing costs incurred on an asset that is constructed by the entity itself.

Capitalisation should start when:

- a) expenditures are incurred – expenditures on the asset are incurred when the prepayments are made;
- b) borrowing costs are incurred – borrowing costs are incurred when borrowing is obtained; and
- c) the activities necessary to prepare the asset for its intended use are in progress – this is met when a third party has started the construction process; determining whether construction is in progress will likely require information directly from the contractor.

### **2.8.4. Income arising on redevelopment of property**

Properties might need to be redeveloped following initial acquisition. Redevelopment might include structural changes to the building, renovations or construction of new facilities. Property owners usually contract property developers to run the redevelopment process.

Depending on the extent of redevelopment, property owners might be unable to lease out the property to tenants and generate income during the redevelopment period. Developers might undertake to compensate the property owners for their loss of income during the period by agreeing to refund the owners for a 'licence' or 'interest' fee. The fee is normally paid throughout the period of redevelopment, and its payment usually reduces the total development cost payable to the developer. Such income is neither revenue nor rental income. It represents a deduction from the total redevelopment cost to the property owner, similar to a discount, and it should be deducted from the total property cost.

***Example – Development contracts: treatment of ‘interest/licence fee’***

**Background**

Entity A acquired a real estate property, and has decided that the property needs to undergo redevelopment activity to continue to be used as investment property. It has entered into a five-year development contract with a developer. Under the terms of the agreement:

- The property will not generate any rental income from tenants during this period.
- The developer will pay a ‘licence fee’ to entity A over the five years as compensation for the loss of rental income.
- The fee is calculated based on a rental yield.
- The fee is invoiced on a typical rental payment date, but remains unpaid.
- The developer will deduct the total fee from the final payment due from entity A to the developer.

How should entity A account for the fee income?

**Solution**

The fee income is part of the negotiated cost for the redevelopment of the property. The income should be recognised as a deduction from the cost for the redevelopment of the property.

## 3. *Subsequent measurement of investment property*

The standard permits an entity to adopt either the fair value model or the cost model as its accounting policy for subsequent measurement of investment property. The policy selected must be applied to all of its investment property. [IAS 40 para 30].

If an entity adopts the fair value model of accounting for investment property, there is a property-by-property choice to classify and account for a property interest held by a lessee under an operating lease as an investment property (see section 2.2.8). [IAS 40 para 6]. There is no such choice if an entity adopts the cost model for investment property.

### **Impact of IFRS 16**

IFRS 16 has removed the above option relating to property interests held under an operating lease, since right-of-use assets related to leased property are recognised on the balance sheet. Therefore, entities have a choice of applying either the cost or fair value model for investment property, and this is not restricted by whether or not property is held under a lease. Once the entity chooses an accounting policy, it applies this to all of its investment property, regardless of whether property is held under a lease or not.

### *3.1. Costs incurred after initial recognition*

Subsequent expenditure should be recognised in the carrying amount of the investment property if it is expected to produce future economic benefits to the entity and its costs can be reliably measured. [IAS 40 para 16].

Such costs are usually capitalised within the carrying amount of an investment property when they increase the investment property's originally assessed standards of performance.

If an entity acquires a property that requires renovation, the price and initial carrying amount would reflect this and would be lower than the cost of a fully renovated property. The cost of renovation work would be capitalised when incurred, because the renovation costs give rise to additional future economic benefits.

Investment property often includes parts, such as lifts or an air-conditioning system, which have shorter useful lives than the rest of the property and might require regular replacement. The replacements give rise to future economic benefits, because the carrying amount takes into account the loss of economic benefits from the deterioration of the originally acquired assets, and the new assets give rise to new economic benefits. Parts that require regular replacement are often called 'components', and the accounting applied to them is referred to as the 'component approach' (see section 3.3.2).

Subsequent costs of day-to-day servicing and maintaining a property are not recognised as an asset. Instead, they are expensed as incurred. Such costs normally include costs of labour and consumables and the cost of replacing minor parts. They are normal repairs and maintenance and, as such, they do not meet the criteria for recognition as an asset, because they do not add future economic benefits. [IAS 40 para 18].

A provision for such subsequent expenditure should be recognised when, and only when, an entity has a present obligation, an outflow of resources is probable, and a reliable estimate can be made of the amount of the obligation. [IAS 37 para 14].

### **Example – Provision for repair and maintenance**

#### **Background**

Entity L has acquired an investment property for CU100. The building's sewage system was not operating, and entity L decided to incur the minimum expenditure that would make the sewage system operational (which is CU5), and to undertake major maintenance of the system at the end of year 5.

Entity L uses the cost model and is proposing to initially recognise this investment property at CU115 (being cost of CU100, expenditure of CU5 and the present value of the planned expenditure at the end of year 5 of CU10).

Can an investment property entity establish a provision for planned repair and maintenance expenditure on an investment property?

#### **Solution**

No. A provision should be recognised when:

1. an entity has a present obligation;
2. an outflow of resources is probable; and
3. a reliable estimate can be made of the amount of the obligation.

The repair and maintenance expenses that will arise at the end of year 5 do not meet the definition of a present obligation, so a provision in accordance with IAS 37 cannot be established.

Entity L should recognise the investment property at CU105, and it should depreciate CU5 over five years. At the end of year 5, when the sewage system will be replaced, CU10 will be capitalised and depreciated over its useful life.

## **3.2. Replacement of parts of investment property and subsequent expenditure**

Subsequent expenditure on an investment property is added to the investment property's carrying amount when it is probable that future economic benefits will flow to the entity. All other subsequent expenditure is expensed in the period in which it is incurred. [IAS 40 paras 16–18]. The cost of a replacement part is recognised as an asset and, where the cost method is used, the carrying amount of the replaced part is derecognised.

It is compulsory to recognise every replacement of a part, and derecognise the replaced part, if the recognition criteria are met. It is not relevant whether a replacement was planned or not. For example, the unplanned replacement of a significant portion of the windows should not be treated as a repair expense. The carrying amount of the replaced windows is derecognised, and the cost of the new windows is recognised.

The significance of the cost of the part, compared to the cost of the total item, is not a criterion for determining the parts of a building for recognition and derecognition purposes. Significance is relevant for the identification of the parts that need to be depreciated separately where the cost model is applied. [IAS 16 para 43]. See section 3.3.2.1.

Where the cost model is applied, management should document the historical cost of the parts of a building that are not depreciated separately. An entity should derecognise the carrying amount of a replaced part, regardless of whether the replaced part had been depreciated separately or not. [IAS 16 para 70]. In order to ensure the correct derecognition of replaced parts, the entity might need to determine the carrying amount of the replaced parts. To do so, the entity depreciates the historical cost of each part over its useful life.

If it is not possible to determine the carrying amount of the replaced part based on historical cost, the cost of a replacement might be a good indication of the cost of the replaced part at the time when it was acquired or constructed. [IAS 16 para 70].

### **Example – Change of a roof: cost model**

#### **Background**

Entity A acquired an investment property on 1 January 20X0. During 20X9, entity A spent a significant amount of money to install a modern upgraded glass roof on this property. Management believes that it is important for the property to have a modern roof system, to attract and retain tenants and resist downward pressure on rents. It also enables management to reduce electricity costs.

Entity A's management would like to capitalise the expenditure.

Can subsequent expenditure on investment properties carried at cost be capitalised if it enhances the property's future income-earning potential?

#### **Solution**

Yes. The roof is usually replaced during the life of a building. The new roof should be capitalised. It is considered likely that the new roof will provide future economic benefits for entity A. The existing roof must be derecognised. The roof of a building is a separate component of the building, and it should be depreciated separately. [IAS 16 para 43].

### **Example – Change of a roof: fair value model**

#### **Background**

The facts are as in the above example, except that entity A applies the fair value model to its investment properties.

Can subsequent expenditure on an investment property carried at fair value be capitalised if it enhances the property's future income-earning potential?

#### **Solution**

Yes. Subsequent expenditure relating to an investment property is added to the investment property's carrying amount where it is probable that future economic benefits will flow to the entity. All other subsequent expenditure is expensed in the period in which it is incurred. [IAS 40 paras 16–18]. The new roof should be capitalised, because it is considered likely to provide future economic benefits for entity A. On the next reporting date, the building's new fair value will be assessed, and any gains/losses will be adjusted accordingly through the income statement. There is no need to derecognise the existing roof or to establish the components of an investment property carried at fair value.

## **3.3. Subsequent measurement: Cost model**

Entities that choose the cost model should apply the requirements in IAS 16 for property, plant and equipment measured at cost. Investment properties that meet the criteria to be classified as held for sale, or that are included in a disposal group that is classified as held for sale, should be measured in accordance with IFRS 5 (see section 6).

### **Impact of IFRS 16**

For right-of-use assets that are investment property under IFRS 16, in addition to applying IAS 16, entities have a further option to adopt a policy of measuring these assets in accordance with IFRS 16, provided that they are not held for sale in accordance with IFRS 5.

#### **3.3.1. Depreciation**

Under the cost model, an entity will need to separately depreciate each component part of investment property which is significant in relation to the total cost of the property.

Depreciation should be recognised over the useful life of each individual component.



### 3.3.2. Component approach and depreciation

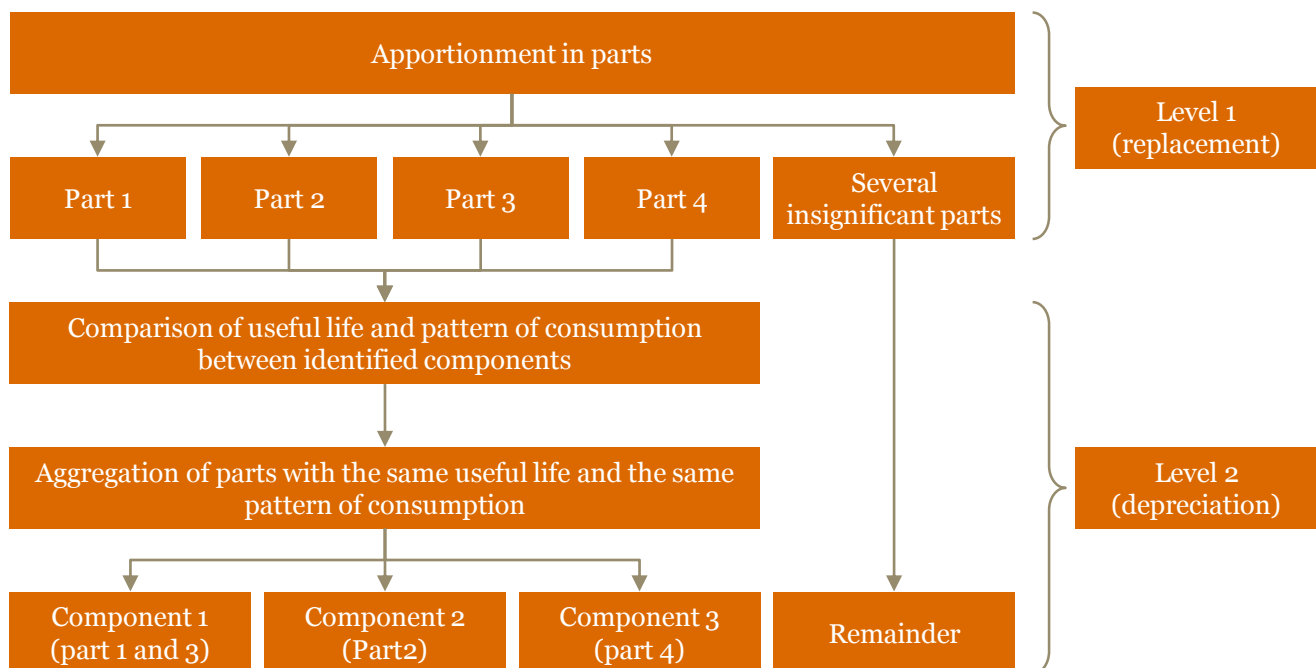
Under the component approach, each part of an investment property with a cost that is significant in relation to the total cost of the property is depreciated separately.

The objective of the component approach is to reflect more precisely the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

To apply the component approach, it is necessary to identify the various parts of an asset. There are two reasons for identifying the parts: depreciation; and the replacement of parts. IAS 16 requires separate depreciation only for significant parts of an item of property, plant and equipment with different useful lives or consumption patterns. However, the principles regarding replacement of parts (that is, subsequent cost of replaced part) apply generally to all identified parts, regardless of whether they are significant or not.

On replacement of a part, the remaining book value of the replaced part is derecognised, and the cost of the new part is recognised, irrespective of whether the part was depreciated separately or not.

The diagram below illustrates the steps required by the 'component approach'.



#### 3.3.2.1. Identification of significant parts of an asset

The significance of a part of a building for depreciation purposes is determined based on the cost of the part in relation to the total cost of the building at initial recognition. [IAS 16 para 43].

The standard is silent on how to determine the parts of a building. The asset's specific circumstances need to be taken into account.

Separation between interior and exterior parts would normally not be sufficient for all types of building and across all regions, depending on the type of building.

Management should carefully evaluate whether separation into interior and exterior truly reflects the significant parts of the building, taking into account the need to make replacements during the useful life of the building. For example, solid walls, floors and ceiling can be used over a longer term, and they can be replaced later than the plasterboard walls and the heating system.

In practice, the first step in determining the parts of a building should be analysis of the construction contracts, the inspection report or the invoice (being parts of the acquisition cost). If these documents do not provide sufficient information, other sources such as construction catalogues should be taken into account. For construction catalogues to be a sufficient source, they need to be a standard that is commonly used in the economic environment in which the entity operates. It would be expected that such standards take into account the specifics of the geographical area as well as type of building.

It might be necessary to request an expert opinion (for example, construction experts) in order to determine the parts of a building.

The following practices are commonly used to identify the parts of a building:

Example practice 1	Example practice 2
<ul style="list-style-type: none"> <li>• Exterior walls</li> <li>• Interior walls</li> <li>• Windows</li> <li>• Ceiling</li> <li>• Roof</li> <li>• Staircase</li> <li>• Elevators</li> <li>• Air conditioning system</li> <li>• Heating system</li> <li>• Water system</li> <li>• Electrical system</li> <li>• Major inspections</li> </ul>	<ul style="list-style-type: none"> <li>• Structural design</li> <li>• Membrane</li> <li>• Exterior doors and windows</li> <li>• Interior walls, doors, windows</li> <li>• Heating and other technical systems</li> <li>• Sanitary facilities</li> </ul>

### 3.3.2.2. Replacement of parts

When a part of an asset is replaced and the recognition criteria are met, the entity needs to derecognise the carrying value of the replaced item and recognise the cost of the replacement.

Note that, for insignificant parts that are replaced, the carrying amount of the replaced parts should be derecognised, regardless of whether the replaced part had been depreciated separately. [IAS 16 para 70].

### 3.3.2.3. Depreciation principles

#### Determining the useful life of the building

An entity is required to estimate the useful life of a building as a whole, in addition to estimating the useful lives of the parts of the building. The entity might include, in its accounting manual, guidance on how the useful life of a building as a whole is estimated.

An entity should estimate the useful economic life of the building, to ensure that the individual useful economic lives of the individual components are reasonably determined within the context of the overall utility of the building to the entity.

Management should estimate the useful life of a building as a whole on a stand-alone basis, taking into account only the expected utility to the entity. [IAS 16 para 57]. The average of the useful lives of the parts is not a sufficient basis to estimate the useful life of the building as a whole.

However, to estimate the useful life of the building as a whole, it might be necessary to consider the useful life or the economic life of significant parts, and whether these parts are so significant that they could affect the useful life of the building as a whole. Management should carefully evaluate situations where the useful life of a building is considered to be longer than the useful life of the structure of the building, such as walls and roof.

### **Determining the useful life of significant parts**

The cost of a part is depreciated on a systematic basis over its useful life. The asset management policy of the entity might involve disposal of significant parts after a specified time, or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of the asset could be shorter than its economic life. The estimation of useful life is a matter of judgement, based on the entity's experience with similar assets.

An entity should review the useful life (and the residual value) of an asset at least at each financial year-end. However, an entity can choose to evaluate the estimated useful life of an asset additionally at each interim reporting date. [IAS 16 para 51].

In principle, the useful life of a part of a building should not be longer than the useful life of the building as a whole. For example, it would be unlikely for a building with a useful life of 25 years to have interior walls with a useful life of 30 years. However, an entity should carefully assess whether parts might be transferred to another building for further use. In those cases, the useful life of the parts might reasonably be longer than the useful life of the building as a whole.

Significant parts can be grouped and depreciated together if their useful life and the depreciation method are the same. [IAS 16 para 45].

### **Determining the useful life of the remainder**

An entity is obliged to depreciate significant parts of a building and the 'rest of the building' separately. The 'rest of the building' consists of parts that are not individually significant. An entity groups these parts to one depreciation unit: 'the remainder' (see diagram in section 3.3.2).

The remainder consists of those parts of the building that are not individually significant but could have a useful life significantly different from the useful life of the building as a whole.

The applicable useful life of the remainder, as well as the depreciation method used, needs to be determined in a way that faithfully represents the consumption pattern and/or useful life of its parts. [IAS 16 para 46]. One acceptable method to determine useful life of the remainder could be the average of the useful life of its parts, rather than the useful life of the building as a whole.

The standard is silent on whether one remainder is sufficient where the useful lives of insignificant parts differ significantly (for example, parts with five years and parts with 20 years of useful life). In such a case, it would be appropriate to have more than one remainder. Further, applying a depreciation rate – calculated based on the average useful life of the parts in the remainder – in that instance might not faithfully represent the consumption pattern and/or the useful life of the parts. [IAS 16 para 46].

## **3.4. Impairment**

### **3.4.1. Overview**

Under the cost model, investment properties should be tested for impairment whenever indicators of impairment exist. Impairment is recognised if the carrying amount of an asset or a cash-generating unit (CGU) exceeds its recoverable amount, which is the higher of fair value less costs of disposal and value in use.

A CGU is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. [IAS 36 para 6]. Management needs to define the CGU at an appropriate level. In the case of investment property, it is likely that an individual investment property would meet the definition of a CGU, since it is usually able to generate independent cash inflows.

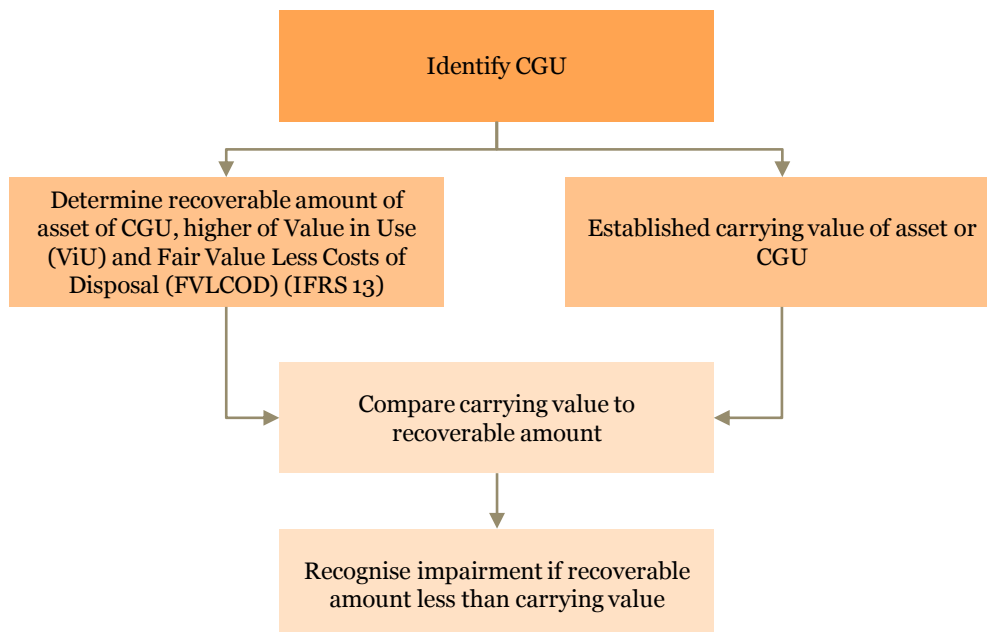
Impairment indicators relevant to the real estate sector include, but are not limited to:

- decline in property prices;
- decline in market rental prices;
- decline in the stock prices for property companies;
- market oversupply of properties;
- decline in building permits, in the event that this limits the options for use of the property;
- unfavourable changes in market interest rates;
- increase in country risk;
- cost overruns for property under construction;
- newly constructed properties that might be more attractive to existing tenants of an entity's property; and
- physical or other damage caused to the property.

Properties measured under the fair value model are not tested for impairment.

An impairment test is performed for investment property under construction, accounted for at cost in accordance with IAS 40, when there is an indication (triggering event) that the property is impaired. At each reporting date, management assesses whether there is a triggering event, irrespective of whether cost accounting is a result of management's decision to apply the cost model or due to the fact that fair value cannot be determined reliably in accordance with paragraph 53 of IAS 40.

The impairment process in accordance with IAS 36 is illustrated in the diagram below:



### 3.4.2. Impairment of individual assets and CGUs

IAS 36 requires a bottom-up, rather than a top-down, approach for impairment testing, and the order in which the testing is performed is crucial.

First, any individual CGUs with indicators of impairment must be tested, and any impairment loss must be recorded in the individual CGU.

The bottom-up approach is applied where there are indications of impairment for individual assets. If those assets do not generate independent cash flows (that is, they are not individual CGUs), they need to be grouped with other assets to determine the CGU (that is, the lowest level at which independent cash inflows arise).

For the purposes of testing goodwill, indefinite-lived intangible assets and corporate asset CGUs might need to be grouped together. The amended carrying values of any individual CGUs that have been adjusted for an impairment charge are used as part of this impairment test. Impairment testing for goodwill is specifically considered in section 3.4.5. It is therefore important to test the individual properties (or CGUs in which the properties are included) for impairment first of all, before testing goodwill for impairment.

If the impairment test shows that the recoverable amount of the group of CGUs exceeds the carrying amount of that group of CGUs, there is no impairment to recognise. However, if the recoverable amount is less than the combined carrying value, the group of CGUs is impaired.

Where goodwill is allocated to the group of CGUs, the impairment charge is allocated first to the goodwill balance to reduce it to zero, and then pro rata to the carrying amount of the other assets within the group.

### **Example – Investment properties measured using the cost model: portfolio basis**

#### **Background**

Entity A is a real estate entity that holds real estate properties with only one operating segment. It purchases a portfolio of investment properties at an amount higher than the aggregated amount of the individual assets' fair value. The portfolio does not constitute a business. However, entity A intends to manage the portfolio together, and it has a clear plan to dispose of the portfolio as a whole in the future.

Management accounts for investment properties using the cost model.

Can entity A test the portfolio of assets, whose carrying value is higher than its fair value, for impairment on a portfolio basis?

#### **Solution**

No, each property is a CGU, and so it should be separately tested for impairment.

### **3.4.3. Calculating the recoverable amount**

The recoverable amount is computed as the higher of value in use and fair value less costs of disposal. Fair value assumes recovery of the asset through its sale. Fair value is an objective, market participant, value, which is independent from the specific company, where market prices and market information are incorporated in its determination. Further guidance on fair value measurement is contained in section 3.6.

Value in use assumes recovery of the asset through its use. Value in use is an entity-specific measure, determined in accordance with the entity's view of use of the investment property. It is a present value measure, in which cash flows incorporate the estimates of the entity rather than the market. Nevertheless, an entity should place greater reliance on market data and corroborate its estimates with external information.

### **3.4.4. Key considerations when estimating value in use**

#### **3.4.4.1. Cash flows**

Cash flow forecasts should be based on the latest management-approved budgets or forecasts for the investment property. Assumptions made in the cash flows should be reasonable and supportable. [IAS 36 para 33]. For example, cash flows should be derived by contractual agreements, and they should take into consideration property yields. They should represent management's best estimate of the economic circumstances that will prevail over the remaining life of the property.

Greater weight should be given to external evidence. For example, the cash flows/forecasts should be compared with external information, such as analysts' reports, the views of other third party experts and economic forecasters.

#### *3.4.4.2. Carrying amount: like with like*

Cash flows being used in the recoverable amount should be consistent with the assets being tested in the carrying amount of the CGU. The impairment test should compare like with like. Working capital and tax are two key areas to consider.

IAS 36 permits cash flows from the settlement of working capital balances to be unadjusted if they are included in the budgets/forecast, provided that the carrying value of the CGU is increased/reduced by the amount of the working capital assets/liabilities. Assets arising from incentives or prepayments should be carefully considered, to avoid double counting.

Cash flow forecasts should exclude cash flows relating to financing (including interest payments). Cash flows should also exclude cash flows relating to tax losses, because these do not affect the recoverable amount of the CGU being tested. Current and deferred taxes are excluded from VIU cash flows. [IAS 36 para 50(a)].

#### *3.4.4.3. Terminal value*

Cash flows are projected over the life of the property. If the investment property is part of a CGU with an indefinite life, a terminal value is required in the cash flow forecast. This represents what an investor might pay for the cash flows beyond the specific forecast period.

This is calculated usually using a perpetuity formula which takes the last year of cash flows into consideration. Careful consideration is needed as to whether the business is cyclical. It is important to ensure that the forecast period is long enough to achieve normalised growth and margin levels.

The long-term growth rate should be reasonable in comparison to long-term inflation expectations. Nominal long-term growth rates in excess of long-term nominal GDP growth imply that the business will eventually grow larger than the economy itself. This is unlikely to be appropriate.

#### *3.4.4.4. Discount rates*

The discount rate used is the rate that reflects the specific risks of the investment property or the CGU to which it relates. Different CGUs might warrant different discount rates (for example, properties held in different countries are likely to be subject to different political and currency risks).

The discount rate should not be adjusted for risks that have already been considered in projecting future cash flows. Management should also consider country risk, currency risk and cash flow risk.

VIU is calculated on pre-tax cash flows using a pre-tax discount rate.

#### *3.4.5. Special considerations: goodwill impairment for real estate entities*

Goodwill is tested for impairment at least annually, when there is an indicator that it is impaired, or when there is an indicator that the CGU(s) to which it is allocated is impaired. When the impairment indicator relates to specific CGUs, those CGUs are tested for impairment separately before testing the group of CGUs and the goodwill together.

Goodwill is tested at the lowest level at which it is monitored by management. The lowest level cannot be higher than the operating segment as defined in IFRS 8 (see section 8.1).

If management monitors goodwill on an individual CGU basis, testing goodwill for impairment should be performed on that individual basis. However, where management monitors goodwill based on a group of CGUs, the impairment testing of the goodwill should reflect this.

### **Example – Testing of goodwill arising on a business combination on a portfolio basis**

#### **Background**

Entity A is a real estate entity that holds investment properties with only one operating segment. Entity A purchases a portfolio of investment property at an amount higher than the aggregated amount of the individual assets' fair value. The portfolio is an individually managed portfolio and constitutes a business.

Entity A recognises each identifiable asset at its fair value at the date of acquisition. [IFRS 3 para 18]. The entity first considers whether the premium has been paid to gain control over any other identifiable and reliably measurable intangible assets, and then the remaining difference is accounted for as goodwill in accordance with paragraph 32 of IFRS 3. Goodwill is monitored at the portfolio level. Entity A needs to test the recognised goodwill annually for any impairment.

At which level should goodwill be tested?

#### **Solution**

The portfolio is the group of CGUs that represents the lowest level at which the entity monitors the goodwill, and it cannot be higher than the operating segment level. Therefore, the goodwill is tested on a portfolio basis, and the recoverable amount of the portfolio needs to be considered to determine whether or not goodwill is impaired. This would apply equally to companies applying the fair value model and the cost model.

### **3.4.6. Special considerations: goodwill arising from deferred tax**

Where a property acquisition meets the definition of a business, the entity should apply IAS 12, and it might need to recognise a deferred tax liability on acquisition. The corresponding debit entry will increase goodwill.

Deferred tax liabilities on investment properties in a business combination might be significant, because there might be no tax deduction for these assets. This leads to the recognition of a higher amount of goodwill.

A value in use calculation, which is a pre-tax value, might indicate an impairment charge soon after an acquisition is made, due to the higher amount of goodwill that is recorded as a result of recognising a deferred tax liability.

In order to address this anomaly, a test should be performed using fair value less costs of disposal. The fair value less costs of disposal is a post-tax measure of recoverable value. The carrying value of a CGU under the fair value less costs of disposal method should include the deferred tax liabilities. The comparison of discounted post-tax cash flows and the CGU's carrying value, including deferred tax liabilities, might eliminate or reduce the amount of any impairment charge.

## **3.5. Subsequent measurement: Fair value model**

An entity that chooses to apply the fair value model for its investment property measures its properties at fair value, with any resulting gain or loss being recognised in the income statement. The measurement of fair value of investment properties is within the scope of IFRS 13. Fair value measurement is a market-based measurement. It is the price that would be received to sell an asset in an orderly transaction between market participants. Market participants are independent, knowledgeable buyers that would be willing to transact with the entity in an orderly transaction.

Management measures the property at fair value until disposal or change in use (for example, the property becomes owner-occupied, [see section 3.7.1](#)), even if comparable market transactions become less frequent or market prices become less readily available. [IAS 40A para 55]. In this case, management uses alternative valuation methods, such as discounted cash flow projections. [IAS 40A para 46(c)]. It is prohibited to change from the fair value model to the cost model. [IAS 40A para 31; IAS 8 para 14(b)].

### *3.5.1. Application where fair value cannot be determined on a continuous basis*

The fair value of the investment property is not reliably determinable on a continuing basis only when comparable market transactions are infrequent and alternative reliable estimates of fair value (that is, based on discounted cash flow projections) are not available. [IAS 40 para 53]. We would expect these situations to be rare.

Fair value measurement is applied if the fair value is considered to be reliably measurable. [IAS 40A para 53]. Excluded from the fair value measurement requirement are investment properties for which:

- the fair value cannot be reliably determined whilst the property is under construction, but for which the entity expects the fair value to be reliably determinable when construction is completed; or
- in exceptional cases, there is clear evidence when an entity first acquires or initially recognises the investment property that the fair value cannot be determined reliably on a continuing basis.

IAS 40 requires an investment property, for which the fair value cannot be reliably determined, to be accounted for at cost. [IAS 40 para 53]. We would expect such situations to be rare.

In the rare event that fair value of a property cannot be reliably determined for any of the reasons stated above, management:

- a) applies the cost model in accordance with IAS 16 for that property [IAS 40A para 53]; and
- b) accounts for its remaining investment properties at fair value if their fair value can be determined reliably.

In order to evaluate whether the fair value of an investment property under construction can be determined reliably, management considers the following factors, among others:

- The provisions of the construction contract.
- The stage of completion.
- Whether the project/property is standard (typical for the market) or non-standard.
- The level of reliable information as to cash inflows after completion.
- The development risk specific to the property.
- Past experience with similar developments.
- Status of construction permits.

The general presumption, for properties under construction, is that fair value can be reliably determined. This presumption can only be rebutted on initial recognition. [IAS 40A para 53B]. We would expect rebuttal of this presumption to be rare. In the event that the presumption is rebutted, once a reliable fair value can be determined for an investment property under construction, management is required to measure the property at fair value if the fair value model is applied to investment property. [IAS 40A para 53A]. Subsequently, the entity can no longer conclude that the fair value of the property cannot be determined reliably. [IAS 40A para 53B].

### *3.5.2. Fair value measurement of assets held in corporate wrappers in consolidated financial statements*

Entities might carry an investment property in a separate legal entity (that is, a corporate wrapper). Usually, this structure is used for tax purposes, as quite often it is more tax beneficial for the entity to sell the corporate wrapper rather than the underlying property itself. The implications of such structures on the recognition of deferred tax are discussed in section 5.3.6.

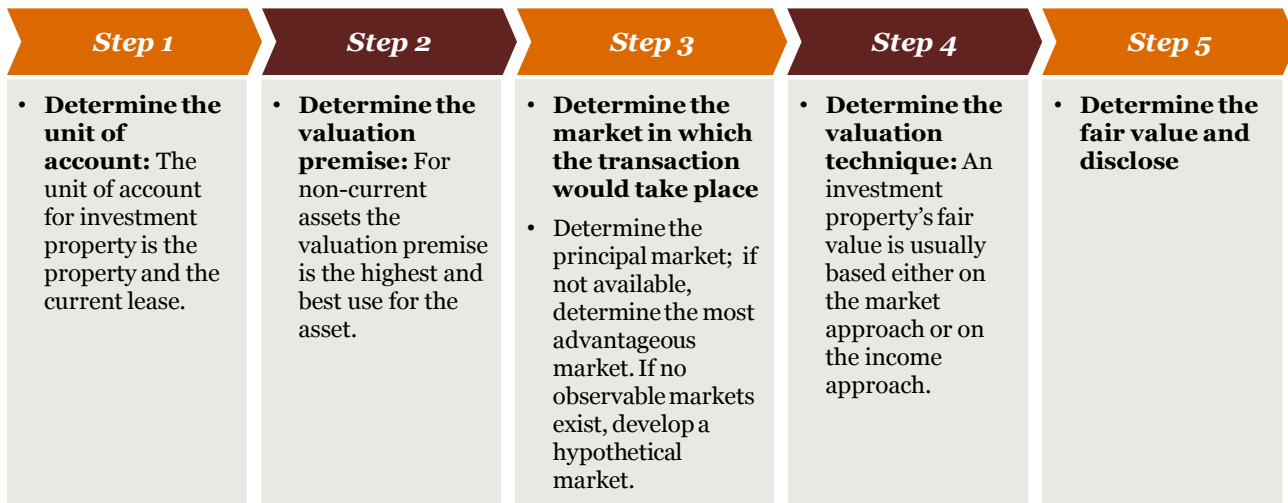
Similar to the accounting for deferred tax, for the purposes of consolidated financial statements, there is no guidance on how to determine fair value of investment properties where they are held in corporate wrappers. In our view, management should determine fair value based on the underlying investment property itself, which is the unit of account for consolidated financial statement purposes, and not by reference to expected sale of the property in a corporate wrapper. The fair value should exclude any benefits from the legal structure. For further guidance on the unit of account, [see section 3.6.2](#).



## 3.6. Fair value measurement of investment property: IFRS 13

### 3.6.1. Overview

As mentioned in section 3.5, entities look to the guidance in IFRS 13 in determining fair value. Fair value is the price that would be received to sell an asset in an orderly transaction between market participants. A fair value measurement takes into account the characteristics of the asset. Applying this to real estate, those characteristics could be the condition and location of the asset and restrictions on its use. The overall fair value approach in IFRS 13 is summarised in the following diagram:



### 3.6.2. Principal market and unit of account for investment property

IFRS 13 requires management to identify the relevant market in which a typical transaction of the asset would take place. A fair value measurement assumes that the transaction to sell an asset takes place in the principal market for the asset or, in the absence of a principal market, in the most advantageous market for the asset. The principal market is the market with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

In the absence of evidence to the contrary, the market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal market or, in the absence of a principal market, the most advantageous market. However, management does not need to continuously monitor different markets to identify the most advantageous market at the measurement date.

The identification of the principal market requires, first, the identification of the unit of account which is subject to transactions in this market. IFRS 13 refers to the unit of account as it is defined by the respective IFRS that requires or permits fair value measurement:

#### Fair value measurement: unit of account

Unit of account for investment properties is defined according to IAS 40	<i>“Whether the asset or liability is a stand-alone asset or liability, a group of assets, a group of liabilities or a group of assets and liabilities for recognition or disclosure purpose depends on its unit of account. The unit of account for the asset or liability shall be determined in accordance with the IFRS that requires or permits the fair value measurement, except as provided in this IFRS”. [IFRS 13 para 14].</i>
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According to paragraph 5 of IAS 40, “investment property is property (land or building, or part of a building, or both) held (by the owner or by a lessee under a finance lease) to earn rentals or for capital appreciation or both”. As a result, the unit of account – the single property (for example, land and building) – is the relevant level at which to measure an investment property.

IFRS 13 allows fair value to be determined in combination with other assets, where this would result into the highest and best use of the asset. The fair value might be the same, whether the asset is used on a stand-alone basis or in combination with other assets. This conclusion is based on the assumption that the use of the assets as a group in an ongoing business would generate synergies that would be available to market participants.

As a result, market participants would judge the synergies on a stand-alone basis as well as in an asset group on the same basis. However, for real estate assets, the valuation of the investment property is generally on a stand-alone basis. Only in rare circumstances “the entity might measure the asset at an amount that approximates its fair value when allocating the fair value of the asset group to the individual assets of the group”. [IFRS 13 para B3].

There might be the following rule/exception for the real estate industry:

- Valuation on a stand-alone basis, considering synergies only to the extent that they are available to typical market participants; and
- Only in limited situations (exception), allocating the fair value of the asset group to the individual asset (considering the unit of account).

### 3.6.2.1. Comparing like with like

When determining the fair value of investment property, entities need to avoid double counting of assets or liabilities that are separately recognised in the balance sheet. [IAS 40 para 50].

For example, the impact of prepayments should be considered. If the cash flow projections include the impact of prepayments, the cash carrying value should include the related prepayment together with the investment property. Conversely, if the cash flows do not include the effect of prepayment, the carrying value should also exclude such impact. Whereas the above principles, if applied correctly, should produce the same answer, the decision to include or exclude certain assets from the valuation might also be driven by regulatory requirements.

#### **Example – Adjustments for prepayments and accruals**

##### **Background**

Entity Z rents a building to third parties under operating leases. It has a receivable of CU1 million in its balance sheet as a result of certain rent incentives that it gave to its tenants during the first year of the leases.

Entity Z uses the fair value model for measuring its investment properties. The valuation of its investment properties is based on discounted cash flows. The fair value of the building at the balance sheet date is CU10 million.

Should management adjust the carrying value of a property to avoid double counting of the accrued revenue?

##### **Solution**

Yes. Management should make an adjustment to the fair value of investment property to the extent of any separately recognised element of revenue not yet received in cash. Fair value calculations will not take into account the fact that a receivable has already been recognised for a portion of the future cash flows. The carrying amount of the building is therefore CU9 million, adjusted for the CU1 million already recognised in the balance sheet.

### 3.6.3. Valuation premise: highest and best use

The valuation premise for non-current assets is the concept of ‘highest and best use’. This is particularly relevant for real estate valuations, because land values depend significantly on the assumptions about the land’s potential use.

Fair value measurement of a non-financial asset takes into account a market participant’s ability to generate economic benefits by using the asset in its highest and best use, or by selling it to another market participant that would use the asset in its highest and best use. The highest and best use takes into account the use of the asset that is physically possible, legally permissible and financially feasible. [IFRS 13 para 27].

<i>Physical possible</i>	<i>Legally permissible</i>	<i>Financially feasible</i>
<ul style="list-style-type: none"> <li>• Takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (for example, the location or size of a property).</li> </ul>	<ul style="list-style-type: none"> <li>• Takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (for example, the zoning regulations applicable to a property).</li> </ul>	<ul style="list-style-type: none"> <li>• Takes into account whether the use of the asset generates adequate income or cash flows (taking into consideration the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.</li> </ul>

An entity’s current use of a non-financial asset is presumed to be its highest and best use, unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

In cases where the current use differs from the highest and best use, management should estimate a fair value based on the hypothetical exit price, assuming the asset’s highest and best use by market participants. This issue will arise from time to time in the real estate industry, because the way in which an entity uses land sometimes differs from the use of surrounding land.

When determining the highest and best use of a non-financial asset, management should take into account two possibilities: the highest and best use of an asset when used in combination with other assets as a group (as installed or otherwise configured for use); or in combination with other assets and liabilities (for example, a business).

If the highest and best use of the asset is to use the asset in combination with other assets or with other assets and liabilities, the asset’s fair value is the price that would be received, assuming that the asset would be used with other assets or with other assets and liabilities, and that those complementary assets and liabilities would be available to market participants.

However, the fair value measurement of a non-financial asset assumes that the asset is sold consistently with the unit of account specified in the standard requiring fair value measurement, being IAS 40 in the case of investment property (see section 3.6.2). This is the case even when the fair value measurement assumes that the highest and best use of the asset is to use it in combination with other assets or with other assets and liabilities.

The estimation of an exit price is not based on a transaction including the complementary asset and liabilities; it assumes that the market participant already holds the complementary assets and the associated liabilities.

**Example – Highest and best use 1**

**Background**

A piece of land being developed for industrial use as a site for a factory could be developed as a site for high-rise apartment buildings if there is a future change in legislation (for example, a new zoning).

How should management estimate the highest and best use?

**Solution**

As a starting point, the current use of land is presumed to be its highest and best use, unless market or other factors suggest a different use. Highest and best use is determined from the perspective of market participants. According to paragraph BC 69 of IFRS 13: “a fair value measurement can assume a different zoning if market participants would do so (incorporating the cost to convert the asset and obtain that different zoning permission, including the risk that such permission would not be granted)”. In this case, there would need to be appropriate supporting evidence that the potential re-zoning would be considered by

market participants when determining the fair value. Furthermore, the use of the asset must be physically possible and financially feasible.

### **Example – Highest and best use 2**

#### **Background**

Entity X holds an undeveloped plot of land (without street access) as investment property. In front of the plot, there are industrial sites with street access. There are three companies located next to the undeveloped plot which are strongly in need of additional storage space. For those three market participants, the undeveloped plot – although hinterland – is very valuable, whereas for all others it is all but worthless.

How should management estimate the highest and best use for the purposes of determining its fair value?

#### **Solution**

The market participants in the market for the plot are the three industrial companies located next to the plot. The value of the plot would be the exit price that one of the industrial companies would be willing to pay.

### **3.6.4. Valuation techniques**

There are three approaches that can be used to derive fair value:

- The income approach: under this approach, future amounts are converted into a single current amount using discounted cash flows;
- The market approach: under this approach, prices and other information generated by market transactions of similar assets are used to determine fair value; and
- The cost approach: this approach reflects the amount that would be required to replace the asset.

Management should use valuation techniques consistent with one or more of these approaches. The valuation techniques used should be appropriate in the circumstances and those for which sufficient data is available. Management should use techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs (see further section 3.6.5). Valuation techniques should be applied consistently. However, a change in the valuation technique or its application can be appropriate if the result is equally or more representative of fair value.

Market participants would usually estimate the price of an investment property based on their expectations about future income. A market or income approach will therefore usually be more appropriate, even if the application of a cost approach is permitted and possible due to the availability of sufficient data.

The challenge in using the cost approach is to consider whether or not an adjustment to the actual building costs (for example, change in materials or change in floor usage) is necessary. The valuation has to be based on the specifications that are considered necessary to reflect the market participants' highest and best use of the property. As a result, specifications that include no added value to the market participants are not considered in the valuation.

IFRS 13 encourages an entity to apply multiple valuation techniques (market approach, income approach and cost approach), if appropriate. In this case, the results (that is, the respective indications of fair value) should be evaluated considering the reasonableness of the range of values indicated by those results.

The fair value measurement is the point within that range that is most representative of fair value in the circumstances. This approach obviously requires significant judgement, and the results of the multiple valuation techniques should be evaluated carefully.

#### **3.6.4.1. The income approach**

The fair value of an investment property can be measured using discounted cash flow projections based on reliable estimates of future rental income and expenditure, supported by the terms of the existing lease and other contracts. External evidence should also be used, such as current market rents for properties of a similar

nature, condition and location. Discount rates that reflect current market participant assessments of uncertainty regarding the amount and timing of cash flows should be used to discount the projected future cash flows.

Using the income approach to measure the fair value of investment property is likely to result in a Level 3 measurement, because the most significant input will be the projected cash flows (see section 3.6.5).

#### *3.6.4.2. The market approach*

The best evidence of fair value is usually provided by current prices in an active market for similar property in a similar location and condition and subject to similar lease terms and other conditions. Clearly, such conditions are not always present, and so an entity should take account of, and make allowances for, differences from the comparable properties in location, nature and condition of the property, or in contractual terms of leases and other contracts relating to the property. For example, if the property is leased by the entity on a finance lease that contains restrictions on the uses to which a property can be put by present and future lessees, that could significantly affect its fair value, because it might restrict the entity's ability to obtain the optimum market rentals.

Where current prices in an active market are not available, entities should consider evidence from alternative sources, such as:

- Current prices in an active market for properties of a different nature, condition or location or that are subject to different lease or other contractual terms, adjusted to reflect the differences.
- Recent prices from transactions on less active markets, adjusted to reflect changes in economic conditions since the date of those transactions.

Using the market approach to measure the fair value of investment property might, in some cases, be a Level 2 measurement. If significant adjustments are made to the observable data inputs to the valuation, the measurement will be classified as Level 3 (see section 3.6.5).

#### *3.6.4.3. Expenditures included in fair value measurement*

Fair value measurement of a property requires the use of estimates and judgements.

Estimates and judgements should be made on the basis of a market participant's expectations. A key issue arising, in measuring fair value of investment properties, is whether future capital expenditures for the development of a property should be considered.

As a general rule, such expenditure should be considered only when a market participant would be reasonably expected to consider these in valuing the property.

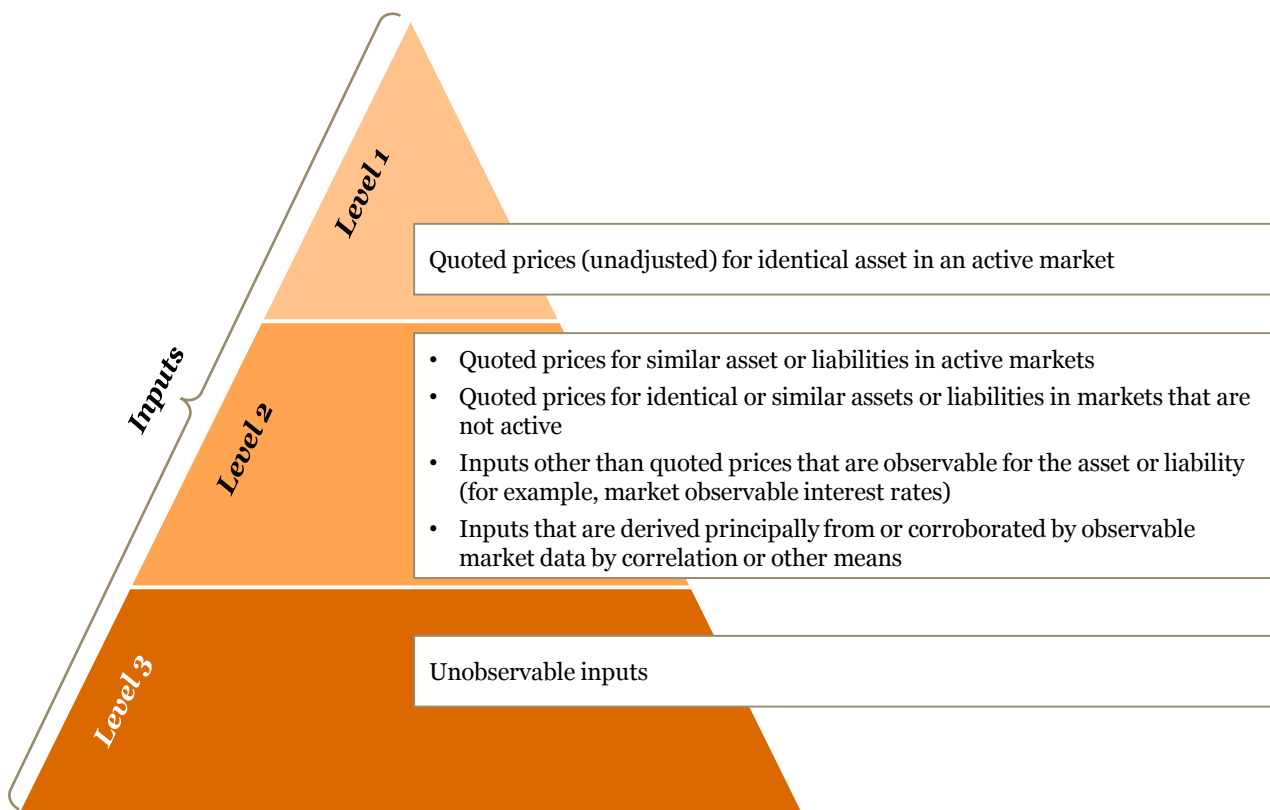
This expectation becomes more prominent for properties under development, in which case a market participant would indeed be reasonably expected to complete the development of the property. In this case, it can be viewed that the related expenditure is part of the strategic construction plan for the property.

#### *3.6.5. Fair value hierarchy and valuation inputs*

Fair value measurements are categorised into a three-level hierarchy based on the type of inputs. The hierarchy is defined as follows:

1. Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset being measured.
2. Level 2 inputs are inputs other than quoted prices in active markets included within Level 1 that are directly or indirectly observable.
3. Level 3 inputs are unobservable inputs that are usually determined based on management's assumptions. However, Level 3 inputs have to reflect the assumptions that market participants would use when determining an appropriate price for the asset.

Entities are not free to choose which level of inputs to use; they must select the most appropriate valuation techniques that maximise the use of observable inputs and minimise the use of unobservable inputs. [IFRS 13 para 61].



In some cases, the inputs used to measure fair value might be categorised within different levels of the fair value hierarchy. In such instances, the fair value measurement is categorised in its entirety based on the lowest level input that is significant to the measurement.

Due to the nature of real estate assets – Which are often unique and not traded on a regular basis – and the subsequent lack of observable input data for identical assets, fair value measurements of real estate will be categorised as Level 2 or Level 3 valuations. All observable market data are given higher priority and should be preferred over unobservable inputs.

The table below gives examples of inputs to real estate valuations and their typical categorisation in the fair value hierarchy:

<i>Level 2 – Valuation inputs</i>	<i>Level 3 – Valuation inputs</i>
<ul style="list-style-type: none"> <li>• Sale prices per square metre for similar properties in similar locations</li> <li>• Observable market rent per square metre for similar flats</li> <li>• Property yields derived from latest transactions</li> </ul>	<ul style="list-style-type: none"> <li>• Yields based on management estimation</li> <li>• Significant yield adjustments based on management’s assumptions about uncertainty/risk</li> <li>• Assumptions about future development or parameters (for example, vacancy, rent) that are not derived from the market)</li> <li>• Cash flow forecast using the entity’s own data</li> </ul>

The use of unobservable inputs is a complex and judgmental area. An entity should develop unobservable inputs using the best information available in the circumstances. An entity might begin with its own data, but it should adjust those data if reasonably available information indicates that other market participants would use different data, or there is something particular to the entity that is not available to other market participants such as an entity-specific synergy.

An entity does not need to undertake exhaustive efforts to obtain information about market participant assumptions. It is, however, expected to take into account all information about market participant assumptions that is reasonably available. [IFRS 13 para 89].

So unobservable inputs should still be adjusted for market participant assumptions, but the information gathered to determine market participant assumptions should be limited to the extent that it is reasonably available.

### *3.6.6. Application to developments in progress*

Developments in progress are the most challenging, from a valuation perspective, because there is normally very little, if any, market evidence which would be representative of fair value. Forced sales are not viewed as representative of fair value.

The lack of transactions and the property-specific nature of development often rule out the use of a market approach for valuation. Instead, the valuation of development properties is typically based on the expected future cash flows, and so it is effectively an income approach.

The first and perhaps most important step when estimating future cash flows is to identify the optimal development scheme to maximise the value of the site (that is, its highest and best use as described in section 3.6.3). The estimation of the end value and the development costs will then be based on this conceptual scheme.

It is important that the assumptions made regarding the proposed development scheme are realistic and achievable, having regard to the site constraints, planning restrictions, project economics and market demand. Once the construction phase has started, the future cash flows will normally be based on the actual scheme in progress, unless it clearly fails to deliver optimal value.

In the very early stages of a development project (for example, at the conception/feasibility stage), a question arises as to whether costs incurred to date are representative of fair value. This approach will only be robust in a stable market with constant values where the site was originally acquired at fair value and the major value accretive steps in the development process have yet to begin.

Two common approaches are followed when determining the fair value of property under construction:

1. The static approach (traditional residual method); and
2. The discounted cash flow approach (dynamic approach).

#### *3.6.6.1. Static approach (traditional residual method)*

The methodology for valuing development properties is reasonably well established in many countries, although it is primarily used for appraising development opportunities prior to acquisition.

Historically, the principal methodology used to value development properties was known as the 'residual method' (alternatively known as the 'static approach'), which is summarised as follows:



This methodology has traditionally been applied using the mathematical formula above, which involves a number of simplifications and needs to be applied with caution. The use of this approach is likely to be most appropriate in the feasibility stages of a project, when the future cash flows have yet to be quantified in detail.

### 3.6.6.2. Discounted cash flow approach (dynamic approach)

A dynamic discount cash flow (DCF) method will often be a more robust approach to determine a development property's fair value, compared to the traditional (static) approach.

The inputs into a DCF methodology will typically be more explicit, both in terms of quantification and timing, than those applied in the traditional approach. The net present value derived from the DCF calculation will represent the current value of the development. The internal rate of return will also be visible. It provides a helpful sense check and indicates whether the implied return is commensurate with the risks involved, having regard to other potential investment opportunities with a similar risk profile.

The fair value measured by applying a dynamic valuation approach has to include the developer's profit that has accrued until the valuation date. The estimation of this profit portion should consider the level of risk that has been mitigated until the valuation date, as well as the level of outstanding risk. For example, such an estimation can be based on a risk matrix approach. Nevertheless the identification and detailed assessment of individual risk factors will arguably be a complex and difficult process.

## 3.7. Change in use of assets: transfers into and out of investment property

Transfers to, or from, investment property are made where there is an evidenced change in use. Changes in use of an existing asset are not changes in accounting policies, and so they are accounted for prospectively. [IAS 8 para 16]. No changes in comparatives should be made.

### 3.7.1. Transfers out of investment property

Investment property to owner-occupied property

An investment property is transferred to property, plant and equipment (PPE) when owner-occupation commences. [IAS 40 para 57(a)]. If an entity begins to redevelop an existing investment property for continued future use as investment property, the property is not reclassified as owner-occupied property during the redevelopment.

### Investment property to inventory

An investment property is transferred to inventory at the time of commencement of development with a view to sale. [IAS 40 para 57(b)].

If a property is to be disposed of without development, there has been no change in use, and the property is not transferred to inventory. It is retained as investment property. The property might be classified to non-current asset held for sale and accounted for in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations', where the relevant criteria are met (see section 6).



### **Example – Property under construction**

#### **Background**

Entity D is engaged in two lines of business: developing property for sale; and holding real estate property for rental purposes. Two of the properties currently classified as investment property are to be sold in the near future.

Property X is going to be redeveloped prior to sale. The redevelopment will significantly improve and enhance the property. Property Y will also be sold, but significant redevelopment is not necessary, although some basic repairs will be undertaken.

Entity D wishes to transfer both properties from investment property to inventory at the date when the developments commence.

How should entity D account for the properties?

#### **Solution**

Entity D should transfer property X to inventory at the commencement of the redevelopment. Property Y should continue to be classified as investment property until the criteria in IFRS 5 are met, at which point the property should be classified as held for sale.

Paragraph 57(b) of IAS 40 requires an investment property to be transferred to inventory only when it is being developed with a view to sale. Developments, in this context, should substantially modify or otherwise enhance the property; basic repairs typically would not qualify as a substantial modification.

### **3.7.2. Transfers into investment property**

Property, plant and equipment to investment property

An item of owner-occupied property is transferred to investment property when owner-occupation ceases. [IAS 40 para 7(c)].

### **Example – Change in use of an existing asset**

#### **Background**

Entity A owns an office building that it has previously used for its own administrative purposes. The building has been classified as PPE.

During the year, management moved the workforce to a new building and leased the old building to a third party.

Should the building be reclassified to investment property?

#### **Solution**

Yes. The building should be reclassified to investment property when management moves to the new building and owner-occupation ceases. The change represents a change in use of the property, and so no restatement of the comparative amounts should be made. [IAS 40 para 60]. The fact that different accounting treatment is applied to the same property in the current and prior years is appropriate, because the building was used for different purposes in the two years.

### **Inventory to investment property**

Property held as inventory is transferred to investment property on commencement of an operating lease with a third party.

A property under construction previously classified as inventory is not transferred to investment property when the intention to sell changes. The inventory will be transferred to investment property when, and only when,

there is a change in use evidenced by commencement of an operating lease to another party. [IAS 40A para 57(d)].

### **Impact of amendment to IAS 40 on transfer of investment property**

IAS 40 was amended to clarify that, in order to transfer to or from investment property, there must be a change in use. To conclude that a property has changed use, there should be an assessment of whether the investment property definition is met. This change must be supported by evidence. The IASB confirmed that a change in intention, in isolation, is not enough to support a transfer.

The amendment also clarifies that the examples illustrating a change in use in paragraph 57 of IAS 40 are non-exhaustive.

The amendment is effective for annual periods beginning on or after 1 January 2018. Earlier application is permitted.

#### **Example – Property under construction 1**

##### **Background**

Entity A, a property developer with a history of developing properties for sale immediately after completion, constructs a residential apartment block for sale. The entity decides to lease out individual apartments when construction is completed, to increase the possibility of selling the entire property after completion. The tenants move in before the property in its entirety is completed and sold.

How should entity A account for the property?

##### **Solution**

Entity A should continue to classify the property as inventory, because this is consistent with the entity's principal activities and its strategy for the property, even after the commencement of leases. The leases are intended to increase the possibility of selling the property, rather than to earn rental income on a continuing basis, and the property is not held for capital appreciation.

The entity's intention to sell the property immediately after completion has not changed, because the property continues to be held exclusively with a view to sale in the ordinary course of business; it does not therefore meet the definition of investment property. [IAS 40 para 9(a)].

#### **Example – Property under construction 2**

##### **Background**

Entity C, a property developer with a history of developing properties for sale immediately after completion, constructs a residential property for sale. However, since property prices are at a multi-year low, entity C decides not to pursue the plan to sell the property after completion and to reconsider the decision to sell at a later stage when the market improves.

The intended change in use is evidenced by a formal decision of the board and a change in entity C's business plan. Entity C intends to rent the property out to third parties on longer lease terms. However, at year end, no lease contract has been signed.

How should entity C account for the property?

##### **Solution**

Entity C should continue to classify the property as inventory. Paragraph 57 of IAS 40 precludes the transfer of such a property to investment property until there is evidence of an actual change in use (for example, by the commencement of an operating lease with a tenant). [IAS 40 para 57(c)]. In the context of the amendment to IAS 40 noted above, all relevant facts and circumstances should be considered when determining whether evidence exists of a change in use of the property. However, the intention to rent out

the building after completion – with no lease contract yet in place – might indicate a change in the intended use but is, in itself, not sufficient to qualify for a change in classification.

## 4. Rental income: accounting by lessors

### 4.1. Overview of guidance

Owners of investment property lease out property to tenants. Guidance on lessor accounting is contained in IAS 17. Accounting for lease incentives is covered by SIC 15.

#### Impact of IFRS 16

In 2016, the IASB issued IFRS 16 which supersedes IAS 17, SIC 15, SIC 27 and IFRIC 4. For lessors, the accounting remains largely unchanged; however, the accounting for lessees will change significantly, with almost all leases being recognised on the balance sheet. Whilst the impact of the new standard on real estate lessors is not expected to be significant, the impact on tenants might, in turn, influence lease negotiations and market behaviour.

### 4.2. Definition of a lease

A lease is an agreement whereby the lessor conveys to the lessee the right to use an asset for an agreed period of time in return for a payment or series of payments. [IAS 17 para 4]. A lease might be in place even if the arrangement does not take the legal form of a lease but bears the characteristics of a lease.

#### Impact of IFRS 16

Under IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. A contract contains a lease if fulfilment depends on an identified asset and it conveys the right to control the use of that identified asset throughout the period of use. It is likely that the vast majority of real estate contracts that meet the definition of a lease under IAS 17 will also meet the definition of a lease under IFRS 16.

Leases are distinguished from service contracts. A lease contract provides the lessee with the right to use an asset, whereas a service contract provides the customer with a service that does not oblige the seller to make an asset available to the customer.

In the context of real estate entities, a contract between the entity and a tenant for the right to use a real estate asset will almost always meet the definition of a lease. The entity might also enter into separate contracts with the tenant for the provision of other items, such as maintenance, cleaning and security. These will likely meet the definition of a service. In some instances, such services might be part of the lease agreement. The extent of ancillary services provided to customers might have an impact on the classification of the property (see section 2.2.2).

#### Impact of IFRS 16

IFRS 16 requires a lessor to account for the lease and non-lease components of a contract separately. [IFRS 16 para 12]. The lessor should also assess whether there are separate lease components in the lease (for example, lease of property, furniture and electrical equipment). [IFRS 16 para B12].

Non-lease components in a rent contract might be the provision of building maintenance services, elevator services or concierge services.

The allocation of the consideration between lease and non-lease components is performed in accordance with IFRS 15. [IFRS 16 para 17]. The lessor should allocate the transaction price to each component on the basis of relative stand-alone selling prices. This is achieved as follows:

- At contract inception, the lessor determines the stand-alone selling price of each component.
- The stand-alone selling price is the price at which an entity would sell the service separately to a customer. IFRS 15 provides further guidance on how to estimate the stand-alone selling price in paragraphs 76–80.
- The lessor allocates the consideration in proportion to the stand-alone selling prices.

The non-lease components would then need to be accounted for in accordance with the relevant standard. For example, security or cleaning services would be accounted for in accordance with IFRS 15. The lease components would be accounted for in accordance with IFRS 16.

#### 4.2.1. Lease term

The lease term is determined at inception of the lease. The inception of the lease is the earlier of the date of the lease agreement and the date of the parties' commitment to the lease's principal provisions.

The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset, and it is also the date of initial recognition of the lease assets and liabilities.

The lease term is the non-cancellable period for which the lessee has agreed to lease the asset from the lessor. [IAS 17 para 4; IFRS 16 App A].

Lessees of property often have the option either to extend the lease or to cancel the lease earlier than the contractual lease term. For example, a lessor and a lessee enter into a lease agreement for five years. The lessee might have the option to cancel the lease after three years at no significant penalty. The lessee might also have the option to extend the lease for an additional five years. When accounting for the lease income in the case of an operating lease, the lessor needs to consider what the lessee might reasonably be expected to do. If the lessee can reasonably be expected to cancel the lease, the lease term would be three years. If the lessee can reasonably be expected to extend the lease, the lease term would be 10 years. If the lessee is reasonably expected to neither extend nor cancel, the lease term would be five years.

### 4.3. Rental income: Lessor accounting

The table below summarises the requirements for lessor accounting under IAS 17 and IFRS 16. The key matter, in determining the accounting for lessors, is whether the leases entered into are classified as finance or operating leases.

#### 4.3.1. General principles

Finance leases	Operating leases
<p><b>Classification</b></p> <p>A lease is classified as a finance lease if substantially all the risks and rewards of ownership are transferred to the lessee. [IAS 17 para 8; IFRS 16 para 62].</p>	<p><b>Classification</b></p> <p>A lease is classified as an operating lease if substantially all the risks and rewards of ownership are retained by the lessor. [IAS 17 para 8; IFRS 16 para 62].</p>
<p><b>Initial recognition</b></p> <p>A receivable is recognised at an amount equal to the net investment in the lease. [IAS 17 para 36; IFRS 16 para 67].</p>	<p><b>Initial recognition</b></p> <p>The underlying asset remains recognised in the lessor's balance sheet. [IAS 17 para 49; IFRS 16 paras 81–88].</p>

Finance leases	Operating leases
<p><b>Initial direct costs</b></p> <p>Initial direct costs in negotiating and arranging the lease are included in the initial measurement of the finance lease receivable, and they reduce the amount of income recognised over the lease term. [IAS 17 para 38; IFRS 16 para 69].</p>	<p><b>Initial direct costs</b></p> <p>Initial direct costs in negotiating and arranging the lease are added to the carrying amount of the leased asset, and they are subsequently recognised as an expense over the lease term. [IAS 17 para 52; IFRS 16 para 83].</p>
<p><b>Subsequent measurement</b></p> <p>Finance income is recognised based on a pattern reflecting a constant periodic rate of return. [IAS 17 para 39; IFRS 16 para 75].</p>	<p><b>Lease income</b></p> <p>Lease income is recognised on a straight-line basis over the lease term. [IAS 17 para 50; IFRS 16 para 81].</p>

### Impact of IFRS 16

IFRS 16 retains the lessor accounting model in IAS 17, and the accounting for operating and finance leases remains broadly unchanged. However, the definition of lease payments is different from IAS 17. IFRS 16 defines lease payments as including only:

- Fixed payments, less any lease incentives;
- Variable lease payments that depend on an index or a rate;
- The exercise price of any purchase option that the lessee is reasonably certain to exercise; and
- Payments of penalties for terminating the lease if this is reflected in the lease term.

For the lessor, lease payments also include any residual value guarantees provided to the lessor. The definition of lease payments in IFRS 16 also specifically excludes payments allocated to non-lease components, and lessors are required to account for these components separately from lease components.

#### 4.3.2. Rental income relating to an underlying variable: contingent rentals

Payments due under lease agreements entered into between real estate entities and tenants might be calculated based on an underlying variable. For example, rental income might be calculated as a percentage of future sales, or it might vary depending on a rate or index. Under IAS 17, these types of payment are referred to as ‘contingent rent’, being lease payments that are based on the future amount of a factor that changes other than with the passage of time. Contingent rental income is recognised when it is received or receivable.

There is no guidance in IAS 17 on accounting for contingent rental income by lessors in an operating lease. IAS 8 requires that, in the absence of specific guidance, users should consider whether other IFRS deal with similar issues. Lessee accounting requires contingent rents to be recognised as incurred. [IAS 17 para 25]. In our view, it would be appropriate for lessor accounting for contingent rents to mirror that of lessee accounting.

### Impact of IFRS 16

IFRS 16 does not include any specific guidance in relation to accounting for contingent or variable rental income by lessors in an operating lease. In respect of lessees, IFRS 16 requires variable lease payments based on an index or a rate (for example, linked to a consumer price index, a benchmark interest rate or a market rental rate) to be accounted for as part of the lease liability. Variable lease payments not based on an index or a rate are not part of the lease liability. Such payments are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs.

### **Example – Treatment of rental income linked to the outcome of an underlying variable**

#### **Background**

Entity V, a tenant, has entered into a 10-year lease with entity Q. The terms of the lease provide that rent will be CU250,000 per annum plus 1% of entity V's annual revenue, as stated in entity V's audited financial statements. Entity Q does not have any audited turnover data relating to entity V when it issues its audited financial statements, but it does have entity V's own annual forecast revenue of CU5 million. Entity V's actual revenue figures have been significantly different from its forecasts in the past.

Management proposes to estimate its contingent rents from entity V using the forecast revenue; is this appropriate?

#### **Solution**

No, contingent rental income should be recognised as incurred. Contingent rental income will be recognised by entity Q when entity V has a contractual obligation to incur the payment. This will be the case when the revenue for the year has been established and entity V is contractually required to make the payment to entity Q.

### **Example – Rent reviews**

#### **Background**

Entity V, a tenant, has entered into a lease with entity Q. The terms of the lease are as follows:

- The rent for the year ended 31 December 20X1 is CU10,000 payable on a monthly basis.
- By 28 February 20X2, entity Q has the right to review the rent charged for the year ended 31 December 20X1 and compare it to market prices for the period. Accordingly, entity Q could request a catch-up payment from entity V, to compensate for any lost income. The catch-up payment needs to be agreed by both parties.
- The determination of the catch-up payment was completed by 31 January 20X2, and the amount was determined to be CU500. The payment was agreed with entity V on 15 February 20X2 and paid on the same date.

When should entity Q recognise the catch-up rent payment?

#### **Solution**

The payment should be recognised when incurred (that is, when the lessor has the contractual right to receive payment). On 31 December and 31 January, entity Q does not have the right to receive payment. The right to receive payment is established on 15 February 20X2, and the rent review catch-up payment is recognised on that date.

### **4.3.3. Lease prepayments**

Lease accounting might give rise to prepayments as a result of the straight-line recognition of rental income (for example, lease contracts that contain fixed escalation clauses).

Lease prepayments are non-monetary assets. The entity should classify the prepayment as current if it expects to realise, sell or consume the prepayment during its normal operating cycle or within 12 months after the reporting period. Otherwise, the prepayment should be classified as non-current.

### **4.3.4. Incentives**

Lessors often give tenants incentives to occupy property. Examples of incentives include rent-free periods and discounts during the initial periods of the lease. All incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset.

The lessor should recognise the aggregate cost of incentives as a reduction of rental income over the lease term. This should occur on a straight-line basis, unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished. [SIC 15 para 4; IFRS 16 para 67]. In practice, the use of an allocation basis other than straight-line is rare.

All incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net contribution agreed for the use of the leased asset, irrespective of the incentive's nature or form or the timing of payments. [SIC 15 para 3; IFRS 16 para 81].

Lease incentives could take the form of reimbursements of a tenant's cost of leasehold improvements. As part of negotiating a new or renewed lease, a lessor might agree to pay the tenant an allowance for leasehold improvements, either through an upfront payment or by requiring a tenant to submit invoices to support expenditures on leasehold improvements. The lessor will need to determine when it has an obligation under the lease contract to pay the tenant for the allowance, because this will determine the recognition point for both the inclusion of the lease incentive in the reduction of rental income under SIC 15, and the liability to reimburse the tenant for these costs.

Except in circumstances where the lessor has substantive discretion to accept or reject future claims under the allowance, the past transaction that obligates the lessor is the commencement of the lease arrangements, rather than the submission of the claim for reimbursement by the tenant or payment of the allowance. The lessor has promised to reimburse the tenant for certain items as part of the net consideration agreed for the use of the leased asset, and that use starts on the commencement date of the lease. Whether or not the tenant submits claims for reimbursement is outside the control of the lessor, and it would usually be considered probable that the tenant would claim all, or a substantial portion, of the reimbursement rights. A provision for the expected amount of reimbursements should be accounted for on the commencement date of the lease and included as a reduction of rental revenue over the lease term.

### **Example – Treatment of rent incentives**

#### **Background**

Entity A, a tenant, has entered into a 10-year operating lease with entity B. To persuade entity A to sign the lease, entity B has granted entity A an initial rent-free period of six months and a discount of 50% of the annual rental of CU1 million over the next 18 months.

Entity B is planning to recognise lower lease income over the first two years, to reflect the incentives given to entity A.

Can entity B recognise lower lease income relating to rental agreements in periods in which incentives are provided?

#### **Solution**

No. Entity B should recognise the rent incentives as a reduction of rental income over the entire lease term and not just the first two years. The incentives are:

1. Initial rent-free period of the first six months (0.5 years); and
2. Discount of 50% of the annual rental over the next 18 months (50% x CU1 million = CU500,000 for 1.5 years, therefore 1.5 x CU500,000 = CU750,000)

Entity B should recognise revenue of CU875,000 each year over the lease term ((CU1,000,000 x 8) + CU750,000/10).



**Example – Loans issued to tenants at off-market terms as a rent incentive**

**Background**

Entity A entered into a five-year operating lease agreement over office property with tenant B. To persuade tenant B to rent the property, A issued a low-interest rate loan (5%) of CU10,000 to tenant B as an incentive. The term of the loan is equal to the term of the lease, being five years. The market interest is 10%.

The fair value of the loan on initial recognition is CU8,105, which is the fair value for a loan with a market interest rate of 10%.

How should entity A account for the difference between the market interest rate and the interest rate on the issued loan?

**Solution**

The cost of incentives given in acquiring a lease should be recognised as a reduction of rental income over the lease term. [SIC 15 para 4]. In this case, the cost of the incentive is CU1,895, which is the off-market element of the loan.

This cost should be amortised over the lease term on a straight-line basis.

*Journal entries:*

[xxx]

*Initial recognition (issue of the loan):*

	Dr (CU)	Cr (CU)
Loan recognised on the balance sheet (BS) – fair value of the loan	8,105	
Lease incentive (BS)	1,895	
Cash		10,000

Subsequent measurement: Loan at amortised cost (using the effective interest method)<sup>2</sup>

At the end of year 1, the loan will be measured at amortised cost using the effective interest method.

	Dr (CU)	Cr (CU)
Loan – (BS) (CU810.50 – CU500)	310.50	
Cash (BS) – repayment of principal	500.00	
Interest income <sup>1</sup>		810.50

Amortisation of lease incentive (on a straight-line basis)

<sup>2</sup> 1 The effective interest method is a method of allocating the interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts throughout the expected life of the financial instrument. In the above scenario, the amortised cost using the effective interest rate would generate interest income of CU810.50 in year 1 (10% \* CU8,105).

	Dr (CU)	Cr (CU)
Rental income (CU1,895/5) (P&L)	379	
Rent incentive (BS)		379

It is important that no double accounting occurs, in line with paragraph 50 of IAS 40. In this example, the cost of the lease incentive (being CU1,895 at commencement of the lease) has been included within the fair value of the property.

#### 4.3.4.1. Accounting for assets arising from operating lease incentives

Assets arising from operating lease incentives are non-financial assets; this is because, at the time of recognition, the entity does not have a contractual right to receive cash. Therefore, the assets are subject to the provisions of IAS 36 for impairment purposes.

These assets are monetary, since they will eventually be received in cash, once the entity has the contractual right to receive payment.

#### Example – Rent incentives in foreign currency

##### Background

Entity A entered into a 10-year operating lease with entity B on 1 January 20X1. To persuade entity A to sign the lease, entity B has granted entity A an initial rent-free period of two years. The rent for the remaining eight years is CU750 per year. Entity B’s functional currency is CAU. The foreign currency rates of CU/CAU are as follows:

Throughout 20X1 and as at 31 December 20X1	2
Throughout 20X2 and as at 31 December 20X2	3

How should entity B recognise rental income for 20X1 and 20X2?

##### Solution

Entity B should recognise rent incentives on a straight-line basis as follows:

31 December 20X1

	CU	CAU
Rent income (CU750 * 8/10)	(600)	(1,200) (CU600 * 2)
Rent incentive asset	600	1,200 (CU600 * 2)

31 December 20X2

	CU	CAU
Rent income (CU750 * 8/10)	(600)	(1,800) (CU600 * 3)
Rent incentive asset	600	1,800 (CU600 * 3)

## 4.4. Premiums for properties in a prime location

Real estate entities might receive initial premiums from tenants over and above annual rents, in order for a tenant to gain access to property in a prime location. In such cases, all incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net contribution agreed for the use of the leased asset, irrespective of the incentive's nature or the form or timing of payments. [SIC 15 para 3; IFRS 16 para 81]. Similar to other lease incentives, real estate entities should recognise the aggregate amount of premiums received in rental income over the lease term.

### **Example – Accounting for initial rental premiums**

#### **Background**

Entity A has developed a state-of-the-art shopping, entertainment and dining complex, which is the only one in its region.

Tenant B has entered into a 10-year lease with entity A. The tenant has agreed to pay an initial premium of CU2 million in addition to the annual rental of CU1 million.

Can entity A recognise the entire initial premium received in the first year of the lease?

#### **Solution**

No, entity A should recognise the premium received on a straight-line basis over the lease term. This would result in lease income of CU1.2 million per annum  $((CU1 \text{ million} \times 10 \text{ years}) + CU2 \text{ million})/10$ .

## 4.5. Surrender premiums

Payments between the lessor and the former lessee, also known as 'surrender premiums', are common in the real estate industry where, for example, the lessor needs to provide an incentive to existing tenants to vacate the property in order to redevelop it. Depending on the specific facts and circumstances, such costs might need to be expensed or capitalised by the lessor. The following table addresses two scenarios that are common in the real estate industry:

### **Surrender premium paid to remove existing tenants to allow ...:**

Redevelopment of a recently acquired or existing investment property

Redevelopment costs are such costs incurred subsequent to the acquisition of the investment property, to add to or replace part of it.

An entity should determine whether subsequent expenditure is capitalised, using a test similar to the test used for owner-occupied property in IAS 16. [IAS 40 para B40].

Since no redevelopment that enhances the previously assessed standard of performance of the property is possible in the presence of the existing tenant, the surrender premium paid to incentivise the tenant to move out is a cost of bringing the investment property to the condition necessary for it to be capable of operating in the manner intended by management. [IAS 40 para B41; IAS 16 para 16(b)].

The surrender premium is therefore capitalised as part of the investment property. This applies to entities using both the cost model as well as the fair value model for investment properties. See 'Example – Surrender premiums paid to remove existing tenants to allow redevelopment of a real estate property' below.

... new tenants to occupy recently acquired or existing investment property

Capitalisation of costs on the carrying amount of an item of property ceases when the item is in the condition necessary for it to be capable of operating in the manner intended by management. The investment property is already in use as intended by management (no redevelopment is necessary), and so the incurred costs cannot be capitalised.

In addition to that, paragraph 52 of IAS 17 requires initial direct costs incurred by lessors in negotiating an operating lease to be added to the carrying amount of the leased asset and expensed over the lease term. Based on this principle, the surrender premium should be expensed, because it is not a cost of entering into the (new) operating lease. This applies to entities using both the cost model as well as the fair value model for investment properties. See also 'Example – Termination premiums paid to remove existing tenants to allow new tenants to occupy the real estate property' below.

***Example – Surrender premiums paid to remove existing tenants to allow redevelopment of a real estate property***

**Background**

Entity A obtained all of the necessary authorisations to significantly redevelop an existing investment property for continued future use as investment property. The redevelopment is only possible if the property is vacant. After redevelopment, the previously assessed standard of performance of the property will be enhanced with significantly more rentable space. Entity A pays a termination premium to remove the existing tenants, to enable it to perform the redevelopment. The entity has chosen to apply the cost model to its investment properties.

Does the termination premium paid to the existing tenants represent an integral part of the costs of redeveloping the property in accordance with paragraph 17 of IAS 40?

**Solution**

The termination premiums are costs that are directly attributable to the redevelopment, and they should be capitalised as part of the investment property. [IAS 16 para 16(b)]. The termination premium paid to incentivise the tenants to move out is a cost of bringing the investment property to the condition necessary for it to be capable of operating in the manner intended by management. [IAS 40 para B41].

***Example – Termination premiums paid to remove existing tenants to allow new tenants to occupy the real estate property***

**Background**

Entity A pays termination premiums to remove the existing tenants, to allow it to rent out the property to new tenants on lease contracts with more favourable terms and conditions. The entity has chosen to apply the cost model to its investment properties.

Does a termination premium paid to existing tenants represent an integral part of the costs of the property in accordance with paragraph 17 of IAS 40?

**Solution**

No. The investment property is already in use as intended by management, and so the incurred costs cannot be capitalised. [IAS 40 para BC B41]. The termination premium is expensed, because it is not a cost of entering into the (new) operating lease. [IAS 17 para 52].

## ***4.6. Assumption of potential tenant's existing lease***

Real estate entities might enter into agreements with prospective tenants, to assume the tenant's existing operating lease with a third party, in order to incentivise the tenant to enter into a new operating lease agreement for their own property.

For example, entities A and B own properties A and B respectively. Entity B has a lease agreement with tenant C over property B. Entity A might undertake to pay any remaining lease payments of tenant C under that lease, in exchange for tenant C entering into a new lease agreement for property A.

The lease payments of entity A to entity B should be recognised as an expense in profit or loss on a straight-line basis in accordance with IAS 17 for a lessee in an operating lease.

### **Impact of IFRS 16**

The impact of IFRS 16 on lessees is explained in section 2.2.8.

## 4.7. Key money

An entity looking to move to a sought-after location might make payments to the lessor in order to take over the lease. Such payments are often referred to as 'key money'. From the lessor's perspective, such payments are considered as part of the lease income and would be recognised over the term of the lease.

### **Example – Key money**

#### **Background**

Entity B entered into a five-year operating lease with entity A for a store in a prime location. Entity A has paid an amount of CU500 to entity B to obtain the lease.

How should entity B account for the amounts received?

#### **Solution**

Entity B should recognise the payment as part of the lease income to be received under the lease agreement. The key money payment would be recognised as deferred rental income on the balance sheet, and it would be amortised over the lease term of five years, resulting in additional rent of CU100 per year (CU500 over five years).

## 4.8. Letting fees

Initial direct costs are often incurred by lessors in negotiating and arranging a lease. They are defined as “... *incremental costs that are directly attributable to negotiating and arranging a lease ...*”. [IAS 17 para 4].

Under this definition, only incremental costs can be treated as initial direct costs. Internal costs that are not incremental – such as administration, selling expenses and general overheads – should be recognised as an expense as incurred. Incremental external costs in the form of agent commissions and legal, arrangement and professional fees normally qualify as initial direct costs.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease are added to the carrying amount of the leased asset, and they are recognised as an expense over the lease term on the same basis as the lease income. [IAS 17 para 52]. It is important to amortise initial direct costs separately from the asset, because they will be recognised as an expense over the lease term rather than over the life of the asset. The lease term is likely to be a significantly shorter period than the life of the asset. Recognition of initial direct costs as an immediate expense is not acceptable.

If an entity measures investment property at fair value, it should carefully assess all effects of letting fees incurred on the calculated fair value, so that no double counting occurs. Valuers might consider the impact of letting fees when determining the fair value of the property. If letting fees are included, the entity will not need to add the impact of letting fees. By contrast, if the valuation excludes the impact of letting fees, the entity will need to add the letting fees when determining the fair value, to ensure that it compares like with like. [IAS 40 para 50(d)]. This is illustrated in the examples below.

### **Example – Letting fees incurred, fair value model**

#### **Background**

Entity A leases out investment property under an operating lease, and it pays letting fees to an agent for attracting new tenants. The agent receives a commission for this service when the tenant enters into a contract to rent the property. The letting fees paid to the agent are directly attributable to the lease agreement with that specific tenant. The lease term is for three years.

Entity A initially measures its investment property on acquisition at cost (including transaction costs), and it adopts a policy of fair value for subsequent measurement in accordance with IAS 40.

The acquisition cost of the property is CU158. The fair value of the property as at the year end is CU159.70.

Should entity A capitalise letting fees under the fair value model?

### Solution

Yes. The letting fees incurred should be added to the carrying amount of the investment property and recognised on a straight-line basis over the lease term. Given that entity A applies the fair value model, the effect of capitalisation of letting fees on subsequent measurement of the property is illustrated below:

	CU	Description
<b>Acquisition cost</b>	<b>158</b>	
Capitalised letting fees	3	<i>Fair value of the property immediately after letting = CU161</i>
Amortisation of capitalised letting fees	(1)	<i>Amortisation over 3 years</i>
Fair value gains/(losses)	(0.30)	<i>The fair value gain/(loss) illustrated is effectively the residual movement in the property's value over the year, after taking into account the effect of capitalising and amortising letting fees (159.70 – 158 – 3 + 1 = –0.30)</i>
<b>Carrying value at 31/12/X1</b>	<b>159.70</b>	<i>Fair value of property at year end, according to the valuation report = 159.70</i>

## 4.9. Tenant deposits received

Under the terms of a lease contract, a real estate entity might receive a deposit from the tenant which will be repaid to the tenant at the end of the lease term. Tenant deposits qualify as financial instruments where the contract gives rise to a financial asset of one entity (the lessee) and a financial liability of another entity (the lessor). [IAS 32 para 11].

Under IAS 39, the lessor's liability is initially recognised and measured at fair value, and then subsequently at amortised cost using the effective interest method (see 'Example – Treatment of rent incentives' in section 4.3.4). [IAS 39 paras 43, 47; IFRS 9 paras 5.1.1, 5.3.1].

The fair value of the deposit at initial recognition might differ from the nominal value of the cash flows received.

The difference between the carrying amount (present value) of the financial liability and the actual consideration received should be treated as an initial premium over and above annual rents. [SIC 15 para 3; IFRS 16 para 81]. Initial premiums are recognised on a straight-line basis over the lease term.

### Example – Accounting for tenant deposits

#### Background

Entity A has received a security deposit from tenant X of CU500,000. Entity A is required to pay interest of 2% to tenant X on the deposit received. Tenant X could receive interest of 5% from a similar type of instrument in the market. The deposit is repayable at the end of the five-year lease agreement.

Can entity A account for the refundable tenant deposit received at nominal value?

#### Solution

No. The tenant deposit received is a financial liability, and it should initially be recognised at fair value.

The fair value is calculated as the present value of the future cash flows, using the market interest rate of 5%, being the interest that would be received from a similar type of instrument in the market. The fair value of the CU500,000 deposit is CU391,763.

The difference between the nominal value and the fair value of the liability of CU108,237, at initial recognition, would be treated as an initial premium and recognised on a straight-line basis over the lease term of five years.

## 4.10. Revenue from managing real estate property

Real estate entities often provide management services to tenants that occupy the real estate that they hold.

Management of real estate might be performed by the real estate owners or by entities designed to provide this service. Real estate management aims to preserve the value of the real estate. The manager is responsible for the oversight of the property, payment of service charges (such as rates, security services and insurance), ensuring that the property is in good condition, and performing repairs and maintenance. Any related costs are usually recharged back to tenants. In turn, the manager earns management fees, which can be fixed or directly linked to the performance of the property.

The rendering of services, such as the provision of management services, to customers by real estate managers is within the scope of IAS 18/IFRS 15.

### **IFRS 15, 'Revenue from contracts with customers'**

IFRS 15 introduces a new five-step model to recognise revenue from contracts with customers.

#### **Step 1: Identify contract(s) with customers**

IFRS 15 applies only to contracts with customers. A contract is defined as a written, verbal or implied (for example, by customary business practice) agreement between two or more parties that creates enforceable rights and obligations.

#### **Step 2: Identify separate performance obligations in the contract(s)**

Performance obligations are promises in a contract to transfer distinct goods or services, including those that a customer can resell or provide to its customer. A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (for example, management services) are a single performance obligation if the following criteria are met:

- Each good or service in the series meets the criteria for a performance obligation satisfied over time; and
- The same method would be applied to measure progress towards satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

#### **Step 3: Determine the transaction price**

The transaction price can be based on the expected value or the most likely amount, but it is constrained up to the amount that is highly probable of no significant reversal in the future. The transaction price is also adjusted for the effects of the time value of money if the contract includes a significant financing component.

#### **Step 4: Allocate the transaction price**

The transaction price should be allocated to distinct performance obligations, based on their relative stand-alone selling prices.

#### **Step 5: Recognise revenue when the performance obligation is satisfied**

Revenue should be recognised when control over the promised goods or services is transferred to the customer. The amount of revenue recognised is the amount allocated to the satisfied performance obligation.

### 4.10.1. Measurement of revenue

Revenue is measured at the fair value of the consideration received or receivable. In most cases, the consideration is in the form of cash or cash equivalents.

IAS 18 is not explicit as to whether all elements of consideration (including contingent consideration) must meet the revenue recognition criteria simultaneously, in order for any portion of the revenue to be recorded.

The standard requires revenue to be recognised when the amount can be measured reliably and it is probable that the economic benefits associated with the transaction will flow to the entity.

An entity can therefore make a policy choice to:

- Consider the contingent and non-contingent elements of consideration separately, when determining when revenue is recognised; or
- Assess the contract as a whole.

### **Impact of IFRS 15**

The transaction price (or contract revenue) is the consideration that the seller expects to be entitled to in exchange for satisfying its performance obligations. Management must determine the amount of the transaction price at contract inception and at each reporting date.

### **Variable consideration**

Variable consideration should be estimated and included in the transaction price to the extent that it is highly probable that there will be no significant subsequent reversal in the cumulative amount of revenue recognised. This new threshold for recognising variable consideration is often referred to as the 'constraint' that must be met in order to recognise the variable consideration as revenue.

Variable consideration should be estimated using the expected value approach (probability weighted average) or the most likely amount, whichever is more predictive in the circumstances. The approach used is not a policy choice, but management should use the approach that it expects will best predict the amount of consideration to which the entity will be entitled, based on the terms of the contract and taking into account all reasonably available information.

The following indicators suggest that including an estimate of variable consideration in the transaction price could result in a significant reversal of cumulative revenue:

- The amount of consideration is highly susceptible to factors outside the entity's influence.
- Resolution of the uncertainty about the amount of consideration is not expected for a long period of time.
- The entity has limited experience with similar types of contract.
- The entity has a practice of offering a broad range of price concessions or changing payment terms and conditions in similar circumstances for similar contracts.
- There is a large number and broad range of possible outcomes.

Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included because it does not pass the highly probable threshold. Management's estimate of the transaction price will be reassessed each reporting period, including any estimated minimum amount of variable consideration.

### **4.10.2. Revenue recognition**

In relation to the provision of services, revenue is recognised by reference to the stage of completion of the transaction, provided that the outcome of the transaction can be estimated reliably. The latter occurs where all of the following conditions are satisfied:

- The amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity;
- The stage of completion of the transaction can be measured reliably; and
- The costs incurred and the costs to complete the transaction can be measured reliably. [IAS 18 para 20].



Where the outcome cannot be estimated reliably, revenue is recognised only to the extent of the expenses that are recoverable.

### **Impact of IFRS 15**

Revenue is recognised when a performance obligation is satisfied, which occurs when control of a service transfers to the customer. Control transfers either at a point in time or over time, based on a range of criteria.

#### **Recognise revenue over time or at a point in time**

Entities should consider whether they meet any of the three criteria necessary for recognition of revenue over time. A performance obligation is satisfied over time where at least one of the following criteria is met:

- The customer receives and consumes the benefits of the entity's performance as the entity performs.
- The entity's performance creates or enhances a customer-controlled asset.
- The asset being created has no alternative use to the entity, but the entity has a right to payment for performance completed to date.

For real estate management services, these will very likely satisfy the first criteria only, since the nature of the services being provided does not create or enhance a customer's asset.

A performance obligation is satisfied at a point in time if it does not meet the criteria above.

#### **Measuring performance obligations satisfied over time**

An entity should measure progress of a performance obligation that is satisfied over time using the method that best depicts the transfer of services to the customer. Note that, for a series of distinct goods or services that are accounted for as a single performance obligation (such as a management fee), the same method must be applied to measure progress in satisfying the obligation.

The method selected should be applied consistently to similar contracts with customers. Once the metric to measure the extent to which control has transferred is calculated, it must be applied to total contract revenue, to determine the amount of revenue to be recognised.

### **4.10.3. Principal/agent relationships**

Real estate entities that lease out properties under operating leases usually generate other forms of revenue from tenants in addition to rental income. Entities might also undertake other transactions that do not directly generate revenue but which are incidental to their revenue-generating activities. Income and related expenses can only be disclosed on a net basis when this presentation reflects the substance of the transaction.

[IAS 1 para 34].

Further, revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties (such as sales taxes, goods and services taxes and value added taxes) are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue.

It is common for real estate entities to charge tenants for service costs. Service costs billed to tenants are presented gross in the income statement of the real estate entity, unless the entity is acting as an agent on behalf of a third party (for example, as a tax collector).

## Impact of IFRS 15

IFRS 15 provides clear guidance on identification of principal-agent relationships (see paras B34–B38).

Where another party is involved in providing goods or services to a customer, the entity determines whether the nature of its promise is:

- A performance obligation to provide the specified goods or services itself (principal); or
- To arrange for the other party to provide those goods or services (agent).

An entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer.

IFRS 15 provides the following indicators that the entity is a principal:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service;
- The entity has inventory risk before or after transfer of control to the customer; and
- The entity has discretion in establishing prices for the specified good or service and, therefore, obtains substantially all of the remaining benefits.

As a result of the new standard, property managers will need to consider whether they are acting as principal or agent in goods or services that they provide to their tenants.

### *Example – Service costs billed to tenants*

#### **Background**

Entity A is the owner and lessor of an office building. It is contractually obliged to maintain the premises' car park and provide cleaning, tenants' insurance and security for the building under the terms of its lease contracts with its tenants. The tenants are not charged separately for these services.

Entity A is proposing to report revenue net of the costs incurred to provide the above services.

Is this appropriate, given that these costs are not separately reimbursed by tenants?

#### **Solution**

No. Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. [IAS 18 para 8].

However, entity A is not acting as an agent, because it is itself contractually obliged to provide these services to its tenants. As such, it should report revenue on a gross basis.

Equally, entity A should also report the costs associated with providing these services gross in the income statement.

Entity A should provide an analysis of the different components of revenue, either on the face of the income statement or in the notes.

#### **Impact of IFRS 15**

Currently, many companies that have contracts which include both an operating lease and a service do not separate the operating lease component. This is because the accounting for operating lease income and a service/supply arrangement is similar.

Under IFRS 16, lessors are required to account for the lease and non-lease components of a contract separately. In the case of non-lease components such as service charges, this must be accounted for under IFRS 15.

### **Example – Treatment of taxes and rates received from lessee**

#### **Background**

Entity A collects local property taxes and water rates, and it pays these to the municipal authorities. These payments are not part of the rental payments receivable by entity A and, in this jurisdiction, tenants retain the primary obligation to the municipality.

Can entity A recognise the receipt and payment of property taxes and water rates on a net basis?

#### **Solution**

Yes. Entity A should present the amounts received from its tenants for property taxes and water rates net of the payments that it makes to the municipal authorities. This presentation is appropriate, because entity A acts as an agent on behalf of the authorities. The amounts collected are not revenue, and they are presented in the income statement net of the amounts paid to the municipal authorities. [IAS 18 para 8; IFRS 15 para 47].

## **4.11. Lease modifications**

There is no explicit guidance in IAS 17 on accounting for modifications of operating leases by lessors. Where the modification of an operating lease does not result in the lease being reclassified as a finance lease, any changes to future lease payments are accounted for prospectively on a straight-line basis over the remaining revised lease term.

### **Impact of IFRS 16**

IFRS 16 provides guidance on modifications of operating leases by lessors. The accounting requirements under IFRS 16 are consistent with previously developed practice for accounting for modifications of operating leases by lessors. Modifications to an operating lease should be accounted for from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. [IFRS 16 para 87].

### **Example – Accounting for lease modification where the initial lease contained a rent-free period**

#### **Background**

Entity A owns and operates a shopping mall. It leases out the shopping mall space to a number of retailers under non-cancellable leases.

Entity A has provided rent-free periods to the lessees during the initial lease period, the effect of which has been accounted for over the lease term in accordance with paragraph 50 of IAS 17 and paragraph 3 of SIC 15. The leases are classified as operating leases in entity A's financial statements.

Due to a market downturn, entity A has agreed with a number of its lessees to modify their lease agreements, reducing the fixed rental payments and increasing the contingent rent component.

Prior to the modification, entity A recognised a rent receivable balance that arose from the initial rent-free period. This receivable is not considered impaired.

How should entity A account for the lease receivable that arose from the initial lease agreement containing the rent-free period following a lease modification?

#### **Solution**

The accrued rent receivable from the original leases represents the cost to entity A of entering into the new lease agreement, and accordingly should be deferred and amortised over the new lease term in accordance with paragraphs 3 and 4 of SIC 15.

## 4.12. Revenue recognition: Surrender premium/break costs

Investment property entities might receive surrender premiums/break costs from tenants seeking to vacate leases before the expiry of the lease term. Such amounts should be recognised as income when the surrender premium/break cost is contractually receivable.

### **Example – Termination premiums received**

#### **Background**

Entity X receives surrender premiums from tenants A and B, who are vacating their leases before expiry, as follows:

- a) Entity X's agreement with tenant A had a contractual surrender premium clause for the payment of six months' rent.
- b) Entity X's agreement with tenant B had no contractual surrender premium clause. The parties have negotiated for a payment of four months' rent.

Entity X will use part of the above receipts for refurbishment of the properties before re-letting them. The payments received are not connected to any obligation by the tenants to bring the property to its working condition before commencement of the lease.

Management is planning to show both surrender premiums received as income on termination of the respective leases, and to account for any subsequent expenditure separately when it is incurred.

Is this approach appropriate?

#### **Solution**

Yes, surrender premiums should be recognised as income in the period when they become receivable from both tenants. There is no ongoing contractual obligation after receipt of the premiums, and so the amounts are not amortised over any subsequent new lease or void period.

The refurbishment costs should be recognised as an expense when incurred, unless they meet the criteria for capitalisation (see further section 3.1).

## 4.13. Tenant obligations to restore a property's condition

Lease agreements might include a clause requiring tenants, at the conclusion of the lease, to restore the property's condition to the same level as existed at commencement of the lease. In such cases, a tenant might make monthly payments to the lessor in respect of bringing the building to its original pre-lease condition on the tenant's behalf. These monthly payments should be recognised as revenue by the lessor on a straight-line basis over the lease term.

### **Example – Reimbursement of recondition expenses**

#### **Background**

Entity T receives a monthly payment from tenant V for tenant V's contractual obligation to bring the building to its original (pre-lease) condition. This payment is included in the monthly lease payment from tenant V.

Entity T is planning to refurbish the property after the end of tenant V's lease.

How should the lessor account for any payments received from the tenant for bringing the property to its pre-lease condition?

#### **Solution**

Tenant V has agreed to pay a higher lease payment each period in lieu of having to restore the building to its pre-lease condition at the end of the lease. As such, the monthly payments should be recognised on a straight-line basis over the lease term.

The fact that entity T is planning to refurbish the property prior to leasing it again does not impact the timing of recognition of lease income, because it does not represent an obligation that entity T must perform under the lease contract with tenant V.

# 5. Real estate structures and tax considerations

## 5.1. Consolidation

### 5.1.1. Overview

A reporting entity prepares consolidated financial statements where it meets the definition of a group as set out in IFRS 10. The 'group' is 'a parent and its subsidiaries'. IFRS 10 provides a single definition of control that applies to all entities. This definition is supported by extensive application guidance that explains the different ways in which a reporting entity (investor) might control another entity (investee).

The key principle is that control exists, and consolidation is required only if the investor possesses power over the investee, has exposure to variable returns from its involvement with the investee, and has the ability to use its power over the investee to affect its returns. Power over an investee is present where the entity has the rights to direct the decisions over relevant activities (that is, the decisions that affect returns).

Relevant activities for a real estate entity include, but are not limited to:

- a) Approval of budgets;
- b) Selection of tenants;
- c) Approval of lease contracts;
- d) Approval of maintenance and renovation plans;
- e) Approval of sale of investment property; and
- f) Investment decisions around investment property.

IFRS 10 provides certain exceptions to the consolidation requirements. One of these exceptions is where the reporting entity is an investment entity. Investment entities are required not to consolidate particular subsidiaries; those subsidiaries are measured at fair value through profit or loss in accordance with IAS 39/IFRS 9.

Determining whether a real estate entity meets the definition of an investment entity requires significant judgement, for which all relevant facts and circumstances (including the purpose and design of the entity) should be considered.

### 5.1.2. Definition of an investment entity

An investment entity is an entity that:

- a) Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- b) Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- c) Measures and evaluates the performance of substantially all of its investments on a fair value basis. [IFRS 10 para 27].

The definition encompasses the following key elements:

- Business purpose including investment-related services;
- Exit strategies;

- Earnings from investments; and
- Fair value measurement.

#### *5.1.2.1. Services*

Part of an entity's business purpose might be to provide investment-related services (including investment advisory services, investment management, and investment support and administrative services) either directly or through a subsidiary. These services could be provided to investors and/or third parties. Participating in such investment-related services does not disqualify an entity from being an investment entity, even if these services form a substantial part of its business; this is because such services are an extension of its operations.

The provision of other services that are not investment-related services (such as providing strategic advice or financial support to investees) is one of the factors that differentiates investment entities from other entities. These activities need to be undertaken to maximise investment returns (capital appreciation and/or investment income) from the entity's investees. They must not represent a separate substantial business activity or a separate substantial source of income.

Examples of permissible management and other services for real estate structures are:

- Providing management services and strategic advice to an investee;
- Providing financial support (such as a loan, capital commitment or guarantee) to an investee;
- Other incidental services increasing or enhancing the value of investments; and
- Other administrative services (that is, accounting at property level).

[IFRS 10 paras B85C, B85D and BC240].

For real estate structures, permitted services include the management of the structure and the properties within it, acquisitions, arranging external financing, market analysis, strategic decisions, and marketing of assets for lease or sale.

Typical structures normally use third party service providers (such as property managers) to manage and run the properties, and real estate agents for capital transactions. This has no impact on whether the investment entity exemption is met. Other structures appoint related service providers, especially in portfolio management, who are remunerated at arm's length.

Management services to third party investment property owners should not be a separate substantial business activity or a separate substantial source of income, for the investment entity definition to be met.

Outside of management services, it is often the case that financing (in the form of equity or debt) or guarantees are granted to related holding or property companies within the structure.

#### *5.1.2.2. Business purpose*

The definition of an investment entity requires the entity to commit to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both. For real estate structures, capital appreciation is synonymous with the increase in fair value of the properties culminating in the gains from disposal, whilst rental income from lease contracts is considered as investment income.

The business purpose is normally presented in offering memorandums, prospectuses, term sheets, partnership agreements, deeds or other corporate documents. The objectives are essential in assessing the structure's purpose and whether this purpose is consistent with the business purpose of an investment entity.

### **Example – Business purpose of an investment entity**

#### **Background**

A real estate fund, Fund F, is a closed-ended fund set up for a limited life of 10 years. The mandate and objective of Fund F, set up at inception, is to maximise total returns on capital by seeking consistent recurring income and capital appreciation through the acquiring and realising of a diverse portfolio of income-producing industrial properties. As such, Fund F will be focused on maximising the fair value of its investments and rental income growth. The investments are owned through wholly owned property subsidiaries.

Does the above meet the business purpose of an investment entity criterion?

#### **Solution**

Yes. The objective of the fund is to invest funds solely for returns from both capital appreciation and investment income.

### **5.1.2.3. Exit strategy**

Real estate structures are required to have a documented exit strategy for their assets, in order to meet the definition of an investment entity. The presence of an exit strategy is essential evidence of an investment entity's business purpose.

The fact that the investment entity does not plan to hold its investments indefinitely differentiates it from other entities. An entity's objective of investing for capital appreciation is not generally consistent with an objective of holding the investments indefinitely. [IFRS 10 para B85F].

An example of an exit strategy includes the sale of the real estate through specialised property dealers or the open market. [IFRS 10 para B85G].

Closed-ended real estate structures generally have a limited life, which is expressed in their offering documents, and so the disposal timeframe is transparent. This can be documented in many different ways and in many different types of document (for example, prospectus, marketing material, investor reports and term sheets).

There is no guidance within the standard on the period or the number of years for the exit strategy.

### **5.1.2.4. Fair value measurement**

An essential element of the definition of an investment entity is that the entity measures and evaluates the performance of substantially all of its investments on a fair value basis. Accordingly, presenting its investments at fair value results in more relevant information than consolidation or using the equity method. [IFRS 10 para B85K].

To meet this criterion, an investment entity [IFRS 10 para B85K]:

- Provides investors with fair value information;
- Measures substantially all of its investments at fair value in its financial statements whenever it is required or permitted in accordance with IFRS; and
- Reports fair value information internally to the entity's key management personnel, who use the fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

A detailed analysis on the management decision process and on the reporting to investors might be required, to understand the primary measurement attributes used.

Some real estate structures, while having other measures, might still use fair value as their primary measurement attribute to evaluate and make investment decisions.

However, where a real estate structure generates substantial investment income (for example, rental income), management might not measure and evaluate the performance of substantially all of its investments on the basis of fair value. In such a case, management and investors might measure the entity's returns in absolute terms, which would include fair value, but fair value would not be the sole primary measurement attribute used in making investment decisions. Yield would typically be another primary measurement attribute. In addition, other measures (such as the internal rate of return, equity multiple, earnings ratio, net present value and EBITDA) might be used. This indicates that the definition of an investment entity is not met, and that consolidation or the equity method would provide more relevant financial information.

#### *5.1.2.5. Typical characteristics of an investment entity*

In assessing whether an entity meets the definition described above, it should consider whether the following typical characteristics of an investment entity are present:

- a) It has more than one investment;
- b) It has more than one investor;
- c) It has investors that are not related parties of the entity; and
- d) It has ownership interests in the form of equity or similar interests.

[IFRS 10 para 28].

The absence of one or more of these typical characteristics does not necessarily disqualify the entity from being an investment entity. However, it is highly unlikely that the definition of an investment entity will be met without having any of these typical characteristics. [IFRS 10 para BC234]. The typical characteristics have to be seen as a supplement to the definition, and real estate structures have to consider whether they display these characteristics.

##### *5.1.2.5.1. More than one investment*

The purpose of an investment entity is to hold several investments to diversify its risk and maximise its returns. This condition is met if a real estate entity is investing, via a holding company, into several properties or several property-holding entities. [IFRS 10 para B85O].

Entities might qualify as investment entities even if they have just one single investment, although the purpose for which the real estate structure has been set up must be taken into consideration.

For example, an entity might have just one single investment in the following situations: during its start-up period, when it only has seed money available; when it is in the course of finding replacements for disposals; or when it is in the process of liquidation. [IFRS 10 para B85P]. This can also occur when the entity is established to pool funds from a number of investors to invest in an investment unobtainable by individual investors (for example, a club deal to acquire a substantial iconic property in a core location). Typically, the investment would be out of reach for any single investor, due to its size and risk, but not for a pool of investors.

##### *5.1.2.5.2. More than one investor*

Typically, an investment entity would have several unrelated investors. However, paragraph B85R of IFRS 10 permits a single investor that represents or supports the interests of a wider group of investors (for example, a pension fund or family trust). Other examples where an investment entity might have only a single investor include the following situations, where an entity:

- a) Is within its initial offering period, and is actively identifying other suitable investors;
- b) Has not yet identified suitable investors to replace ownership interests that have been redeemed; or
- c) Is in the process of liquidation.

[IFRS 10 para B85S].



Other typical situations might include master-feeder structures, where there are multiple investors in the feeder funds.

#### *5.1.2.5.3. Unrelated investors*

If one or more of the investors in a real estate structure are related parties, the structure might not meet the definition of an investment entity. For example, this might arise where the fund manager of a real estate structure has contributed initial seed money and there are, as yet, few (if any) other investors.

IFRS 10 states that, typically, an investment entity has several investors that are not related parties, as defined in IAS 24. If, along with the invested fund manager, there are several other investors that are not considered related parties, the condition is met. This characteristic was introduced to prevent entities from structuring around the requirement to have more than one investor. The purpose under which the fund has been set up has to be taken into consideration.

In addition, IFRS 10 gives an example of when an entity qualifies as an investment entity, even where all of the investors are related. For example, an investment entity might set up a 'parallel' fund for its key management personnel which mirrors the investments in the main structure. This fund might qualify as an investment entity. [IFRS 10 para B85U].

#### *5.1.2.5.4. Ownership interests*

Typically, the investment entity is a separate legal entity, with the result that ownership interests are in the form of equity or similar interests, such as participation in a limited partnership by way of fund units, to which proportionate shares of the net assets of the investment entity are attributed. [IFRS 10 para B85V]. The entity might still be an investment entity, even if different classes of investors have rights only to specific investments or to a different proportionate share of the net assets. These could include partnership interests, investors in trust structures and structures with different classes of shares or units.

In fund structures, the units of the investors are often classified as liabilities. For the purpose of an investment entity assessment, these liabilities are considered as 'similar interests'.

In addition, a real estate structure that has significant ownership interests in the form of financing or debt (for example, profit participating loans or shareholders loans) might qualify as an investment entity if the holders are exposed to the variable returns from changes in the fair value of the entity's net assets.

Consideration is given to the range, scope and extent of the ownership and exposure to variable returns.

#### ***Example – Real estate fund***

##### **Background**

A real estate fund is set up to invest in real estate assets for the benefit of institutional and retail investors. It is set up and managed by an investment manager experienced in the real estate business. The fund invests in real estate companies and other real estate investment funds which own, manage and lease out real estate assets.

The investment manager has a policy of acquiring and disposing of its real estate investments over a five- to 10-year timeframe.

The fund earns dividends and it realises capital gains from its real estate investments.

The fund reports (internally and externally) all of its investments at fair value, and its performance is assessed based on those fair values.

The fund issues redeemable participating units which are redeemable at a share of the fund's net asset value (NAV). The founding documents of the fund confirm its objectives and strategy as stated.

Is the fund an investment entity?

### **Solution**

Yes. The fund meets the definition of an investment entity because:

- Its objective is to generate returns from capital appreciation and investment income through investment management services.
- It manages its investments on a fair value basis, which is reported to its investors.
- It displays the typical characteristics of an investment entity, which are: it has more than one unrelated investor; it holds multiple investments; and it has ownership interests in the form of fund units which represent a proportionate share of its underlying assets.

### **Example – Real estate entity**

#### **Background**

Real Estate Investments ('REI') was formed in order to develop, own and operate retail, office and other commercial properties.

REI usually holds each of its properties in separate wholly owned subsidiaries. Those subsidiaries have no substantial assets or liabilities other than borrowings used to finance the related investment property.

REI and each of its subsidiaries report their investment properties at fair value.

REI does not have a set timeframe for disposing of properties, although it uses fair value to help identify the optimal time for disposal.

REI and its investors also use measures other than fair value (including information about expected cash flows, rental revenues and expenses) to assess performance and to make investment decisions.

The directors and managers of REI do not consider fair value information to be the primary measurement attribute in evaluating investment performance; rather, they see that information as part of a group of equally relevant key performance indicators.

REI undertakes extensive property and asset management activities (including property maintenance, capital expenditure, redevelopment, marketing and tenant selection), some of which it outsources to third parties. This includes the selection of properties for refurbishment, development and the negotiation with suppliers for the design and construction work to be done to develop such properties. This development activity forms a separate substantial part of REI's business activities.

Is REI an investment entity?

#### **Solution**

No. REI is not an investment entity because:

- It has a separate substantial business activity that involves the active management of its property portfolio, including lease negotiations, refurbishments and development activities, and marketing of properties, to provide benefits other than capital appreciation and/or investment income.
- Its investment plans do not include specified exit strategies for its investments. As a result, it plans to hold those property investments indefinitely.
- Although it reports its investment properties at fair value under IAS 40, fair value is not the primary measurement attribute used by management to evaluate the performance of its investments. Other performance indicators are used to evaluate performance and make investment decisions.

(See also IFRS 10 para IE9, example 3.)

## 5.2. Joint arrangements

### 5.2.1. Overview

Entities in the real estate industry commonly use joint arrangements in structuring their business and operations.

Joint arrangements exist when joint control is present. Joint control is the agreed sharing of control when decisions over relevant activities require the unanimous agreement of the parties sharing control. It provides entities with a mechanism by which to:

- Manage their exposure to particular geographical regions and asset classes;
- Share risks in relation to the ownership and/or development of property; and/or
- Leverage the expertise, experience and knowledge of the joint arrangement partners.

The structuring of joint arrangements in the real estate industry varies from straightforward arrangements (for example, direct joint ownership of property assets) to more complicated arrangements (for example, joint arrangements to develop and construct property structured through separate vehicles and subject to various contractual agreements).

### 5.2.2. Classification and measurement of a joint arrangement

Under IFRS 11, there are two types of joint arrangements: joint operations, and joint ventures. A joint arrangement is classified as a joint operation where the investors have direct rights to the assets and obligations for the liabilities of the arrangement. A joint arrangement is classified as a joint venture where the investors have rights to the net assets of the arrangement.

Classification of an arrangement determines its accounting treatment: joint operations are accounted for by recognising the operator's relevant share of assets, liabilities, revenues and expenses; joint ventures are accounted for using equity accounting.

Entities need to assess their rights and obligations under the joint arrangement in order to determine the appropriate classification as either a joint operation or a joint venture.

Investment property that is directly owned as 'tenants in common', and not through a separate vehicle, meets the joint operation classification, where joint control exists.

Investment property or development projects undertaken through a separate vehicle (such as a trust, company or unincorporated partnership) will need to be carefully assessed. The accounting for a joint arrangement is not driven solely by its legal form. Operators will account for their involvement in a joint arrangement in a manner that is consistent with their rights and obligations. As such, it is important to understand the contractual terms of the agreements.

#### **Example – Joint arrangements with no separate legal structure**

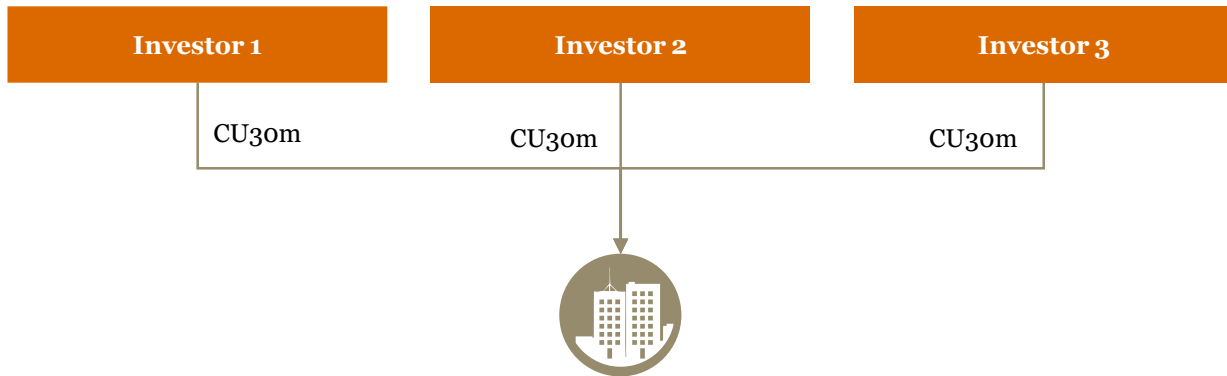
##### **Background**

An investment property with a value of CU90 million was purchased by three investors. Each investor has an equal interest in the property and is listed as a tenant in common on the title deed. Each investor has funded their interest individually, either through external borrowings or through capital. A joint ownership agreement has been signed between the investors to govern their joint ownership of the investment property.

The arrangement is depicted as follows:

- All parties must agree to decisions relating to:
  - The appointment/removal of the property manager;
  - Capital expenditure, including the decision to redevelop part or all of the investment property;

- Signing/re-signing major leases;
- Entering into service contracts greater than CU100,000 in relation to the property (for example, for cleaning services); and
- The approval of building insurance.
- Each party is liable for obligations and claims against the property.
- The net property income (NPI) will be distributed to investors based on their ownership interest. NPI is rental income collected by the property manager, less property expenses not recovered by the tenants.



Is the arrangement a joint operation or a joint venture?

**Solution**

The above is a joint operation under IFRS 11.

The fact that the investors share in the NPI of the investment property does not preclude it from being a joint operation, because each investor has direct rights to the investment property and is liable for obligations and claims arising. Each investor recognises its share of:

- Investment property;
- Tenants' receivables outstanding at period end;
- Trade creditors and accruals outstanding at period end;
- Property expenses incurred during the period; and
- Rental income generated during the period.

Each investor will also recognise the respective borrowings or additional capital obtained in order to fund the acquisition in their financial statements.

Paragraph BC 27 of IFRS 11 clarifies that it is possible for parties to a joint arrangement, which is not structured through a separate vehicle, to establish terms in the contractual arrangement under which the parties have rights only to the net assets of the arrangement. However, such structures would be very rare in practice.

***Example – Joint arrangements structured in a company***

**Background**

Company X was established in the current year by investors A and B, who own 60% and 40% respectively.

The company owns and operates a diversified property portfolio, which it has funded through external borrowings and capital contributed by investors A and B. The legal form of the company restricts the liability of investors to any unpaid capital contributions. Creditors of the company have no recourse against the investors.

The company's articles of association outline that an 85% majority is required for decisions regarding the relevant activities of the company. Each investor votes in proportion to their ownership interest; as such, both investors A and B must unanimously agree on decisions in relation to the company.

Is the arrangement a joint venture or a joint operation?

**Solution**

The above is a joint venture under IFRS 11. The company is a separate vehicle, which confers separation between the investors and the company itself – that is, the investors are only entitled to their share of the net assets of the company.

Both investors apply equity accounting to their interest in the joint venture.

***Example – Joint arrangements structured in an unincorporated partnership***

**Background**

Two parties have entered into an arrangement to construct an office building on a parcel of land.

Company A currently owns the land that will be developed as part of the joint arrangement. It will also undertake the development activities in order to construct the office building for a fee. Company A will retain legal title of the land. A development deed is entered into between both companies that provides a beneficial interest in the land to company B. As a result, both companies A and B will have a direct right to the land.

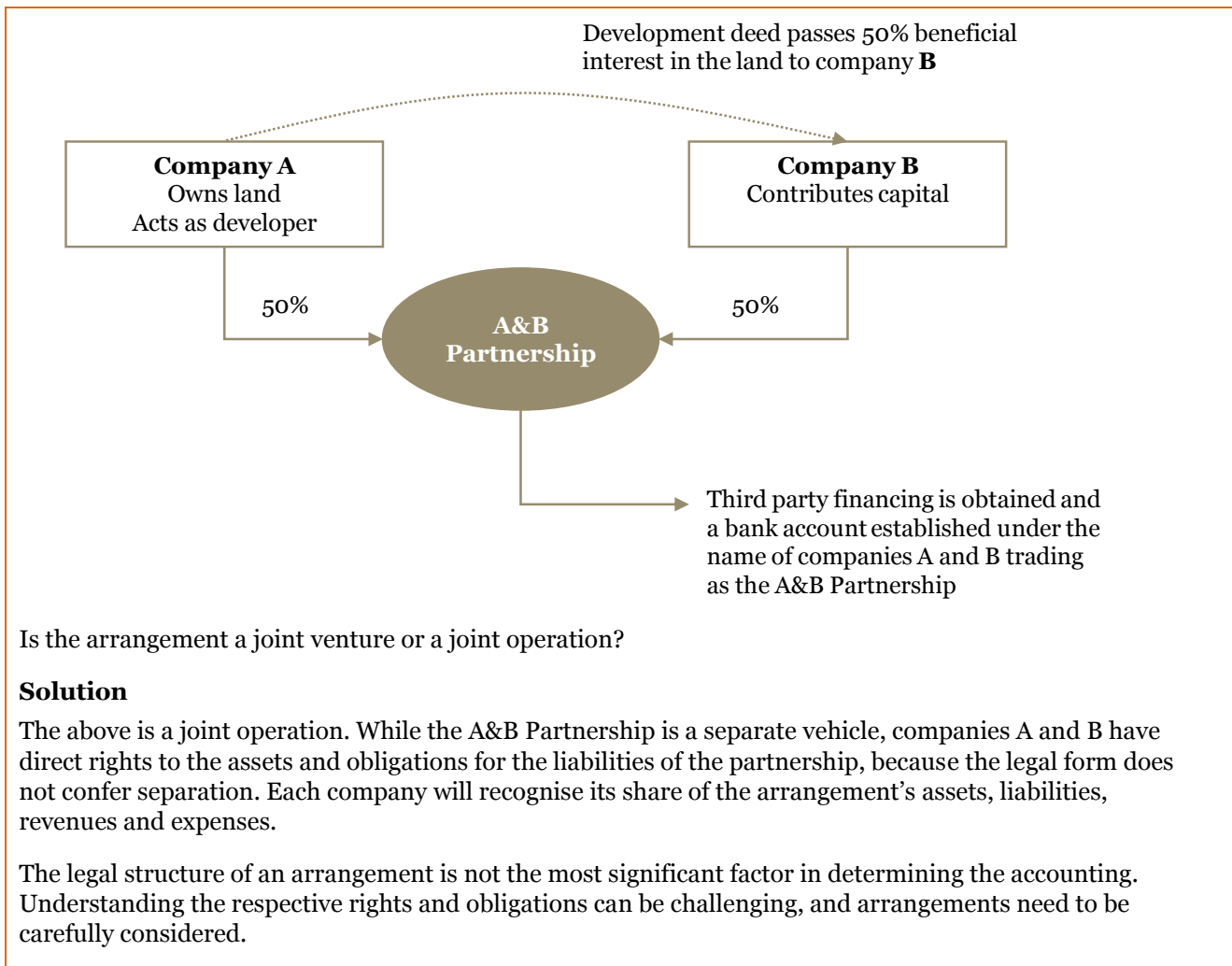
Company B identified the opportunity to partner with company A and will provide capital to the arrangement.

Companies A and B have established an unincorporated partnership to undertake the activities of the joint arrangement. The unincorporated partnership does not create legal separation between the entity itself and companies A and B.

Third party financing has been obtained by companies A and B trading as the A&B Partnership. The financing is secured against the land subject to development; however, companies A and B still have a direct obligation for the third party financing.

A bank account has also been established by companies A and B trading as the A&B Partnership. All payments for the development and receipt of income will pass through this bank account.

Separate books and records are maintained for the A&B Partnership, and financial statements are prepared on an annual basis for distribution to both companies.



A summary of the requirements is as follows:

Type	Rights and obligations	Accounting
Joint operations	Direct rights to the assets and obligations for the liabilities of the arrangement.	<p>A joint operator will recognise its interest based on its involvement in the joint operation (that is, based on its direct rights and obligations) rather than on the participation interest that it has in the joint arrangement. The balance sheet and income statement will be presented gross.</p> <p>“A joint operator shall recognise in relation to its interest in a joint operation:</p> <ul style="list-style-type: none"> <li>• Its assets, including its share of any assets held jointly.</li> <li>• Its liabilities, including its share of any liabilities incurred jointly.</li> <li>• Its revenue from the sale of its share of the output arising from the joint operation.</li> <li>• Its share of the revenue from the sale of the output by the joint operation.</li> <li>• Its expenses, including its share of any expenses incurred jointly.”</li> </ul> <p>[IFRS 11 paras 20, 26(a)].</p>

Type	Rights and obligations	Accounting
Joint ventures	No rights to individual assets or obligations for individual liabilities. Instead, joint venturers share in the net assets and the profit or loss of the arrangement.	Joint ventures are accounted for using the equity method in accordance with IAS 28, 'Investments in associates', unless a scope exclusion applies. [IFRS 11 para 24].  In the consolidated financial statements, the net investment in the venture, reflecting the share of net assets, is a single line in the balance sheet; and the share of profit or loss appears as a single line in the income statement.

## 5.3. Taxation

### 5.3.1. Overview

The general principles of recognition and measurement of income taxes are set out in IAS 12. IAS 12 applies to all domestic and foreign taxes that are based on taxable profits or taxes on distributions from subsidiaries, joint ventures or associates, such as withholding taxes. [IAS 12 para 2].

### 5.3.2. Current tax

Current tax is generally recognised as income or expense, unless it arises from a transaction or event that is recognised in other comprehensive income or equity. [IAS 12 para 58]. Since gains or losses on investment property are recognised in the income statement, tax relating to the sale or use of investment property is recognised in the income statement.

Current tax liabilities are recognised for any unpaid tax expense for the current and prior periods. They are measured at the tax rates enacted or substantively enacted at the reporting date.

### 5.3.3. Deferred tax

Deferred tax arises when expenditure, gains and losses, assets and liabilities are recognised in one period but are included in the computation of taxable profits in future periods. For example, fair value movements on investment property measured at fair value in accordance with IAS 40 are often not taxed until the property is disposed of.

The approach to determining deferred tax can broadly be summarised as follows:

1. Determine tax base.
2. Calculate temporary difference, being the difference between accounting carrying value and tax base.
3. Assess any deductible temporary difference for recoverability.
4. Determine the tax rate that is expected to apply when the temporary difference reverses.
5. Calculate deferred tax, being the temporary difference multiplied by the tax rate.

Deferred tax normally arises from:

- a) Fair value movements recognised on investment property carried at fair value; and
- b) The difference between the tax base and carrying value of investment property measured at cost as a result of different depreciation rates being used for tax and accounting purposes.

### 5.3.4. Deferred tax on investment property measured at fair value

The general principle in IAS 12 is that entities should measure deferred tax using the tax bases and tax rates that are consistent with the manner in which the entity expects to recover or settle the carrying amount of the item. For assets, the carrying amount of an asset is normally recovered through use, or sale, or use and sale. The distinction between recovery through use or sale is important since, in some jurisdictions, different rates might apply for income (recovery through use) and capital gains (recovery through sale). However, for investment

property carried at fair value, there is a rebuttable presumption that recovery will be entirely through sale, even where the entity earns rentals from the property prior to its sale. [IAS 12 para 51C].

In order to rebut this presumption, investment property must be depreciable and held as part of a business model whose objective is to consume substantially all of the economic benefits embodied in the property through use over time. An investment property might not qualify for tax depreciation, and no part of the property's cost is deductible against taxable rental income. Instead, the cost of the property (uplifted by an allowance for inflation, where applicable) is allowed as a deduction against sales proceeds for the purpose of computing any taxable gain arising on sale. [IAS 12 para 51C].

Deferred tax for investment properties carried at fair value should generally be measured using the tax base and rate that are consistent with recovery entirely through sale, and using capital gains tax rules (or other rules regarding the tax consequences of sale, such as rules designed to claw back any tax depreciation previously claimed in respect of the asset). If the presumption is rebutted, deferred tax should be measured reflecting the tax consequences of the expected manner of recovery.

The presumption also applies where investment property is acquired in a business combination and the acquirer later uses fair value to measure the investment property. [IAS 12 para 51D].

The freehold land component of an investment property can be recovered only through sale.

***Example – Deferred tax on investment property at fair value: clawback of tax depreciation and 0% capital gains tax***

**Background**

On 1 January 20X7, entity A in jurisdiction X purchased an investment property for CU100. The investment property does not have a freehold land component. The investment property is subsequently measured at fair value.

At 31 December 20X9, the fair value of the investment property is CU120. The tax written-down value is CU88 (that is, the accumulated tax depreciation is CU12).

The tax legislation in jurisdiction X is as follows:

1. A tax allowance equal to purchase cost is claimed in annual instalments on an investment property held for use.
2. The income tax rate is 30%.
3. Cumulative tax depreciation claimed previously will be included in taxable income if the investment property is sold for more than tax written-down value.
4. Sale proceeds in excess of original cost are not taxed.

What would the deferred tax liability be in each of the following scenarios?

- a) Entity A expects to dispose of the investment property within the next year.
- b) Entity A's business model is to consume substantially all of the economic benefits of the investment property over time, rather than through sale.
- c) Entity A has no specific plans to sell the investment property and holds it to earn rental income, although the investment property might be sold in the future.

**Solution**

- a) There is a rebuttable presumption that the carrying amount of an investment property measured at fair value will be recovered entirely through sale. This presumption is consistent with management's expected manner of recovery. Entity A recognises a deferred tax liability as follows:



	CU
At 31 December 20X9	
Carrying amount at fair value	120.00
Tax base	(88.00)
Taxable temporary difference	32.00
Clawback of tax depreciation below cost (CU12 at 30%)	3.60
Fair value in excess of cost (CU20) at 0%	0.00
Deferred tax liability	3.60

b) If entity A's business model is to consume substantially all of the economic benefits of the property (other than the freehold land) over time, the presumption of recovery through sale will be rebutted.

Entity A therefore recognises a deferred tax liability as follows:

	CU
At 31 December 20X9	
Carrying amount at fair value	120.00
Tax base	(88.00)
Taxable temporary difference	32.00
Deferred tax liability at 30%	9.60

c) Entity A has no specific plans to sell the investment property and no business model to consume substantially all of the economic benefits of the property over time, so the presumption of recovery through sale is not rebutted. Deferred tax is determined based on the tax consequences of sale as in scenario a), which is a deferred tax liability of C3.60.

**Example – Deferred tax on investment property at fair value: clawback of tax depreciation and capital gains tax**

**Background**

Entity B owns an investment property in jurisdiction Y. The investment property does not have a freehold land component. Entity B has a policy of carrying properties at fair value, and the carrying amount of the investment property is CU50 at 31 December 20X0. It acquired the investment property originally for CU100 and has claimed tax deductions to date of CU40, hence the tax base is CU60.

The tax legislation in jurisdiction Y is as follows:

1. Tax deductions claimed are clawed back when the property is sold.
2. Capital gains tax is charged at 15% on the excess of the selling price over the original purchase price.
3. Income is taxed at 30%.
4. Capital losses can only be offset against capital gains.

What would the deferred tax liability be in each of the following scenarios?

- a) Entity B expects to dispose of the investment property within the next year.

- b) Entity B’s business model is to consume substantially all of the economic benefits of the property over time, rather than through sale.
- c) Entity B has no specific plans to sell the property and holds it to earn rental income, although the investment property might be sold in the future.

**Solution**

- a) Entity B expects to recover the carrying amount of the investment property from sale, which will result in a clawback of the previously claimed allowances of CU40. The deferred tax asset (DTA) and deferred tax liability (DTL) are calculated as follows:

	Taxable (deductible) temporary difference	Tax rate	DTL/(DTA)
Tax depreciation clawback	40	30%	12
Capital losses (fair value less purchase price)	(50)	15%	(7.50)

The tax relief on capital losses can only be utilised if there are sufficient capital gains to offset the loss. As such, the deferred tax asset can only be recognised if the criteria in paragraph 24 of IAS 12 are met. Note that, in line with paragraph 74 of IAS 12, the deferred tax liability and deferred tax asset cannot be offset in this case, since jurisdiction Y only allows capital losses to be offset against capital gains.

- b) Entity B is able to rebut the presumption if it has a business model that it will consume substantially all of the property’s economic benefits over time, rather than through sale. In this case, entity B will recognise a deferred tax asset of C3 [(CU50 – CU60) \* 30%], subject to the criteria in paragraph 24 of IAS 12.
- c) Entity B has no plans to sell the investment property, and no business model to consume substantially all of the economic benefits of the property over time, so presumption of recovery through sale is not rebutted. Deferred tax is determined based on the tax consequences of sale as in scenario a).

**Example – Deferred tax on investment property at fair value: no tax depreciation with capital gains tax**

**Background**

Entity C acquired an investment property on 1 January 20X9. The investment property does not have a freehold land component. The entity’s accounting policy is to measure investment properties at fair value. The cost of the investment property is CU50, which is its tax base for capital gains tax purposes.

Management expects to use the property for 10 years, to generate rental income, and to dispose of the property at the end of year 10. The property’s residual value at the end of 10 years is estimated to be C20. The fair value of the property is CU60 at 31 December 20X9.

The tax legislation in jurisdiction Z is as follows:

1. The cost of an investment property is not deductible against rental income, but any sales proceeds are taxable after deducting the acquisition cost.
2. The tax rate is 30% for taxable income and 40% for capital gains.
3. No annual tax allowance is available on an investment property held for use.

What is the deferred tax liability on initial recognition and at the end of year 1?

**Solution**

Entity C’s business model is not to consume substantially all of the economic benefits of the property over time, given its intention to sell the property in year 10. As a result, the entire property is presumed to be

recovered through sale. There is a tax base available on sale, being the purchase price of the property of CU50 at acquisition. There is no temporary difference on initial recognition.

At the end of year 1, the fair value of the investment property has increased to CU60, with no change in the tax base on disposal. There is a taxable temporary difference of CU10. Entity C would recognise a deferred tax liability of CU4 (CU10 x 40%) at the end of year 1.

### 5.3.5. *Deferred tax on investment property measured at cost*

Investment property carried at cost is depreciated over its useful life for accounting purposes. The rebuttable presumption that the asset will be recovered through sale (noted in section 5.3.4) does not apply to investment property measured at cost. The expected manner of recovery might be through a combination of use and sale. The asset's carrying amount is split between the use and sale elements, and these carrying amounts are compared to their respective tax bases. If the only tax deduction available for the property is on sale, the tax base of the building's use element carried at cost would be nil on initial recognition and in all future periods. [IAS 12 para 51].

#### **Example – Deferred tax on investment property at cost**

Entity E in jurisdiction E acquired 100% of the shares in entity S for CU500 on 31 December 20X0. The identifiable assets acquired included an investment property with a fair value of CU250 and other net assets with a fair value of CU100.

Entity S purchased the investment property for CU180. The cumulative tax depreciation at 31 December 20X0 is CU45.

The tax legislation in jurisdiction E is as follows:

1. Gains on disposal (sales proceeds over the original purchase price) are not taxed, but the previously claimed tax allowance is clawed back.
2. The income tax rate is 30%.

What would the impact in the consolidated financial statements of entity E be, on the recognition of deferred tax on the property and on the goodwill at acquisition, where entity E applies the cost model and assumes recovery of the property through use?

#### **Solution**

Entity E should apply the expected manner of recovery principle when the cost model is applied. Since recovery of the property is assumed to be through use, entity E recognises a deferred tax liability on acquisition of CU34.50 ((CU250 – CU180 + CU45) x 30%). The corresponding debit is recognised in goodwill.

### 5.3.6. *Deferred tax on investment property held in a corporate wrapper*

In some jurisdictions, investment properties are held in individual legal entities, often referred to as 'corporate wrappers'.

This allows entities to buy and sell properties without the need to change the legal title or incur any associated stamp duties. Specific structures might also give rise to differences in tax treatment, particularly where the tax rate for the sale of property is different from the tax rate for the sale of shares. These structures give rise to accounting issues around transaction costs and deferred tax.

#### **5.3.6.1. Consolidated financial statements**

IAS 12 does not explicitly provide guidance on how to account for deferred taxes where investment properties are held in corporate wrappers. However, in our view, consistent with an agenda decision issued by the IFRS Interpretations Committee in July 2014, management should apply a two-step approach to considering provisions for deferred taxes:

1. Level of the legal entity that is the corporate wrapper: management should determine the expected manner of recovery of the underlying property (that is, whether the underlying property will be recovered through use or sale by the corporate wrapper). Management should then determine the temporary difference based on the expected manner of recovery (referred to as the 'inside basis' difference) and calculate the deferred tax in the books of the corporate wrapper.
2. Level of the consolidated financial statements: management should also identify any additional 'outside basis' difference between the accounting carrying value of the subsidiary and its tax base. Deferred tax on the outside basis difference should be recognised if required by paragraph 39 of IAS 12.

This applies even where the group expects to recover its investment in the corporate wrapper without an impact on taxable profit, or with a lesser impact than from selling the property itself (for example, by selling the corporate wrapper). Deferred tax is recognised on the inside basis difference, being the difference between a property's carrying amount and its tax base. The property itself (not the investment in the corporate wrapper) is recognised in the consolidated balance sheet, so the relevant tax base is that of the asset and not that of the investment.

The outside basis difference arises where the carrying amount of the subsidiary in the consolidated financial statements is different from the tax base, which is often the cost of the investment at the date of acquisition. Outside basis differences usually arise where undistributed profits in the investee increase the carrying value of the parent's investment in the investee above its tax cost, where the investment's carrying amount is impaired, or where the investment's carrying amount changes as a result of changes in foreign exchange rates (for example, where the investee has a functional currency different from the reporting currency). In the context of corporate wrappers, unrealised profits might arise when the underlying property is remeasured to fair value.

However, deferred tax on the outside basis difference might not need to be recognised, because IAS 12 provides an exception from recognising the deferred tax arising on the outside basis difference. The exception applies if:

- The parent controls the timing of the reversal of the temporary difference; and
- It is probable that the temporary difference will not reverse in the foreseeable future.

[IAS 12 para 39].

The carrying amounts for such investments or interests can be recovered through distributions or disposal. Therefore, if the parent has determined that the subsidiary's profits or reserves will not be distributed in the foreseeable future and the entity will not be disposed of, no deferred tax is recognised on the outside basis difference.

### *5.3.6.2. Separate financial statements*

In the separate financial statements of the entity holding the investment in the corporate wrapper, prepared under IAS 27, deferred tax would be determined on the basis of the carrying value of the investment in the corporate wrapper, since this is the asset recognised on the balance sheet.

#### ***Example – Deferred tax on properties held within corporate wrappers***

##### **Background**

Entity Y holds property X within a corporate wrapper, entity W. The fair value of the property recognised in the consolidated financial statements of entity Y is CU10 million and its tax base is CU5 million. Entity Y's management expects the eventual disposal of property X to take place through a sale of entity W, giving rise to a tax charge of CU750,000 relating to sale of the investment. If entity Y decided to sell the property by itself, this would give rise to a tax charge in entity W of CU1.5 million. This is based on the assumption that the expected manner of recovery of the property is through sale. In addition, entity Y has determined that the exception in paragraph 39 of IAS 12 applies, so deferred tax is not recognised on any outside basis differences in relation to entity Y's investment in entity W.

How should entity Y recognise deferred tax:

- a) In its consolidated financial statements?
- b) In its separate financial statements?

**Solution**

- a) Entity Y should record a deferred tax liability of CU1.5 million in its consolidated financial statements. In the consolidated financial statements, the property is an asset that gives rise to a temporary difference, and the expected manner of recovery is through selling the asset.
- b) Entity Y should record a deferred tax liability of CU750,000 (unless the exemptions in para 39 of IAS 12 apply). In the separate financial statements, it is the investment balance in entity W that gives rise to a temporary difference. Note that, in cases where the investment in a subsidiary is measured at cost and has not been remeasured subsequent to initial recognition, the deferred tax liability might be nil.

**5.3.6.3. Deferred tax on initial recognition of corporate wrappers**

IAS 12 does not permit the recognition of deferred tax on initial recognition of an asset. [IAS 12 paras 15, 24]. Note that, in consolidated financial statements, this exception does not apply in the event that assets held in corporate wrappers are acquired as part of a business combination (see section 2.3). In the case of an asset acquisition, in line with an agenda decision issued by the IFRS Interpretations Committee in July 2014, the exceptions in IAS 12 in respect of recognition of deferred tax apply. Regardless of whether the acquisition price takes into consideration the benefit of tax implications, no deferred taxes should be recognised. The acquisition price should be allocated solely to the acquired assets pro-rata, ignoring any deferred taxes.

## 6. Disposal of investment property

### 6.1. Classification as held for sale under IFRS 5

Investment property is classified as held for sale under IFRS 5 where its carrying amount will be recovered principally through a sale transaction rather than continuing use. [IFRS 5 para 6].

For a property to be classified as held for sale, the following conditions need to be met:

- the asset must be available for immediate sale in its present condition; and
- the sale must be highly probable.

[IFRS 5 para 7].

For a sale to be highly probable, management must be committed to a plan to sell the property and have an active programme to locate a buyer and complete the plan. The property must be actively marketed at a price that is reasonable in relation to its current fair value, and the sale should be expected to complete within one year of classification. [IFRS 5 para 8]. For investment property carried at fair value, the measurement provisions of IFRS 5 do not apply. [IFRS 5 para 5(d)]. For investment property under the cost model, measurement under IFRS 5 is at the lower of the carrying amount and fair value less costs to sell.

#### 6.1.1. Property under construction

For property under construction to be classified as a non-current asset held for sale, it is required to be available for immediate sale in its present condition, and the sale should be highly probable and should occur under normal market conditions.

The criterion of marketability should be particularly scrutinised. If the property cannot be sold as property under construction but only following completion, the investment property is not available for immediate sale in its present condition, because completion is required to reach marketability. If there is, in exceptional cases, a possibility to dispose of the property before the construction is completed, meaning that the property is transferable 'as it is', presentation as held for sale is required, provided that all other conditions in IFRS 5 are met.

### 6.2. Sale of investment property

Revenue for sale on investment property is recognised when:

- the entity has transferred significant risks and rewards of ownership;
- the entity has no continuing managerial involvement to the degree associated with ownership;
- revenue can be measured reliably; and
- it is probable that future economic benefits will flow to the entity.

[IAS 18 para 14].

### Impact of IFRS 15

Revenue is recognised when a performance obligation is satisfied, which occurs when control of the property transfers to the buyer. The standard provides a list of indicators to consider when determining the point in time at which control passes to the customer, including but not limited to whether:

- the entity has a right to payment;
- the customer has obtained legal title to the asset;
- the entity has transferred possession of the asset to the customer;
- the customer has significant risks and rewards of ownership of the asset;
- the customer has accepted the asset.

Gains on disposal are the difference between the net disposal proceeds and the carrying value of the assets. Such gains are recognised in the income statement. [IAS 40 para 69].

Any consideration received is measured at fair value. Deferred consideration receivable for the sale of an investment property is discounted to present value to arrive at the cash price equivalent, which is the proceeds of sale. The difference between this amount and the amount receivable is treated as interest income and recognised, over the period until the actual receipt, using the effective interest method. [IAS 40 para 70].

#### *Example – Treatment of deferred sales proceeds*

##### **Background**

Investment property entity T has recently sold a property for CU12 million. The sale agreement provides for CU10 million to be remitted at the date of legal completion of the sale, with the remaining CU2 million payable after one year. The market rate of interest for 12-month loans to entities with a similar credit rating to the buyer is 7%.

Is entity T required to discount deferred sales proceeds to their net present value?

##### **Solution**

Yes, the arrangement effectively constitutes a financing transaction. Entity T should record an amount receivable of CU1,869,159 ( $CU2,000,000/1.07$ ). It would recognise the difference between CU1,869,159 and CU2,000,000 as interest income over the 12-month period using the effective interest method.

Proceeds for disposal are measured in accordance with IAS 18/IFRS 15.

Whereas, in most cases, the disposal proceeds are readily determinable, complications might arise where:

- consideration for the sale includes contingent consideration (that is, consideration dependent on the occurrence of a specific event);
- consideration is variable (for example, consideration that is a percentage of revenue); or
- additional services are also provided to the buyers as part of the sale transaction.

For example, a vendor might provide transition or other management services to the buyer on an ongoing basis. The vendor might also make head lease payments on vacant space.

The entity needs to consider the accounting for more complicated recognition and measurement items in accordance with relevant standards.

### ***Example – Variable consideration on sale of property***

#### **Background**

A real estate owner sells property to a developer for C1 million. The owner is also entitled to receive 5% of any future sales price of the property in excess of C5 million.

The owner determines that its experience with similar contracts is of little predictive value, because the future performance of the real estate market will cause the amount of variable consideration to be highly susceptible to factors outside the entity's influence. Additionally, the uncertainty is not expected to be resolved in a short period of time, because the developer does not have current plans to sell the land.

Should the real estate owner include variable consideration in the transaction price?

#### **Solution**

No amount of variable consideration should be included in the transaction price, because the amount cannot be measured reliably and it is not probable that economic benefits will flow to the real estate owner. The transaction price at contract inception is therefore C1 million.

#### **Impact of IFRS 15**

It is not highly probable that a significant reversal of cumulative revenue recognised will not occur, resulting from a change in estimate of the consideration that the land owner will receive on future sale of the land. The land owner will update its estimate, including application of the constraint, at each reporting date until the uncertainty is resolved. This includes considering whether any minimum amount should be recorded.



## 7. Other reporting issues

### 7.1. Functional and presentation currency

#### 7.1.1. Overview

IAS 21 requires an entity to determine its functional currency and measure its results and financial position in that currency. The functional currency serves as the basis for determining whether the entity is engaging in foreign currency transactions. IAS 21 defines foreign currency as a currency other than the functional currency. Identifying the functional currency has a direct impact on which transactions are foreign currency transactions that give rise to exchange gains and losses and, thereby, on the reported results.

The standard permits an entity to present its financial statements in a currency other than its functional currency. The currency in which the financial statements are presented is referred to as the 'presentation currency'.

#### 7.1.2. Functional currency

Functional currency is the currency of the primary economic environment in which the entity operates. [IAS 21 para 8]. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash.

The functional currency determination is straightforward for a simple investment property entity operating in a single country. As investment property entities become more complex, this can also increase the complexity of determining the functional currency.

A listed investment property fund might be domiciled in a particular country, its shares traded on the country's stock exchange and denominated in the local currency. However, it might not hold all or any of its investment properties in that country. The currency of the primary operating environment is the most relevant factor in determining functional currency.

The most significant factors for determining functional currency are:

- It is the currency that mainly influences the sale prices for goods and services. For example, if an entity owns only one property in country X, by which it earns rental in country X's currency, this would indicate that country X's currency would be the functional currency of the entity.
- It is the currency of the country whose competitive forces and regulations mainly influence the sales prices of goods and services. In the above example, the competitive forces in country X would drive the determination of sales price.
- The currency that mainly influences labour, material and other costs.

[IAS 21 para 9].

Where the above factors are not clear, the following factors are also considered:

- The currency in which funds from financing activities (such as issuing debt or equity) are generated.
- The currency in which receipts from operating activities are retained (that is, the currency in which the entity maintains its working capital balance).

IAS 21 provides additional factors for consideration when determining the functional currency of foreign operations held as subsidiaries:

- The degree of autonomy of a foreign operation from its parent entity.
- Whether transactions with the parent are significant.
- Whether cash flows of the foreign operation are readily available for remittance to the parent.
- Whether the foreign operation can meet its debt obligations without the support of the parent.

[IAS 21 para 11].

### 7.1.3. *Presentation currency*

An entity can choose to present its financial statements in any currency. There is no requirement in the standard for an entity to present its financial statements in its functional currency.

Where the entity has a different presentation currency from its functional currency, it translates its financial statements from functional currency to presentation currency as follows:

- assets and liabilities are translated at the closing rate;
- income and expenses are translated at exchange rates at the transaction dates; for practical reasons, most entities use average rates as an approximation; and
- all resulting differences are recognised in other comprehensive income.

#### ***Example – Determination of functional currency: operations and capital in different countries***

##### **Background**

Entity X invests primarily in investment properties in the United States. Entity X is incorporated in the Netherlands. All acquisitions and divestments of properties are undertaken in US Dollars (USD). Entity X is an autonomous entity. Rental agreements are in USD. The entity is financed in Euros (EUR); reporting to the European-based investors is also in EUR.

What is the appropriate functional currency for an investment property entity with operations in different countries?

##### **Solution**

The appropriate functional currency for entity X is USD. It represents the most relevant currency, because it is the currency that mainly influences its rental revenue and expenses.

Given the nature of the entity, the primary indicators for this type of entity are significant. Provided that these indicators are conclusive, there is no need to consider the currency in which its financing activities are generated and in which its receipts from operating activities are usually retained.

Entity X can choose to present its financial statements in EUR.

**Example – Determination of functional currency: investment properties in various countries**

**Background**

Investment property entity X is domiciled in Switzerland. Entity X's shares are denominated in Swiss Francs (CHF) and are traded on the local stock exchange. Entity X invests principally in investment properties in countries having EUR as their national currency. The entity also invests, directly, approximately 10% of its funds in Russia, but 90% of its income and revenue expenditure is determined and denominated in EUR. Entity X is an autonomous entity. Its debt is denominated in EUR and its financial statements are presented in CHF.

What is the appropriate functional currency for an investment property entity with investments in various countries?

**Solution**

The appropriate functional currency for entity X is EUR. It represents the most relevant currency, because it is the currency that mainly influences its rental revenue and related expenses.

**Example – Functional currency of an entity with transactions denominated in a foreign currency**

**Background**

A real estate entity operates in Russia. It owns several office buildings in Moscow and St Petersburg that are rented to Russian and foreign entities. All lease contracts are denominated in USD, but payments can be made either in USD or in Russian Roubles (RUB). However, almost all of the lease payments are settled in RUB. This has also been the historical pattern of payment.

What is the appropriate functional currency for the investment property entity?

**Solution**

The 'sales and cash inflows' indicators produce a mixed response:

- a) The currency that mainly influences the pricing of the lease contracts is USD, whereas the cash inflows are in RUB.
- b) Cash outflows (such as the principal operating costs, management of properties, insurance, taxes and staff costs) are likely to be incurred and settled in RUB.

The lease payments are denominated in USD, but US Dollars are not considered to be significant to the entity's operation because:

- a) most of the collection is in RUB, which is subject to short-term changes in USD/RUB exchange rates; and
- b) it is the local conditions and circumstances in Russia, and not in the US, that determine the rental yields of properties in Moscow and St Petersburg that mainly influence the pricing of the lease contracts, which are merely denominated in USD.

It is, therefore, the currency of the Russian economy, rather than the currency in which the lease contracts are denominated, that most faithfully represents the economic effects of the real estate activity in Russia.

## 7.2. Cash flow statement

### 7.2.1. Overview

IAS 7 requires all entities to prepare a cash flow statement as an integral part of their financial statements for each period for which financial statements are presented. The cash flow statement reports changes in cash and cash equivalents in the period, classifying these as arising from operating, investing or financing cash flows.

### 7.2.2. Definition of cash and cash equivalents

Cash and cash equivalents comprise cash on hand and demand deposits, as well as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. [IAS 7 para 6]. Cash and cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. [IAS 7 para 7].

Cash and cash equivalents must be readily convertible to known amounts. Restricted cash or blocked accounts, depending on the nature and severity of the restrictions, might not qualify as cash and cash equivalents.

### 7.2.3. Cash flows from operating activities

Cash flows from operating activities represent cash flows in the normal course of business and operations of an entity.

Rental income is usually classified within operating activities for a real estate entity, because it is viewed as part of the normal operations of the entity.

Initial direct leasing costs and tenant incentive payments should also normally be classified as an operating activity, because they are considered to be costs of obtaining the lease and are part of the normal revenue-generating activities of the entity.

In addition, if a real estate entity routinely sells real estate property, gains from disposals would be recognised within operating activities; otherwise, they would represent investing activities and would be recognised as such.

### 7.2.4. Cash flows from investing activities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Payments for acquisition of investment properties are normally classified within investing activities.

### 7.2.5. Cash flows from financing activities

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. [IAS 7 para 6].

Borrowings to finance the acquisition of investment property are classified within financing activities.

#### **Example – [xxx]**

##### **Background**

Entity A is generating property rental income. On 31 December 20X1, it sold real estate property X for CU1 million, of which:

- a) CU0.8 million is transferred from the purchaser directly to a blocked account; and
- b) the remaining CU0.2 million is paid to entity A at the sale date.

The amounts in the blocked account will be used to settle entity A's bank borrowings for property X in six months' time. This will legally release entity A from its obligation to settle the liability. Entity A is not able to use the amounts transferred to the blocked account for any other purpose than to repay the bank borrowings. The entity does not routinely sell real estate property.

How should the amounts held in the blocked account be recorded in entity A's statement of cash flows?

##### **Solution**

Given the nature of Entity A's operating activities, it should disclose the cash inflow of CU1 million from the sale of the investment property as part of investing activities. However, the amount of CU0.8 million should be recorded as a non-cash transaction in investing activities, with adequate disclosure given in the notes.

[IAS 7 para 43]. When the entity receives the cash and repays the loan in the following year, it should recognise the remaining proceeds and the repayment of borrowings.

Extract from the cash flow statement as of 31 December 20X1:

<b>Cash flow from investing activities</b>	<b>Current year</b>
Proceeds from sale of investment property	+ CU0.2 million
Cash outflow from non-cash equivalent investment	-
<b>Cash flow from investing activities</b>	<b>CU0.2 million</b>

Extract from the cash flow statement as of 30 June 20X2:

<b>Cash flow from investing activities</b>	<b>Current year</b>
Proceeds from sale of investment property	+ CU0.8 million
<b>Cash flow from investing activities</b>	<b>CU0.8 million</b>

<b>Cash flow from investing activities</b>	<b>Current year</b>
Cash outflow from repayment of long term borrowings	- CU0.8 million
<b>Cash flow from investing activities</b>	<b>CU0.8 million</b>

# 8. Disclosures

## 8.1. Segment disclosures

Public entities are required to disclose, in their financial statements, information regarding the nature and financial effects of activities in which they engage and the economic environments in which they operate. The disclosures should be consistent with the information presented to the entity's chief operating decision maker (CODM). Information is presented for the entity's reportable segments.

### 8.1.1. Definitions

An operating segment is a component of an entity:

- that engages in business activities from which it can earn revenues and incur expenses;
- whose operating results are regularly reviewed by the entity's CODM to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete financial information is available.

[IFRS 8 para 5].

A reportable segment is an operating segment that:

- generates revenue exceeding 10% of total revenues;
- has an absolute net profit of 10% of the combined reported profit of the segments that report a profit;
- has an absolute net loss of 10% of the combined reported loss of the segments that report a loss; or
- has assets exceeding 10% of total assets.

Management discloses information about each reportable segment. Once an entity has identified the reportable operating segments, it can combine information about the remaining operating segments to produce a reportable segment. This is possible only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria in IFRS 8. [IFRS 8 para 14].

### 8.1.2. Considerations for operating segments in real estate: managing properties on a portfolio basis

A real estate entity might have only one operating segment – for example, if the entity's only business activity is that of investing in similar real estate properties in a specific geographical area with similar tenants. In such a case, the properties might be managed together and the CODM might regularly review the portfolio's operating results and performance on a combined basis, with decisions about resources to be allocated also being made at that level.

Even if the real estate entity comprises less uniform properties, the CODM might review the performance of, and allocate resources to, the portfolio together. Ultimately, an entity's operating segments are determined 'through the eyes of management'.

Even if a real estate entity has only one operating segment, it will still need to present segment information to satisfy the minimum requirements of IFRS 8. [IFRS 8 para 31].

### 8.1.3. Considerations for operating segments in real estate: managing real estate on a property-by-property basis

In some cases, real estate entities manage their real estate portfolio on a property-by-property basis.

Each property would be an operating segment, if the CODM reviews the results and performance of the properties on a property-by-property basis and makes decisions about resources to be allocated to the properties on the same basis.

However, if only the day-to-day management is performed on a property-by-property basis, but the CODM does not use this information and does not assess performance on a property-by-property basis, the entity's operating segments would be determined on the same basis as that used by the CODM.

There is, in theory, no limit on the number of operating segments that an entity can have, given that these are based on reporting to the CODM. However, IFRS 8 states that an entity with more than 10 reportable segments should consider whether a practical limit of reportable segments has been reached. [IFRS 8 para 19]. Entities with a significant number of reportable segments should consider aggregating segments.

Examples of single properties which might be operating segments are as follows:

- A single asset in the US could be an operating segment, if all other real estate assets are located in Europe and information about the asset is reported separately to the CODM.
- A single logistics asset could be a stand-alone operating segment, if all other assets in the real estate entity's portfolio are office buildings and information about the logistics asset is reported separately to the CODM.

#### *8.1.4. Matrix information provided to the CODM*

The CODM of a real estate entity might receive information that aggregates the portfolio of property according to different criteria. Such information might distinguish the information by property type or by geographical area.

If the CODM uses more than one set of segment information, the real estate entity needs to determine which component constitutes the operating segment. Factors that can be considered include the nature of the business activities of each component, the risks and rewards profile, the existence of managers responsible for them, and information presented to the board of directors. [IFRS 8 para 8].

If the CODM uses overlapping sets of components (for example, it manages the company's activities on a matrix basis), the entity should determine which set of components best constitutes the operating segments by reference to the core principle in IFRS 8. [IFRS 8 para 10].

#### *8.1.5. Criteria used to determine operating segments*

Depending on how a real estate entity is managing its properties, the CODM might receive information on the following basis:

- Types of property: office buildings, logistics, retail areas, warehouses, hotels, retail housing, etc.
- Nature of the attached business model: developed properties, properties under development, non-development property.
- Nature of management: individually managed properties, properties managed on a portfolio basis.
- Location of properties: Europe/US/Asia, town centre/inner suburbs/outer suburbs.
- Types of tenant: retail, corporate, governmental.
- Number of tenants: multiple-tenant property, single-tenant property.
- Types of investment: direct property investments, indirect property investments.

### 8.1.6. Aggregation

Operating segments that meet the quantitative threshold (as explained in section 8.1.1) could be aggregated into a single operating segment if aggregation is consistent with the core principle of IFRS 8, the economic characteristics are similar, and segments are similar with regard to:

- a) nature of services and products sold;
- b) nature of production processes;
- c) type or class of customers;
- d) methods use to provide services; and
- e) nature of regulatory environment.

In some cases, the aggregation characteristics in IFRS 8 are not as relevant to a real estate entity as they would be for other entities outside the industry (for example, the nature of the regulatory environment being similar). In such cases, a real estate entity could still aggregate operating segments, provided that the other criteria that are relevant or meaningful, when applied, are met.

In assessing the areas listed in paragraph 12 of IFRS 8 for a real estate entity, management should consider the relevant attributes of the segments, including the nature of the investment properties and how they are managed, the economic environment of the properties' location, and the different types of tenant.

IFRS 8 requires disclosures of judgements relating to aggregation of segments, specifically the economic indicators that have been assessed to determine that the aggregated segments share similar economic characteristics. [IFRS 8 para 22].

### 8.1.7. Future plans in determining reportable segments: abandonment of operations with a view to reinvesting

A real estate entity might sell all of its investment properties that are in one specific location, but have plans to buy another property in the same location in the future.

The entity might continue to report the respective segment, even though it contains no assets. If the CODM continues to review this segment and expects that the absence of assets in this segment will be temporary, management might choose to continue to report a segment in the current period, even though separate reporting of the segment is no longer required. [IFRS 8 para 17].

However, if the purchase of the new property takes more than one year, such that the segment results for all periods presented are zero, management should assess whether continued reporting of this segment provides useful information for users.

### 8.1.8. Transfers of investment property

A real estate entity might reclassify a property from investment property to inventories, due to the commencement of development with a view to sale. The operating segment which now includes this inventory might not have previously met the quantitative thresholds for separate reporting. If, after reclassification, the operating segment now meets the quantitative thresholds, the entity is required to disclose the operating segment containing inventory as a separate segment, with prior year comparative information.

Note that this does not mean that the entity should restate the comparative information to show the property as inventory in the prior year. The property was investment property in the prior year, and the transfer only affects the current period. Further, the property was not reflected as inventory in the reporting to the CODM in the previous year.

The transfer of one property to another segment is not a change in the internal structure of the entity in a manner that causes the composition of the reportable segments to change. [IFRS 8 para 29].



### *8.1.9. Change in the manner in which properties are managed*

A real estate entity might change the way that it manages its investments for various reasons (for example, due to increasing risk related to property investments in a geographical area). This might require a change in the reporting to the CODM, which will result in a change of the composition of the reportable segments.

If the change in the internal organisation results in a change to the information that the CODM reviews to assess performance of operating segments and allocate resources, the entity will need to change the composition of its operating and reportable segments.

This requires a restatement of prior year segment data, unless this information is not available and the cost to develop the information would be excessive. [IFRS 8 para 29]. In the latter case, the entity must disclose that fact and present segment information on both the new and the old basis in the year in which the segment changes occur. [IFRS 8 para 30].

### *8.1.10. Use of non-IFRS information*

An entity should report information using the same measures used in the reports regularly provided to the CODM.

If the report to the CODM uses non-IFRS information, the entity is required to use this information for its segment reporting. For example, management in the industry often reviews performance of the business on a 'look-through' basis – that is, it analyses and reviews the performance of not only the portfolio that is directly held but also those held jointly through separate vehicles.

The amount of each segment item reported should be the measure reported to the CODM for the purpose of making decisions about allocating resources to the segment and assessing its performance. [IFRS 8 para 25].

### *8.1.11. Measurement of reportable segments*

An entity should report information on reportable segments as presented to the CODM. Disclosures should be presented to explain:

- the basis of accounting for inter-segment transactions;
- the nature of differences between reportable segments' profit or loss before tax from continuing operations and the reported IFRS profit;
- the nature of differences between reportable segments' assets/liabilities and the assets/liabilities reported in the balance sheet;
- any changes from prior years in measurement methods; and
- the nature/effect of asymmetrical allocations to segments.

[IFRS 8 para 27].

If the CODM uses only one measure to allocate resources and assess performance, and this single measure is based on non-GAAP information, this measure should be used for the purpose of segment reporting. In this case, the explanations of the measurements used as required by paragraph 27 of IFRS 8 gain additional significance, and a reconciliation of the segments' financial information to the consolidated IFRS financial statements will be necessary. [IFRS 8 para 28].

If the CODM uses both non-IFRS and IFRS-compliant information, the entity should report measures that are determined in accordance with the principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements. For example, if the CODM uses both net profit excluding unrealised fair value gains or losses on investment property and net profit before tax, the latter measure would be more consistent with the profit figures used in the financial statements. [IFRS 8 para 26].

### *8.1.12. Material items of income and expense to be reported*

A real estate entity should disclose several different financial measures if they are reviewed by the CODM when measuring the performance of the segment. The following are examples of typical financial information that a real estate entity might disclose:

- rental income from external customers;
- interest income;
- interest expenses;
- depreciation and amortisation;
- net gains or losses from fair value adjustments;
- income tax;
- property operating expenses; and
- ground rents paid.

[IFRS 8 para 23].

An entity might report items to the CODM on a net basis, although these are recorded on a gross basis in the income statement – for example, the CODM reviews rental income net of rental expenses, but rental income is presented on a gross basis in the income statement. In such cases, the entity should disclose the fact that the amounts are regularly provided to the CODM on a net basis. It should present the amounts of revenue net and then reconcile those to the consolidated IFRS revenue.

A similar example would be where a real estate entity enters into swap agreements to economically hedge the interest rate cash flow risk of variable interest borrowings that finance its property investments.

The information reviewed by the CODM only presents the interest received from the swap, since the entity presents the interest payments on the borrowings, and the interest received and paid from the swap, net.

Even though the standard requires an entity to report interest income separately from interest expense for each reportable segment, in the above scenario the interest expense should be presented net. This is because the CODM relies primarily on the net interest expense to assess the interest rate cash flow risk. The entity should reconcile the net interest expense to the figures presented in the primary financial statements.

Disclosure is required of revenues from external customers for each product or service, or each group of similar products and services. If a real estate entity has only one operating segment, it would not be required to disclose revenue on a property-by-property basis. [IFRS 8 para 32].

### *8.1.13. Geographical information*

Disclosure of revenue from external customers and certain non-current assets, such as investment properties, is required for the entity's country of domicile and in total for all other countries. Revenue from external customers and non-current assets attributed to an individual foreign country are disclosed separately, if they are material. Disclosure of revenue by continent would normally not be acceptable. [IFRS 8 para 33].

### *8.1.14. Major customers disclosure*

Entities should disclose the extent to which they rely on major customers. If the revenue of the real estate entity is driven by a single tenant (10% or more of revenue), the entity is required to disclose that fact and state the total amount of revenue from that tenant. However, the standard does not require disclosure of the name of the tenant or the property that it relates to. If the revenue is driven by a large number of tenants, and no single tenant or group under common control contributes more than 10% of the entity's revenue, the real estate entity does not need to give this disclosure. However, the entity should state that fact. [IFRS 8 para 34].

## 8.2. IFRS 13 disclosures

### 8.2.1. Overview

IFRS 13 requires entities to disclose detailed quantitative and qualitative information about assumptions made and processes used when measuring assets or liabilities at fair value. Further guidance on the measurement requirements of IFRS 13 is contained in section 3.6.

### 8.2.2. Fair value hierarchy

As noted in section 3.6.5, fair value measurements in IFRS 13 are categorised into a three-level hierarchy. Fair value measurements of real estate are usually categorised as Level 2 or Level 3 valuations, with Level 3 being the most common categorisation. Certain IFRS 13 disclosures are only required for fair value measurements categorised as Level 3.

### 8.2.3. Disclosure of valuation techniques

Paragraph 93(d) of IFRS 13 requires the following disclosures for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy:

- a description of the valuation technique(s) used; and
- the inputs used in the fair value measurements. An entity should provide quantitative information about the significant unobservable inputs used in the fair value measurement for fair value measurements categorised within Level 3 of the fair value hierarchy.

As noted in section 3.6.4, there are three widely used valuation techniques. Whilst the standard does not indicate a preferred valuation technique, an income or market approach will often be more suitable to measure fair value for real estate.

### 8.2.4. Asset classes for disclosure purposes

For the purposes of presenting disclosures, entities are required to determine appropriate classes of assets on the basis of the following:

1. the nature, characteristics and risks of the asset; and
2. the level of the fair value hierarchy in which the fair value measurement is categorised.

[IFRS 13 para 94].

The number of classes is expected to be greater for fair value measurements categorised within Level 3 of the fair value hierarchy, because those measurements have a greater degree of uncertainty and subjectivity. Judgement is required for the determination of appropriate classes of investment property for which disclosures about fair value measurements should be provided.

Companies often disaggregate the classes of properties in accordance with their disclosed segments.

Companies might also disaggregate properties on a basis other than their disclosed segments, usually providing more detail compared to the segment reporting information. Quite often, companies disaggregate disclosures by geography, or class of property, or both.

### 8.2.5. Sensitivities and sources of estimation uncertainty

Paragraph 93(h) of IFRS 13 requires the following disclosures to be provided for investment properties measured at fair value categorised within Level 3 of the fair value hierarchy:

“... a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To

comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs shall include, at a minimum, the unobservable inputs disclosed when complying with (d).”

IFRS 13 requires companies, at a minimum, to include a narrative description of the sensitivity to changes in significant unobservable inputs used in the fair value measurement. The guidance does not explicitly require a quantitative sensitivity analysis. However, such sensitivity analysis might be necessary in order to satisfy the requirements of IAS 1.

Paragraph 125 of IAS 1 requires that “an entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of: (a) their nature; and (b) their carrying amount as at the end of the reporting period”.

Where assumptions made in determining the fair value of investment property are significant assumptions in the context of IAS 1, further information should be provided within the financial statements so that users understand the effect of estimation uncertainty. The disclosure of the sensitivity of carrying amounts to significant assumptions is an example of information to be provided in accordance with paragraph 129 of IAS 1. The format of the disclosure might be in a tabular or narrative format.

### *8.3. Disclosure of fair value for properties accounted for using the cost model*

The disclosure of the fair value of investment property accounted for under the cost model is required, except for those properties where the fair value cannot be determined reliably. In such a case, in addition to a description of the investment property, management is required to explain why the fair value cannot be determined reliably and, if possible, the range of estimates within which the fair value is highly likely to lie. [IAS 40 para 78(a) to (c)].

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