Property Fund Accounting
Jersey Funds Association*
February 2008

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Course objectives

- What is an investment property? Some basics…
- Accounting
- Accounting overview
- Key auditing and accounting Issues

What is an investment property?

What is an investment property?

A piece of real estate that is owned for the purposes of financial gain, either,

- through appreciation in value, or
- through income from the property
- or both

Other types of real estate

Development Property

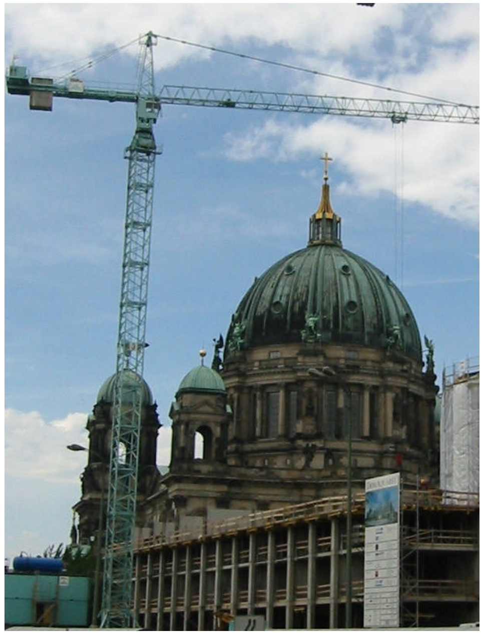
- Properties which on completion are intended to be investment properties

Trading Property

- Properties developed or purchased for immediate resale

Owner-occupied Property

- Property held for use in the production or supply of goods or services or for administrative purposes.



Leasehold Vs freehold

Leaseholders:

- Own the lease to the property
- Land on which the property stands is owned by the freeholder
- Can be referred to as ‘tenants’ or ‘lessees’
- Pay ground rent to the freeholder

Freeholders:

- Own the property and the land on which it stands
- Can be referred to as ‘landlords’ or ‘lessors’

Leases

Lease

- A contract between a lessor and a lessee for the hire of a specific asset.
- NB Head lease: A head lease usually relates to an entire, multi-tenanted, sub-leased building and is usually for a longer term than the sub-leases.

Leases

Lessor

- The party in a lease that retains the ownership of the asset

Lessee

- The party in a lease that has the right to use of the asset in return for the payment of specified rentals

Rent – some typical types

Base Rent

- Fixed rent currently payable by the tenant
- Typically at 80% of full market rent and subject to review every 5 years

Turnover Rent

- Rent payable as a percentage of turnover over the base rent

Stepped Rent

- Rent that increases by steps over the first few years of the lease to the full value of the rent

Accounting

“Key” standards comparison

Subject	IFRS	UK GAAP
Investment Property	IAS 40	SSAP 19
Property Plant & Equipment	IAS 16	FRS 15
Inventories	IAS 2	SSAP 9
Construction	IAS 11	
Lease Incentives	SIC 15	UITF 28
Operating & Finance Leases	IAS 17	SSAP 21

Accounting overview

- **Investment properties**
- Development properties
- Lease accounting
- Operating lease incentives
- Other accounting issues

What is investment property?

IAS 40 Definition:

Property held (by the owner or by the lessee under a finance lease) to earn rental income, or for capital appreciation or both rather than for:

- Use in the production or supply of goods or services or for administrative services,
- Sale in the ordinary course of business, or
- Owner occupation.

What is investment property?

IAS 40 Definition Key Components:

Property — Rental income / Capital appreciation — Investment Property

Property — Owner Occupied / Inventory — ~~Investment Property~~

Investment property

UK GAAP - SSAP 19 Definition

Similar to the IFRS definition - BUT (and there always is one!)

- Rental income negotiated at arms length
- Excludes property let to and occupied by other group companies
- Requires that construction work and development must have been complete
- There is no reference to redeveloped investment properties

Investment property – Measurement at recognition

IFRS	UK GAAP
IAS 40 : Investment Property	**SSAP 19 : Investment Property**
Included in non-current assets.	Classified as tangible fixed assets or fixed asset investments.
Investment property shall be measured initially at cost (including transaction costs = directly attributable).	Should be recognised in the balance sheet at open market value.
Accounting policy choice: the fair value model or the cost model (choice applies to whole portfolio) – required to be disclosed.	Does not explicitly address initial measurement but assumed to be cost including transaction costs (directly attributable expenses).

Investment property - depreciation

IFRS	UK GAAP
IAS 40 - Investment Property	**SSAP 19 - Investment Properties**
No depreciation: Fair Value – no depreciation requirement.	**No depreciation:** Properties with head leases greater than 20 years not depreciated.
Depreciation: If accounting policy is the cost model account - depreciate in accordance with IAS 16.	**Depreciation:** Properties with head leases <20 years are depreciated over the lease term.
Disclosure: When using cost model - disclose the depreciation methods used; useful lives or depreciation rate used; gross carrying amount and accumulated depreciation.	**Disclosure:** When <20 years - disclose the depreciation methods used; useful lives or depreciation rate used; gross carrying amount and accumulated depreciation.

Investment property – subsequent revaluation

IFRS	UK GAAP
IAS 40 - Investment Property (Fair Value Model)	**SSAP 19 - Investment Properties**
Fair value of investment property shall reflect market conditions at the balance sheet date (without deduction for disposal costs).*	Market value*
Gain or loss arising on the change of the fair value of the investment property recognised in the Income statement in the period in which it arises.	Revaluation movements through the **STRGL** •Upwards •Temporary diminutions
	Permanent diminutions taken through P&L account.

** Net of lease incentives (i.e. accrued rent receivable debtor).*

Investment property - disclosures

IFRS	UK GAAP
IAS 40 - Investment Property (Fair Value Model)	**SSAP 19 - Investment Properties**
Fair value or cost method Assumptions for determining the fair value Valuations based on independent valuer	Name and professional qualification Basis of valuation Valuer employee/officer of the group Comparable amounts under historical accounting
Fair value or cost method: reconciliation between carrying amounts of investment property at beginning and end of the period.	Aggregate amount at beginning and at end of financial year

Investment property – income statement presentation

IFRS		UK GAAP	
IAS 40 - Investment Property		**SSAP 19 - Investment Property**	
Rental income	x	Rental income	x
Service and management charges	x	Service charge recoveries	x
Revenue	**x**	**Gross property income**	**x**
Net gain/(loss) from fair value adjustment on investment property	*x*		
Ground rent costs	x	Rents payable	x
Service charges paid	x	Service charges paid	x
Other direct property expenses	x	Other property outgoings	x
Other costs	x	Other costs	x
Operating profit	**x**	**Operating profit**	**x**

IFRS – cost model – up to 31 December 2008

IAS 40 allows cost accounting in accordance with IAS 16 ‘Property, Plant & Equipment’

Cost includes:

- purchase price
- any directly attributable expenditure

Disclosures:

- Depreciation method
- Reconciliation of opening & closing balances
- Fair value!

Accounting overview

- Investment properties
- **Development properties**

Development property – accounting framework

	IFRS	UK GAAP
Relevant accounting standard	IAS 16 'Property, Plant & Equipment' Post 1 January 2009 – under IAS 40 (R)	FRS 15 'Tangible Fixed Assets'
Property held in Balance Sheet at	Cost / Valuation	
Elements of cost	Acquisition costs of land and costs incurred in bringing property to present location and condition	
Financing costs	May capitalise interest under FRS 15 / IAS 23 'Borrowing Costs' but only whilst property is under development and only directly attributable costs. IAS23 revised now and option to expense has been removed.	

Development property – accounting framework

	IFRS	UK GAAP
Cost model	Cost (less impairment)	
Revaluation model	Through Equity	Through STRGL
Common Disclosures	Carrying Value at start / end of period	
Cost Model Disclosures	Reconciliation of opening & closing balances Impairment losses	

Development property – accounting framework

	IFRS	UK GAAP
Revaluation Model Disclosures	Dates of revaluation Methods / assumptions used Name of valuers Amount per cost model	
Interest disclosure	Accounting Policy Used Amount Capitalised Capitalisation Rate Used	

Accounting for transfers of properties under IFRS to 31 December 2008

Initial status	Transfer	New status	Accounting
Investment Property (IAS 40)	Redevelop existing investment property for continued future use as an investment property	Investment Property (IAS 40)	No impact
Inventory (IAS 2)	Development completed with view to sale	Inventory (IAS 2)	No impact
Development Property (IAS 16) – Post 1 Jan 09 – under IAS 40(R)	Development completed and let as an investment	Investment Property (IAS 40) (at fair value)	Difference between fair value of the property at date of transfer and previous carrying value recognised in I&E
Investment Property (IAS 40)	To be developed with a view to sale	Inventory (IAS 2)	Transfer to inventories at fair value

Accounting overview

Investment properties

Development properties

Lease accounting

“Key standards” comparison

Subject	IFRS	UKGAAP
Accounting for Leases	IAS 17	SSAP 21
Investment Property	IAS 40	SSAP 19

Operating lease or finance lease?

Definition of a finance lease centres on “economic substance”.

- IFRS - a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not transfer.
- PV of the minimum lease payments amounts to substantially all of the fair value of the leased asset.
- UKGAAP – same definition, includes the “90% test”

Key question is:

Are the risks and rewards of ownership substantially transferred to the lessee or the tenant occupying the property?

Split accounting for land and buildings (IAS17)

- Land and buildings within an occupational lease will be split
- The land element of a lease will be an operating lease if title is not transferred at the end of the lease
- The buildings element may be a finance lease or operating lease depending on the terms
- Applies to lessors and lessees

Split accounting for land and buildings - practicalities

- Initial valuation split
- Rental split
- Useful economic life
- Residual value

Accounting overview

Investment properties

Development properties

Lease accounting

Operating lease incentives

Key questions….

- What is an operating lease incentive?
- What forms may they take?
- How are they identified? (auditing & accounting issue)
- How are they accounted for under IFRS and UK GAAP?

What is an operating lease incentive?

In negotiating a new or renewed tenant lease, the landlord may provide incentives for the tenant / lessee to enter into the agreement to encourage the lessee to rent a building.

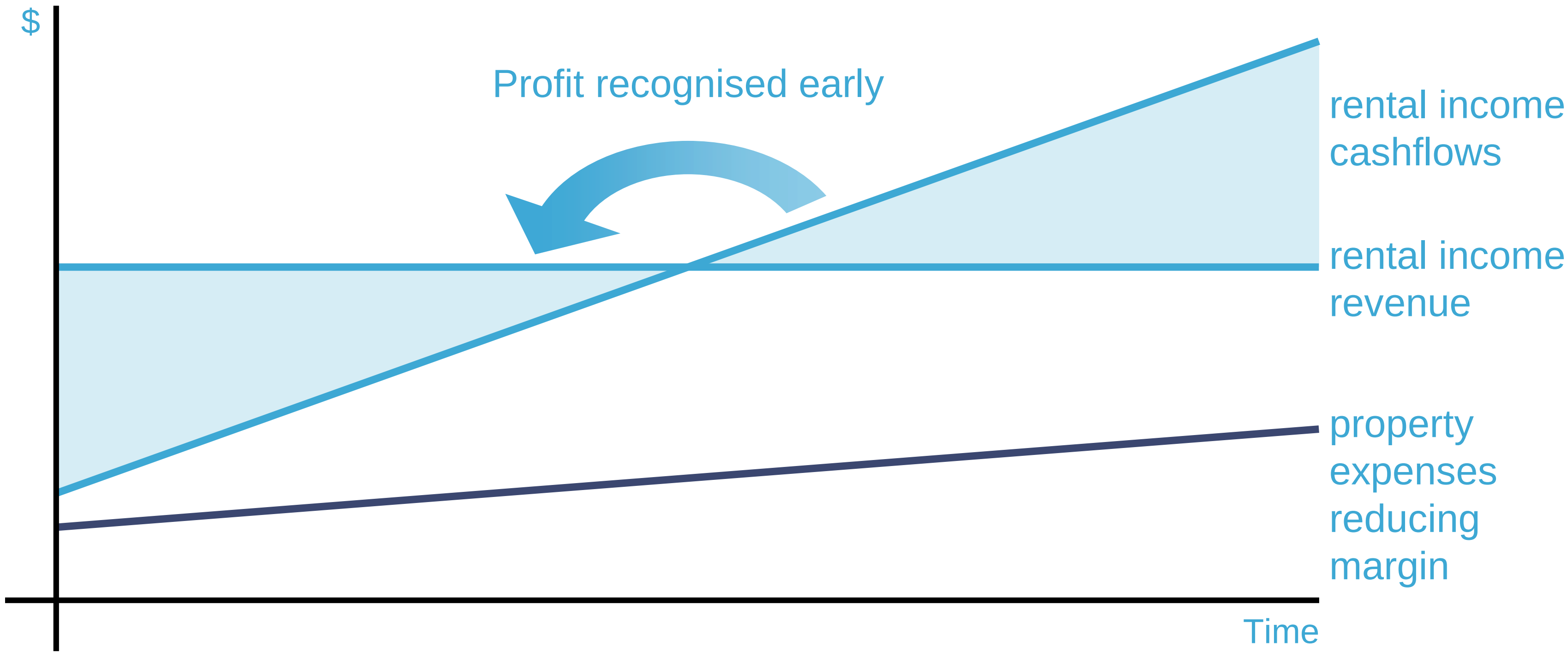
Some common examples:

- Initial rent free periods
- Reduced rent periods
- Upfront cash payments to the lessee
- Reimbursement of costs of the lessee
- “Fit-out” incentives

Lease incentives – accounting standards

	IFRS	UK GAAP
	SIC 15	UITF 28 Operating Lease Incentives
Period over which to spread the incentive	Length of lease – other systematic basis	First rent review date, when rentals revert to prevailing market rate

Purpose of the lease incentive is to - Straight lining the rental income



Accounting for lease incentives – IFRS

Principals of accounting for lease incentives – SIC 15

- Recognise costs of incentives as a reduction of rental income
- Net rental income / expenses spread on a straight line basis over the lease term (or the period to a break option in the lease)
- Unless another systematic basis is more representative of the time pattern over which the benefit of the leased asset is diminished.

Accounting for lease incentives – UK GAAP

Principals of accounting for lease incentives under UITF 28 (Broadly the same)

- Net rental income / expense spread over the period of lease commencement to earlier of:
  - Lease end date
  - First rent review date when rentals revert to prevailing market rate (Difference)
- Allocate costs on a straight line basis

Worked example – rent free period

- 10 year lease, rent review date after 5 years
- 1st year rent free followed by fixed rentals of £1m for 9 years

Question – What is the accounting treatment by the landlord using both GAAP'S?

Reminder:

	IFRS: SIC 15	UK GAAP: UITF 28
Period over which to spread the incentive	Length of lease – other systematic basis	First rent review date, when rentals revert to prevailing market rate

Lease incentives – GAAP differences – worked example

	IFRS (SIC 15)	UK GAAP (UITF 28)
Actual cash received for calculation of lease incentive	9,000,000 Years 1-10	4,000,000 Years 1-5
Spread over	10 Years	5 years
Annual rental Income charge	900,000	800,000
Straight line – total income statement		
1-5	4,500,000 (5*900,000)	4,000,000 (5*800,000)
6-10	4,500,000 (5*900,000)	5,000,000 (5*1,000,000)
Total rental income over life of lease	9,000,000	9,000,000

Lease incentives – journal entries – years 1-5

	Year 1	IFRS	UK GAAP	Closing IFRS Debtor	Closing UK GAAP Debtor
Dr	Lease incentive debtor	900,000	800,000	900,000	800,000
Cr	**Rental income**	**900,000**	**800,000**		
	Year 2				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**800,000**		
Cr	Lease incentive debtor	100,000	200,000	800,000	600,000
	Year 3				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**800,000**		
Cr	Lease incentive debtor	100,000	200,000	700,000	400,000
	Year 4				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**800,000**		
Cr	Lease incentive debtor	100,000	200,000	600,000	200,000
	Year 5				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**800,000**		
Cr	Lease incentive debtor	100,000	200,000	500,000	0

Lease incentives – journal entries – years 6-10

	Year 6	IFRS	UK GAAP	Closing IFRS Debtor	Closing UK GAAP Debtor
Dr	Bank	1,000,000	1,000,000	400,000	0
Cr	**Rental income**	**900,000**	**1,000,000**		
Cr	Lease incentive debtor	100,000	0		
	Year 7				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**1,000,000**		
Cr	Lease incentive debtor	100,000	0	300,000	0
	Year 8				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**1,000,000**		
Cr	Lease incentive debtor	100,000	0	200,000	0
	Year 9				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**1,000,000**		
Cr	Lease incentive debtor	100,000	0	100,000	0
	Year 10				
Dr	Bank	1,000,000	1,000,000		
Cr	**Rental income**	**900,000**	**1,000,000**		
Cr	Lease incentive debtor	100,000	0	0	0

Some additional points to watch

Interaction of Rent Frees with Property Valuation…

1. UK GAAP…Disclose investment property at Market Value less the separate tenant incentives debtor (avoid double counting cash flows under lease)
2. IFRS has same issue on fair value where may adjust the valuers market valuation as market value would lead to double counting as well
3. Not cash based...causes distributing funds major issues

Accounting overview

Investment properties

Development properties

Lease accounting

Operating lease incentives

Other accounting issues

Service charges

Normally an appointed agent to deal with common area costs – electric, heat, insurance etc.

The electric, heat, insurance costs are invoiced to the Fund/Company.

The service charge agent will then recharge this to tenants.

Service charge income and service charge expense belongs to the Fund/Company and should be included within the financial statements of the Fund/Company.

Consideration needs to be given about how this is presented within the financial information.

Surrender premiums

Payment made by either tenant or landlord to surrender the lease….typically seen from the property fund perspective

- Tenant pays: Surrender Premium Received (in lessor's books)
- Landlord pays: Surrender Premium Paid (in lessor's books)

No specific accounting standard dealing with these payments in UK GAAP or IFRS.

Surrender premium received – UK GAAP/ IFRS

Income transaction

- The surrender premium received is seen to be a compensation for future rent and a lease cancellation.
- Tenant no longer renting property so immediate income receipt. No future spreading to income.
- Taken to the income statement or P&L in the period receivable.
- Impact on operating profit for the financial year.
- Will have implications on distributions!

Surrender premium paid – UK GAAP/ IFRS

No definitive view.

At present, PwC view is as follows:

- UK GAAP certain limited circumstances where the surrender premium paid to allow redevelopment can be capitalised or paid to bring in a better tenant can be treated as a cost to amortise over the new tenant lease

- IFRS surrender premiums paid should always be written off as expense to income statement.

Rental guarantees

Weaker tenant rental market and vendors keen to supplement purchasers cash flows to make sale attractive or to fill void

Cash amounts that a vendor of a property guarantees to pay the purchaser for void or under-rented units.

- Rental guarantees should be taken off the cost of purchase of a property as they are connected to the acquisition cost.
- Rental guarantees should not be treated as lease incentives or rental income they are not connected with tenant leases.
- Payment/reduction in purchase price is from the vendor – not from a lessee.

Rental income issues - outstanding rent reviews / turnover rents / fixed uplift rental agreements

- Outstanding rent reviews - Reasonable estimate must be made of the likely increase.
- Turnover rents – Based on latest and historic information, should book a receivable for turnover element of rent from the tenant when reasonably assured of receipt and can be quantified.
- Fixed uplift rentals – Assured fixed uplift rentals should be booked and spread over the term of the lease.
- Again has implications on distributions

Letting costs

Finance Lease

- Initial direct costs incurred by lessors in negotiating and arranging a finance lease are included in the initial measurement of the finance lease receivable.

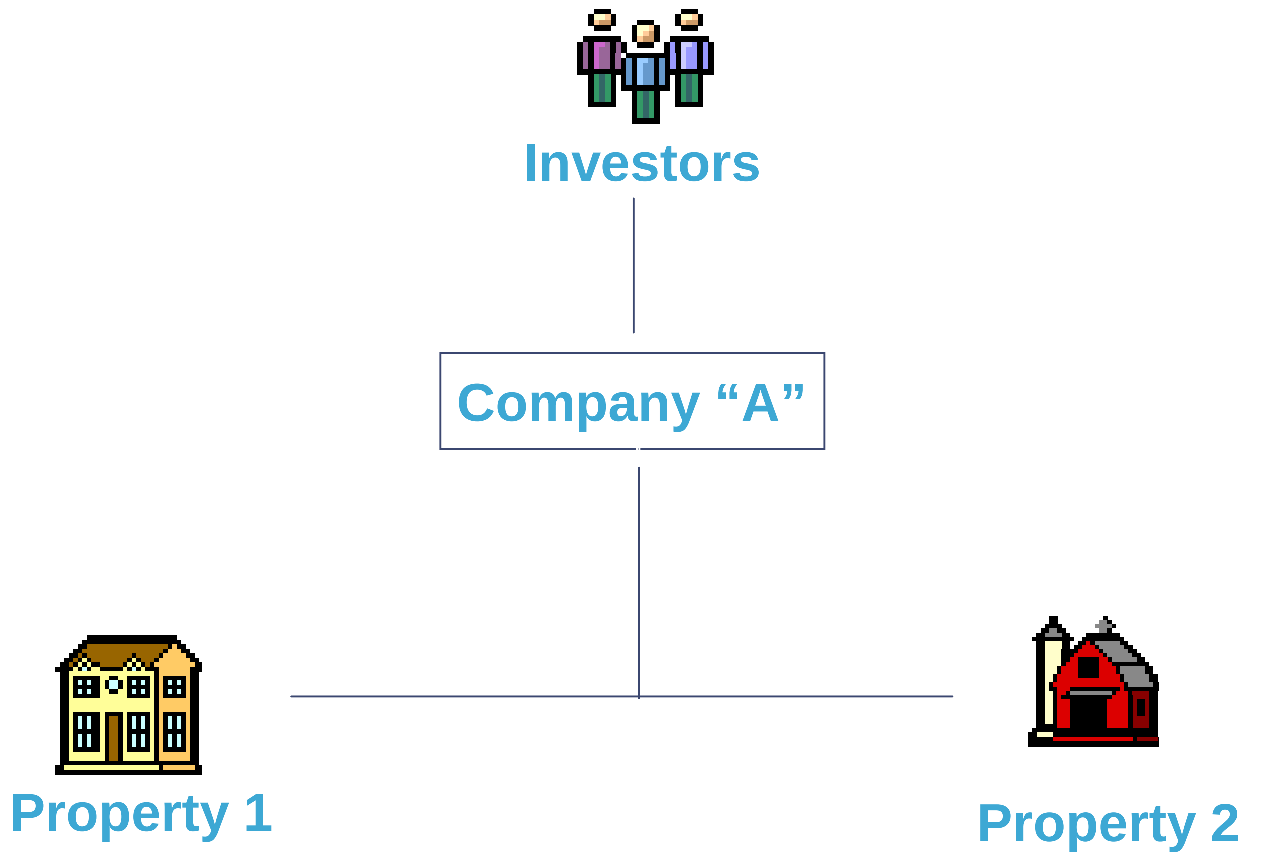
Operating Lease

- Initial direct costs incurred by lessors in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and are recognised as an expense over the lease term on the same basis as the lease income.

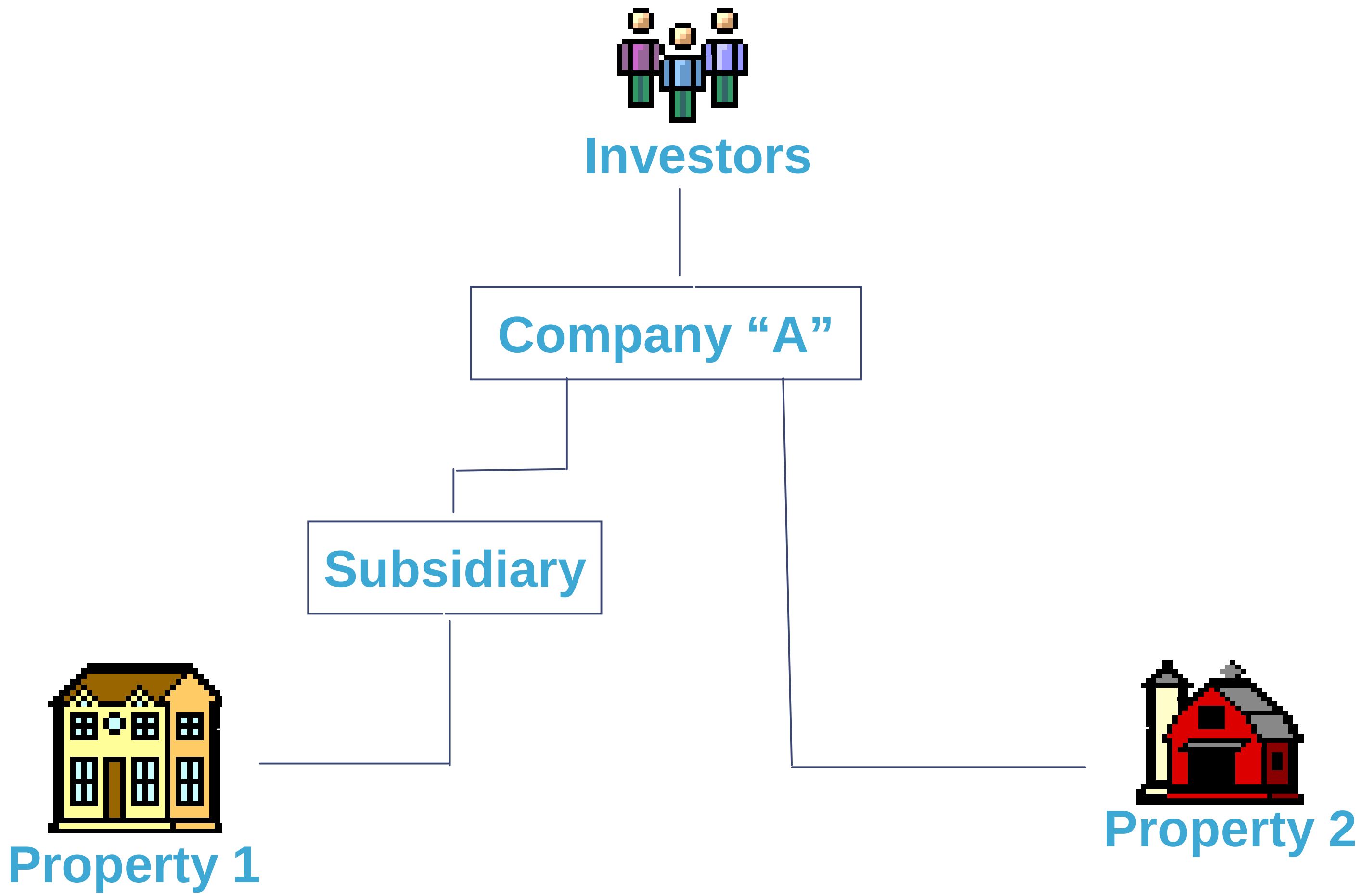
What are the different type of property investments?

- Direct Property Investments
- Properties held through a subsidiary
- Limited Partnerships
- Unit Trusts
- Joint Ventures

Direct property investments



Investment via a subsidiary



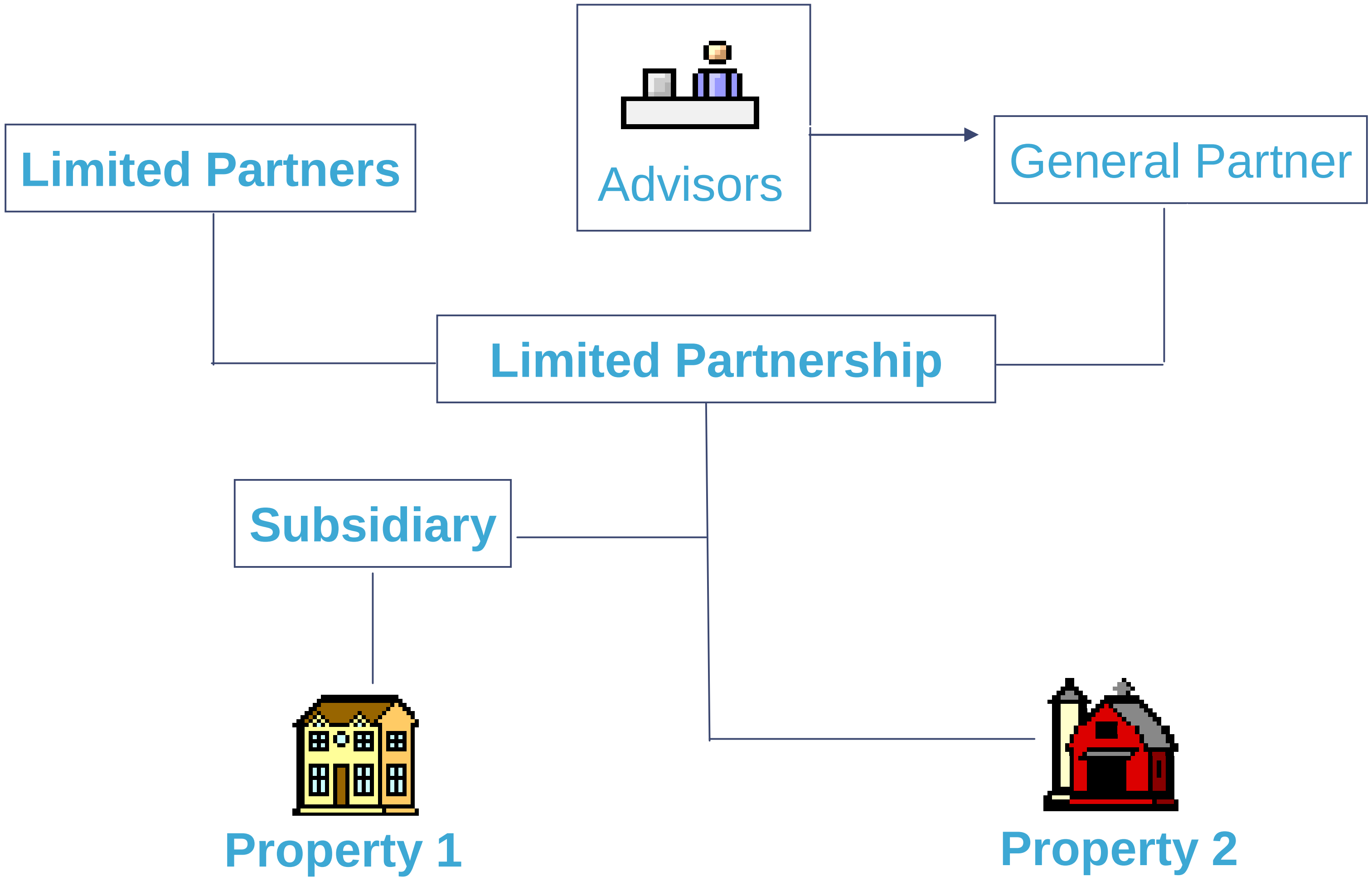
Why?

- Simple structure
- Can be part of a more complex structure
- Liquidity – especially for listed companies
- Limited Liability

Accounting impact

- Balance Sheet – Assets (Investment Property)
- Profit and Loss – Gross Property Income

Limited Partnership



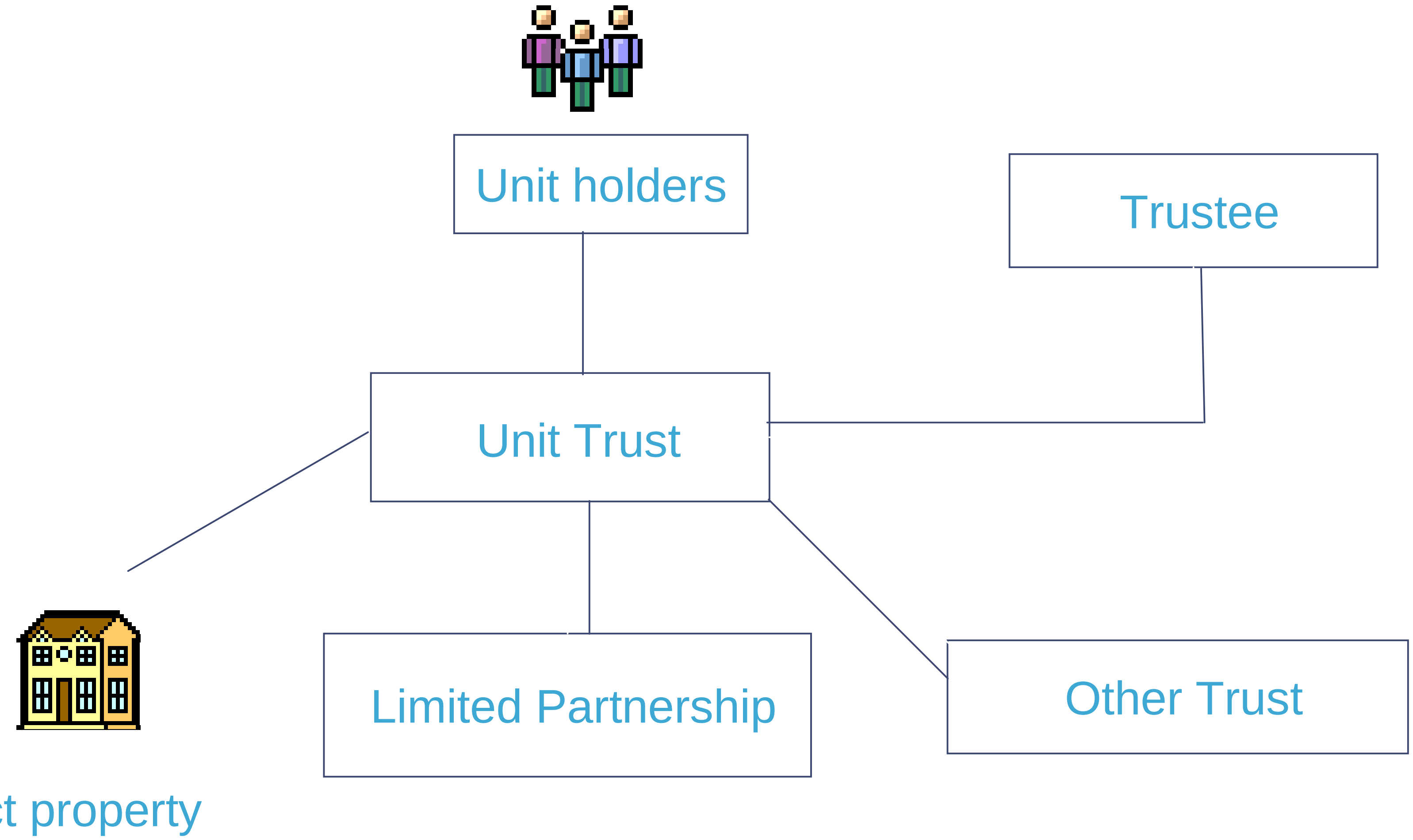
Why?

- Tax transparent entity
- Limited partners – limited liability
- General partner – unlimited liability
- Carry partners – preferential return
- Investors do not have to commit full capital at the outset – commitment is drawn down as investments are made
- Less onerous regulations – not driven by companies act but by limited partners agreement

Accounting impacts

- GP – Limited company
- LP – audited in accordance with the Limited Partnership Agreement

Unit Trust



Unit holders
Trustee
Unit Trust
Limited Partnership
Other Trust
Direct property

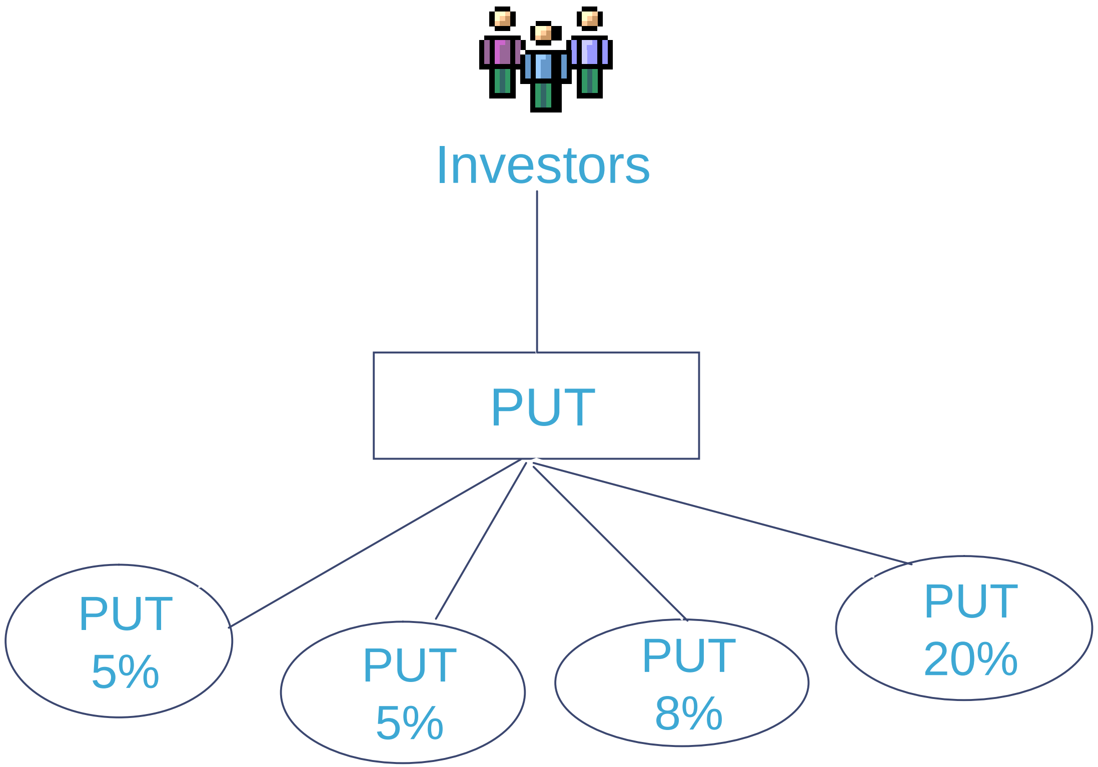
Why?

- Tax transparent
- Open or closed
- Not heavily regulated – can have offshore regulations

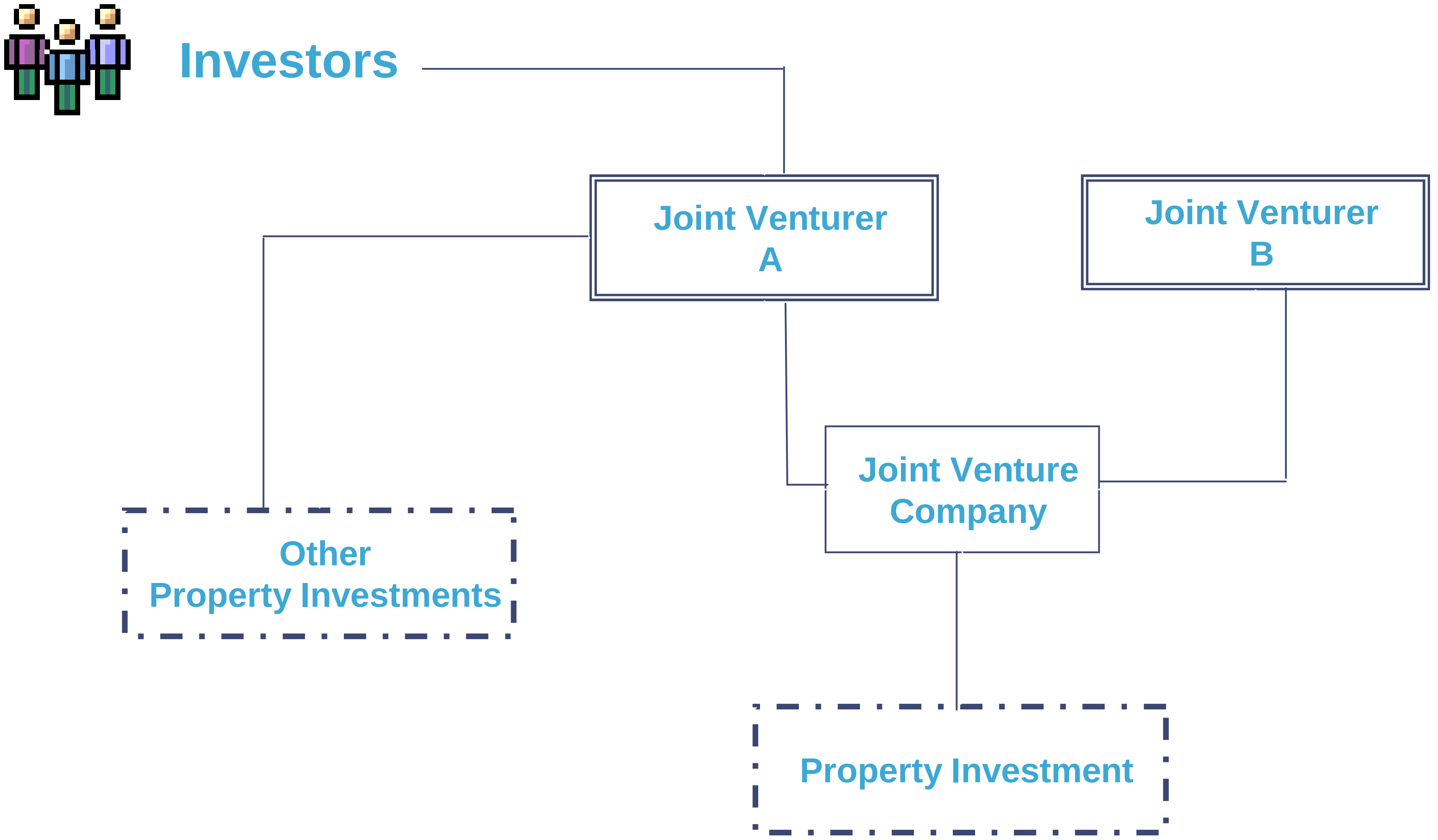
Accounting impact

Accounting in line with trust deed

Fund of Funds



Joint Venture



Why?

- Risk shared
- Pooling skills
- Increased access of capital

but

- Requires careful planning
- Potential disputes
- Rewards are shared

Key auditing and accounting issues

Areas of audit focus

Existence

- Proof of beneficial ownership – increasingly lawyers will not confirm beneficial ownership

Legal agreements

- Performance fees, commitments/contingencies

Valuation

- Valuation uncertainties (GN 5)
- Impact on bad/doubtful debts on valuation – valuations based on DCF models – how are these affected?

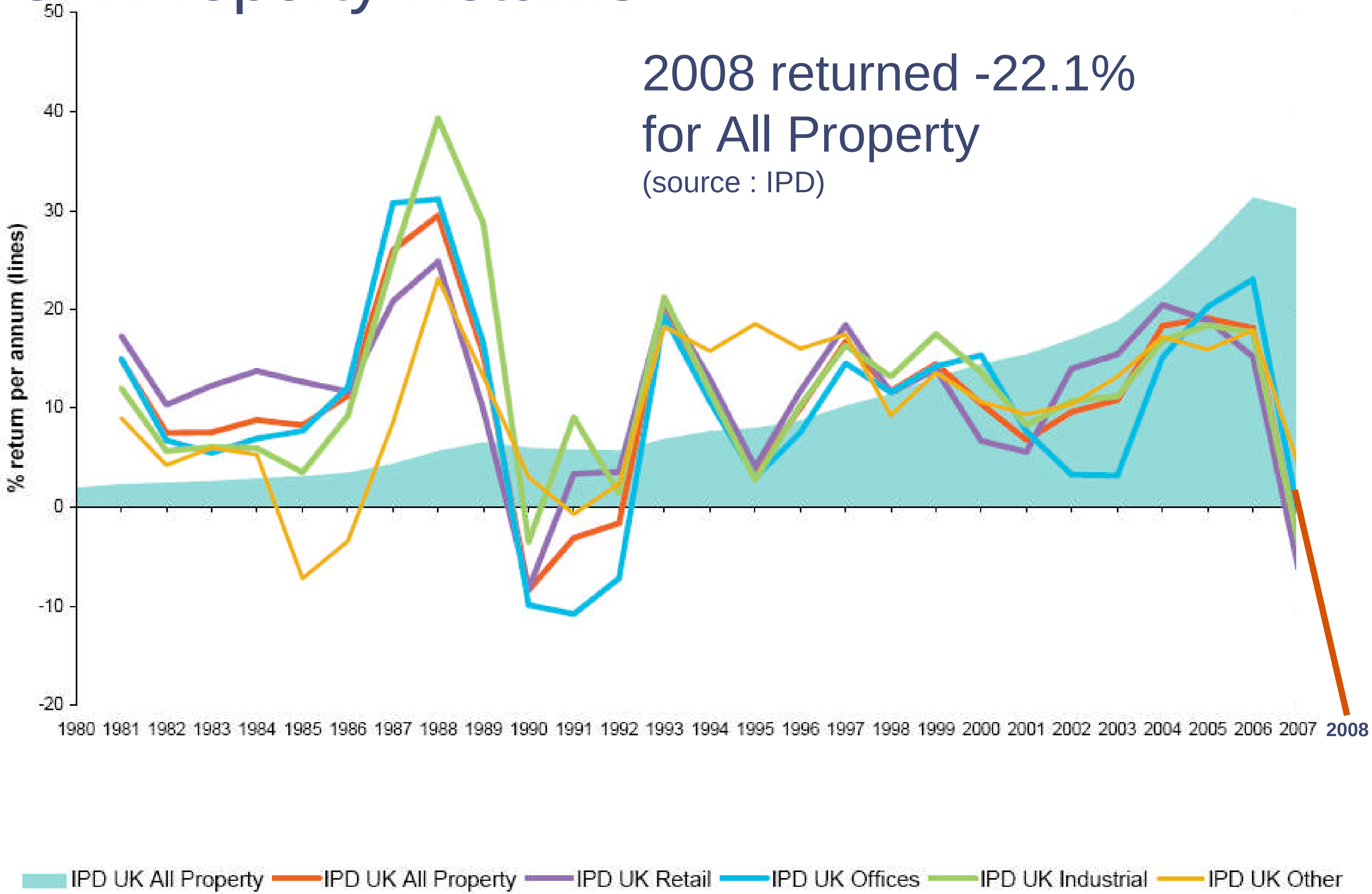
Going concern

- Loan covenants

Hedge accounting (IAS 39) – documentation and testing

Deferred Taxation (IAS 12)

UK Property Returns



Valuation uncertainty – example conclusion

Therefore under GN 5 of the RICS Valuation Standards, we are of the opinion that "abnormal" market conditions currently prevail and that there is likely to be a greater than usual degree of uncertainty in respect of the figures now reported

Until the number and consistency of comparable transactions increases, this situation is likely to remain.

Valuation uncertainty – example

The values were arrived at by reference to market evidence on arm's length terms generated by observable prices in the market.

However, the market for the subject properties is presently facing exceptionally difficult conditions principally on account of very low levels of available credit and much reduced (or in some cases almost non-existent) volumes of sales.

Consequently the volume of transactional evidence available to support our valuations is lower or more historic than we would like.

In accordance with the guidance set out at GN5 of the RICS Valuation Standards we consider it necessary to advise you that we have a lower than normal level of confidence in the certainty of our valuations.

Valuation uncertainty

How are the directors/management comfortable with this?

Disclosure - Where the valuer highlights the uncertainty of the current market, significant disclosure will be needed in the Directors report and also in the notes to the financial statements.

As noted - there may be instances where certain valuers seek to disclaim their opinion altogether or otherwise conclude that their values cannot be relied upon

NEED TO CONSIDER THE IMPLICATIONS OF THIS FOR THE FS

Going concern – Directors/management

Directors have the onerous responsibility for preparing the financial statements – the adoption of the going concern assumption is a critical element of this exercise.

Management should undertake an assessment of an entity’s ability to continue as a going concern.

Where there are material uncertainties relating to events that may cast doubt upon the entity's ability to continue as a going concern, these uncertainties must be disclosed in the financial statements.

Going concern - procedures

Procedures that should be done by management are:

- Prepare forecasts and budgets – cash flows forecasts:
  - Sensitivity analysis on critical assumptions should be perfomed.
- Review the liability management
- Contingent liabilities
- Review tenant ratings
- Review of borrowing requirements/covenants

Going concern - loan covenants

In a volatile market, financial covenants of any debt agreements may require more frequent monitoring to ensure compliance with those debt agreements.

Banks may have the right to require immediate repayment on demand in the event of default.

Covenants such as:

- Loan to Value ("LTV")
- Interest cover

The directors/management should discuss early with their bankers any concerns that they may have over their banking arrangements

Going concern – audit considerations

It is important to organise the meetings with the auditors early in the audit process.

Auditors

•will evaluate the directors process

•decide whether they agree with the conclusions reached

•assess the adequacy of related disclosures and consider the implications for the auditor's report.

Implications of going concern on audit opinion

- Unqualified opinion – FUNDAMENTAL UNCERTAINITY

-Qualified opinion -

- Scope limitation or
- Disagreement due to inadequate disclosure

Subsequent events considerations

IAS 10/FRS 21 “Events after the balance sheet date” requires disclosures of abnormally large changes after the balance sheet date in asset prices.

There is a need for expanded disclosure in the financial statements on key assumptions, sensitivities etc

Disclosures should mention:

- recent volatility in global (and country) financial markets
- impact on liquidity
- impact on tenants
- impact on real estate valuations

Standard updates

IAS 40 (R) – Investment property

IFRIC 15 - Agreements for the Construction of Real Estate

IAS 40 (R)

- Property being constructed or developed for future use as an investment property was accounted for under IAS 16 – from 1 January 2009 this will now be accounted for under IAS 40.

- Entities who have adopted the fair value of investment properties must measure such property at fair value except in exceptional circumstances where it is not possible to reliably determine its fair value.

- Entities adopting the cost model will disclose the fair value of investment property in the notes to the financial statements.

- Subject to endorsement by the EU, for relevant entities

IFRIC 15 Agreements for the Construction of Real Estate

Guidance for revenue recognition:

IAS 11 Construction Contracts - recognise revenue as construction progresses.

OR

IAS 18 *Revenue* and to recognise revenue only when the completed real estate is delivered to the buyer.

Emerging Trends in Real Estate Europe 2009

500 individuals surveyed

Key findings

- 2009 will be “a very difficult” year
- Capital for real estate will continue to be in short supply
- Valuation crisis could turn into an occupier crisis
- Economic growth has continued to decline

Markets to Watch

Munich   Hamburg   Istanbul

Zurich   London   Moscow

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