Asset Management

A practical guide to amended IAS 40

Accounting for investment properties under construction

August 2009

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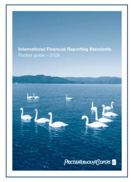

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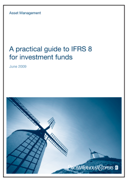

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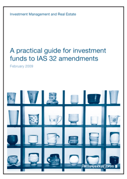

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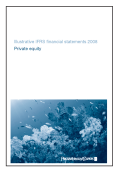

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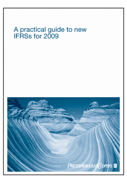
Financial statements of a fictional private equity limited partnership illustrating the disclosure and presentation required by IFRSs applicable to financial years beginning on or after 1 January 2008. The company is an existing preparer of IFRS financial statements; IFRS 1 is not applicable.



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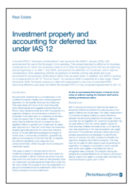

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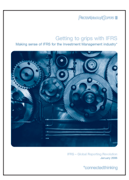

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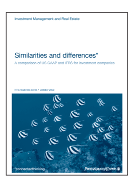

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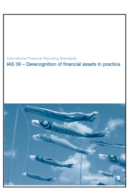

IAS 39 – Derecognition of financial assets in practice
Explains the requirements of IAS 39, providing answers to frequently asked questions and detailed illustrations of how to apply the requirements to traditional and innovative structures.

Understanding new IFRSs for 2009 – A guide to IAS 1 (revised), IAS 27 (revised), IFRS 3 (revised) and IFRS 8
Supplement to IFRS Manual of Accounting. Provides guidance on these new and revised standards that will come into force in 2009 and will help you decide whether to early adopt them. Chapters on the previous versions of these standards appear in the IFRS Manual (see above).

IFRS disclosure checklist 2008
Outlines the disclosures required by all IFRSs published up to October 2008.

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Introduction

The IASB's annual improvements project provides a vehicle for making non-urgent but necessary amendments to IFRSs.

The improvements issued in May 2008 include an amendment to IAS 40 (the amended IAS 40 is referred as IAS 40A in this publication). It revises the scope of IAS 40, 'Investment property', (and correspondingly the scope of IAS 16, 'Property, plant and equipment') and introduces new requirements for accounting for properties under construction or development for future use as investment properties. These are now within the scope of IAS 40A. Previously, IAS 16 was applied to all properties under construction up to the point when construction or development was completed (except to those properties recognised as inventory in accordance with IAS 2, 'Inventories'), regardless of the intentions for future use as either own-used property or investment property.

The IASB revisited the exclusion of investment property under construction from the scope of IAS 40. It decided that investment property within the scope of IAS 40 being redeveloped at a later stage would remain within the scope of IAS 40; investment property under construction would remain within the scope of IAS 16 until completion of the construction. The exclusion of investment property under construction gave rise to a perceived inconsistency. The IASB also concluded that, with increasing experience regarding the use of fair value as the measurement basis since IAS 40 was issued, entities were more able to reliably measure the fair value of investment property under construction.

The amended IAS 40 applies prospectively for annual periods beginning on or after 1 January 2009. Early adoption is permitted from any date before 1 January 2009, provided that the fair values of investment properties under construction were determined at the adoption date [IAS 40A.85B].

The following questions and answers assume that the financial year is the calendar year and that IAS 40A is not early adopted.

1. Scope and transition requirements

1.1 Is the amended IAS 40 applicable to property under construction for which construction started before 1 January 2009?

Yes, IAS 40A para 85B requires prospective application of the amended standard. It permits adoption at an earlier date only if the fair values of the investment properties under construction were determined at that date. IAS 8 para 5 defines prospective application of a standard as applying the new accounting policy to transactions, other events and conditions occurring after the date at which the policy was changed.

The amendment is applicable for all investment properties under construction irrespective of the date at which the construction commenced. All investment properties under construction are therefore measured in accordance with IAS 40A at the first reporting period after the adoption of this standard.

1.2 Is the amendment to IAS 40 a change in accounting policy?

Yes, the requirement to account for investment properties under construction in accordance with IAS 40A is a change in accounting policy [IAS 8.14(a)]. Management is required to account for the change in accounting policy resulting from the initial application of IAS 40A in accordance with the specific transition provisions of IAS 40A [IAS 8 para 19(a); and IAS 40A para 85B] and to provide the disclosures required by IAS 8 para 28.

1.3 Is a property under construction previously classified as inventory transferred to investment properties when the intention to sell changes?

No, a property under construction originally classified as held for sale in the ordinary course of business is 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.57(d)].

2. Measurement provisions

2.1 Are all investment properties under construction measured at fair value starting from 1 January 2009?

Property under construction that is intended to be used as investment property after construction is completed is accounted for under IAS 40A from 1 January 2009. Management is required to choose between the application of the fair value model and the cost model for the accounting of investment properties. Once the decision is taken, it is applied consistently to all investment properties. There is a requirement to re-measure property under construction at fair value if the fair value model [IAS 40A paras 33-55] is applied.

Fair value measurement is only 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 at present, but for which the entity expects the fair value to be reliably determinable when the construction is completed; or
- In exceptional cases, there is clear evidence when an entity first acquires the investment property that the fair value cannot be determined reliably on a continuing basis (or when an existing investment property first becomes investment property after a change in use).

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 40A para 53].

It may sometimes be difficult to determine reliably the fair value of the investment property. 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 cash inflows after completion.
- The development risk specific to the property and who has the responsibility.
- Past experience with similar constructions.
- Status of construction permits.

2.2 How should investment properties under construction be measured if the fair value cannot be reliably determined?

IAS 40A requires an investment property for which the fair value cannot be reliably determined to be accounted for at cost [IAS 40A para 53]. However, there is no reference to the cost model in IAS 16, 'Property, plant and equipment', in that regard. IAS 40A para 3 differentiates between:

- Investment property under construction for which the fair value cannot be reliably measured at present but for which in future the fair value would be reliably determinable; and
- Investment property that cannot be reliably measured at fair value on a continuing basis.

In the latter case, IAS 40A refers to the application of the cost model in accordance with IAS 16; however, if this is the case, the residual value of the property should be assumed to be zero.

2.3 Is it admissible to choose the fair value model to account for investment property under construction even though the cost model is used to account for completed investment property?

No, management is required to choose between the application of the fair value model and the cost model when accounting for investment properties. Once the decision is taken, it is applied consistently to all investment properties including investment property under construction. It is not admissible to account for an investment property under construction under the fair value model while opting to account for other investment properties under the cost model.

However, in the exceptional case explained above – where an entity chooses to apply the fair value model, but one of its investment properties is one for which the fair value cannot determined reliably on a continuing basis – management applies the cost model in accordance with IAS 16 for that property [IAS 40A para 53]. In this situation, management accounts for the investment property under construction at fair value if the fair value can be determined reliably irrespective of the application of the cost model for the other property [IAS 40A para 54].

2.4 Is it admissible to measure an investment property under construction at cost in future periods if the fair value was determined reliably in the past?

No, management continues to measure the property at fair value until disposal or change in use (for example, the property becomes owner-occupied), 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)].

In addition, it is generally prohibited to change from the fair value model to the cost model [IAS 40A para 31 and IAS 8 para 14(b)]. This also applies to completed investment properties for which the fair value model was chosen and the fair value of which could be determined reliably in the past.

With respect to investment property under construction, the general presumption that the fair value can be determined reliably can only be rebutted on initial recognition [IAS 40A para 53B]. Once a reliable fair value has been 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] and subsequently the entity can no longer conclude that the fair value of the property cannot be determined reliably [IAS 40A para 53B].

2.5 How does management account for a property under construction that is transferred from investment property to owner-occupied property at commencement of owner occupation.

IAS 40A para 60 requires the investment property's fair value at the date of transfer to be deemed its cost for subsequent accounting under IAS 16. If the fair value cannot be determined reliably at the date of transfer (that is, it was also not available in the past), the cost of the construction less impairment is used to account for the property under construction.

Management allocates the amount recognised at the date of transfer in respect of the building under construction to its significant parts [IAS 16 para 44]. IAS 16 does not state which method should be used to allocate the cost.

2.6 Are future capital expenditures for development of a property and the related future benefits from these future expenditures considered when determining the fair value of the investment property under construction?

Yes, because such expenditure is not considered to improve or enhance the property; it is part of the strategic construction plan.

The issue arises because IAS 40A para 51 prohibits consideration of future capital expenditures that will improve or enhance the property as well as the related benefits arising from those future capital expenditures when determining the fair value of an investment property.

This should not be interpreted as referring to expenditures/benefits that a knowledgeable, willing buyer would consider when calculating the purchase price of an investment property under construction. Fair value reflects open market conditions and the knowledge and estimates of value of those knowledgeable willing buyers and sellers who participate in that market as well as general economic factors that affect the market. The market value of an investment property is determined on the basis of the highest value considering any use that is financially feasible, justifiable and reasonably probable.

In addition, any future capital expenditure that would be undertaken by the average market participant to get the investment property to its highest and best use is reflected in the property's fair value. However, if the planned development would be undertaken by the existing owner only, those capital expenditures and related benefits are not reflected in the property's fair value.

3. Recognition of fair value gains and losses

3.1 Where is gain or loss from initial measurement of investment properties under construction recognised on adoption of the new standard?

Entities applying the fair value model are required to account for investment properties under construction at fair value with fair value changes recognised in profit or loss, unless the fair value is not reliably determinable, from the date of adoption of IAS 40A.

Previously, such properties were generally accounted for at cost under IAS 16 until completion. Upon completion, the difference between fair value and cost was recognised in profit or loss.

The transition provisions of the amended IAS 40A provide for prospective application of the amended standard [IAS 40A para 85B]; the fair values at previous dates are not therefore required.

For entities with existing investment property under construction at the date of adoption, the previously unrecognised fair value gains or losses (if the losses have not already been recognised through impairment) are recognised in the income statement as fair value gain or loss in the financial statements for the first period after the date of adoption. Appropriate disclosures are made in the notes to the financial statements, including the disclosures required for newly adopted standards under IAS 8 (see section 5).

Example

Entity A started construction of investment property X in 2007 and investment property Y in 2008. X was completed in the first quarter of 2009; Y is expected to be completed in 2010.

The cost of construction as of 31 December 2008 amounts to C10 million for X and C5 million for Y.

During 2009, A incurred additional C1 million costs for the completion of X during the first quarter and C6 million for Y.

As part of the 2008 year-end procedures, A performed a valuation of the investment property under construction. This revealed that the fair value of the properties at 31 December 2008 amount to C14 million for X and C8 million for Y.

At 31 December 2009, the fair value of X is C16 million, and the fair value of Y is C14 million.

Entity A measures its investment properties at fair value and does not early adopt IAS 40A.

How does A account for the investment property?

A accounts for the investment properties in its financial statements at 31 December 2008 at cost in accordance with IAS 16. In 2009, the investment properties are fair valued.

The fair value gain of C5 million (fair value of C16 million less cost of C10 million up to 31 December 2008 and C1 million in 2009) on X relates to gains in the period since commencement of construction. It is recognised in profit or loss for 2009.

The fair value gain of C3 million (fair value of C14 million less cost of C5 million in 2008 and C6 million 2009) on Y relates to gains in the period since commencement of construction. It is recognised in profit or loss for 2009.

It is not appropriate to recognise the C7 million (fair value of C22 million at 31 December 2009 less fair value of C15 million at 31 December 2008) relating to construction in prior periods as an adjustment to retained earnings in the opening balances on 1 January 2009.

3.2 Are changes in fair values of investment property under construction for which construction commenced in 2008 or earlier determined as at 1 January 2009?

No, there is no requirement to determine the fair values of investment properties under construction at the date of adopting the revised standard.

The transition from accounting under IAS 16 to accounting under IAS 40A is a change in accounting policy due to a change in a standard, according to IAS 8 para 14(a). IAS 8 para 28(f) only requires disclosures regarding the effects of the initial application of new accounting policies; there is therefore no requirement to disclose the valuation effects relating to previous periods separately from the effects relating to 2009. Fair value would only be required on the first reporting date (for example at 31 March; 30 June; December 2009).

3.3 How are additional construction costs accounted for if the investment property under construction is measured at fair value?

Costs incurred in the course of the ongoing construction are capitalised and added to the previously recognised construction costs, provided they meet the definition of cost in IAS 40A para 5. After the new cost basis has been determined, the profit or loss from re-measuring the investment property under construction at fair value is calculated. It is not appropriate to recognise actual construction costs as an expense and recognise a corresponding adjustment to the fair value change. That would result in presentation of higher valuation profit (or lower valuation loss), with the difference being construction cost recognised as expense. Based on the example above, entity A recognises the additionally incurred costs of C1 million for X and C6 million for Y as part of the cost of construction and not as expense.

4. Impairment of investment properties and provisions for onerous contracts

4.1 Is an impairment test performed for investment property under construction accounted for at cost in accordance with IAS 40A?

Yes, when there is an indication (triggering event) that investment property is impaired. At each reporting date, management assesses whether there is a triggering event that an investment property under construction measured at cost may be impaired, irrespective of whether the cost accounting relates to management's decision to account for the investment property under the cost model or to the fact that the fair value cannot be determined reliably in accordance with IAS 40A para 53.

If there are indications (triggering events) that an investment property is impaired, impairment testing is performed at the end of the reporting period [IAS 36 para 9]. Excluded from this requirement and therefore not subject to an impairment test are investment properties that are measured at fair value [IAS 36 para 2(f)].

Given the present economic crisis, there might be a triggering event for investment property under construction (or any advance payments relating thereto), irrespective of whether the entity as a whole is profitable.

4.2 How is the impairment test performed?

The entity estimates the recoverable amount (that is, the higher of (i) the fair value of the asset less costs to sell and (ii) its value in use) of the investment property under construction carried at cost [IAS 36 para 9]. If the recoverable amount of the investment property under construction is less than its carrying amount, the carrying amount of the investment property under construction is reduced to its recoverable amount (impairment loss) [IAS 36 para 59].

If the recoverable amount cannot be estimated reliably for the individual property, management determines the recoverable amount of the cash-generating unit (CGU) to which the investment property belongs. 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, which may also be the individual investment property under construction or any other level below the operating segment level.

Note: the definition of the CGU is independent from the decision about the level that any existing goodwill would be tested for impairment in accordance with IAS 36 para 80 (that is, operating segment level).

4.3 Is there an obligation to recognise a provision, if an entity entered into a construction contract, for which at the balance sheet date it can be foreseen that the market value of the property after it is completed will not cover its construction costs (onerous contract)?

A provision for onerous contracts is recognised if the unavoidable costs of meeting the obligations under the contract or existing from it exceed the economic benefits expected to be received under it [IAS 37 paras 66-69]. This would be the case, for example, if an entity enters into a binding forward purchase agreement to purchase a completed property after the construction has been completed, and this contract requires the entity to pay a fixed purchase price with a net present value of C100 million at the reporting date, and the estimated economic benefits of the completed investment property at the reporting date is below that (say, C80 million). The loss of C20 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 (that is, the future economic benefits cannot cover the fixed purchase price), 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, 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, IAS 40A para 75(h) requires disclosure of contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements).

5. Disclosure and other issues

5.1 Following the change in accounting policies, what disclosures are required?

IAS 8 para 28 requires disclosures about the initial application of a new or amended standard. Those disclosures include, among others, disclosures on the nature of the change in accounting policy as well as the amount of the adjustments made for each financial statement line item affected. The disclosure includes all effects of adopting the amended standard, regardless of which period they should be attributed to economically.

For investment property that was under construction at the date of adoption of the amended IAS 40A and that remains under construction at the next reporting date, disclosure is required of the effect of measuring the property at fair value, with valuation adjustments recorded in the income statement. Management therefore discloses, as a minimum, the fair value gains or losses recognised during the period that have been recognised because of the adoption of the revised standard [IAS 8 para 28(f)]. Management separately discloses the fair value gains or losses recognised in the period on all properties under construction at the reporting date, as these gains/losses would not have been recognised if the new accounting policy had not been adopted.

Based on the example in Q&A 3.1, entity A separately discloses the gain of C3 million arising on property Y that is still under construction at year end; there is no need to disclose C5 million arising on property X, as the gain would have anyway be recognised in the income statement based on its previous accounting policy.

There is no requirement to disclose the fair value changes from investment properties under construction separately from the other gains and losses from fair value adjustments in the reconciliation between the carrying amounts of investment property at the beginning and the end of the year [IAS 40A para 76].

5.2 Is it admissible to separately disclose the valuation effect from 1 January 2009?

There is no requirement to disclose the valuation effect as of 1 January 2009 relating to investment properties under construction held at that date. However, management may wish to disclose the fair value gains or losses recognised at the date of adoption, if different from the amount disclosed under IAS 8 para 28(f), as a result of the initial application of the amended IAS 40A on existing investment properties under construction at the date of adoption. The users of the financial statements might find such a disclosure useful, as it improves the users' ability to analyse and compare information given in financial statements.

5.3 Is there a separate sensitivity analysis required for investment properties under construction?

In addition to disclosures on sources of estimation uncertainty relevant for existing investment properties, under IAS 1 paras 125 and 129(b), there may be some parameters for investment property under construction carried at fair value that might become subject to a sensitivity analysis (such as the effect on the valuation of the potential prolongation of the construction or letting periods). When applying parameters used for existing investment properties to property under construction, sensitivity analysis for valuation of investment properties under construction should take into account the uncertainty relating to the parameters used for valuation. These may be significantly higher than those for completed investment properties.

5.4 Can a property under construction be classified as property held for sale?

The classification of property under construction as property held for sale requires the criteria set out in IFRS 5 paras 6-12 to be met and the property under construction not to be accounted for under IAS 2 (for example, the property under construction was originally intended to be used as investment property but is now part of a portfolio of investment properties the entity intends to dispose of). Among other things, property under construction is required to be available for immediate sale in its present condition. In addition, that sale should be highly probable and should occur under normal market conditions.

For property under construction, the criterion of marketability should be particularly scrutinised. Classification under IFRS 5 is not permitted if the property cannot be sold as property under construction but only following completion (that is, it requires significant further development before a sale can be achieved). In this case, the investment property is not available for immediate sale in its present condition, because completion (further development) is required to reach marketability.

If there is – in exceptional cases – a possibility to dispose of the property before the construction is completed, meaning the property should be transferable 'as it is', 'rather today than tomorrow', the presentation as held for sale is required, provided that all other conditions are met.

The question will then arise of how to account for the construction costs incurred after the classification of the property as an asset held for sale. In order to measure the investment property under construction classified as held for sale, the additional construction costs are capitalised (including borrowing costs meeting the criteria for capitalisation) irrespective of whether the investment property is scoped in or out of the measurement provisions of IFRS 5. Management does not directly expense construction costs.

5.5 Is there an obligation to determine fair values for investment property under construction even though the cost model is used to account for investment property?

Yes, IAS 40A para 79(e) requires the disclosure of the fair value of investment property accounted for under the cost model. This disclosure is not required for those properties where the fair value cannot be determined reliably. In this case, some further disclosures are required. Apart from the description of the investment property, management explains 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 40A para 79(e)].

5.6 Are there specific disclosures required with respect to the change in accounting policies?

Yes, the amendment to IAS 40 is a change in accounting policy required by a standard in accordance with IAS 8 para 14(a). Management is required to provide the disclosures required in IAS 8 para 28. This requires management to disclose, among other things:

- The title of the IFRS and the nature of the change in accounting policy.
- A description of the transition provision, whether the change in accounting policy has been made in accordance with the transition provisions and whether the transition provisions might have an effect on future periods.
- For the current period and each period presented, the amount of the adjustment for each line item affected.

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PricewaterhouseCoopers' IFRS and corporate governance publications and tools 2009

IFRS surveys

Presentation of income measures
Trends in use and presentation of non-GAAP income measures in IFRS financial statements.

IFRS: The European investors' view
Impact of IFRS reporting on fund managers' perceptions of value and their investment decisions.

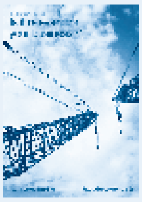
Business review – has it made a difference?
Survey of the FTSE 350 companies' narrative reporting practices. Relevant globally to companies seeking to benchmark against large UK companies.

IFRS market issues

IFRS 7: Ready or not
Key issues and disclosure requirements.

IFRS 7: Potential impact of market risks
Examples of how market risks can be calculated.

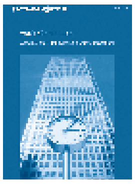
IFRS real estate survey 2008 – Are you keeping up the pace?
2007 survey of 50 IFRS financial statements of audited real estate entities, assessing the status of the real estate industry in applying IFRS and industry guidance, and the application of new IFRS developments.



IFRS for SMEs – Is it relevant for your business?
It outlines why some unlisted SMEs have already made the change to IFRS and illustrates what might be involved in a conversion process.

Making the change to IFRS
This 12-page brochure provides a high-level overview of the key issues that companies need to consider in making the change to IFRS.

Corporate governance publications



Audit Committees – Good Practices for Meeting Market Expectations
Provides PwC views on good practice and summarises audit committee requirements in over 40 countries.

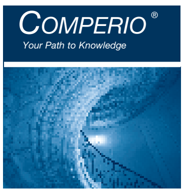
World Watch magazine
Global magazine with news and opinion articles on the latest developments and trends in governance, financial reporting, broader reporting and assurance.

Building the European Capital Market – A review of developments – January 2007
This fourth edition includes the key EU developments on IFRS, the Prospectus and Transparency Directives, and corporate governance. It also summarises the Commission's single market priorities for the next five years.

To order copies of any of these publications, contact your local PricewaterhouseCoopers office or visit www.cch.co.uk/ifrsbooks

IFRS tools

PwC inform – IFRS online
Online resource for finance professionals globally, covering financial reporting under IFRS (and UK GAAP). Use PwC inform to access the latest news, guidance, comprehensive research materials and full text of the standards. The search function and intuitive layout enable users to access all they need for reporting under IFRS.
Register for a free trial at www.pwcinform.com



Comperio – Your path to knowledge
Online library of global financial reporting and assurance literature. Contains full text of financial reporting standards of US GAAP and IFRS, plus materials of specific relevance to 10 other territories.
Register for a free trial at www.pwccomperio.com

About PricewaterhouseCoopers

PricewaterhouseCoopers provides industry-focused assurance, tax, and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 155,000 people in 153 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

Contacting PricewaterhouseCoopers

Please contact your local PricewaterhouseCoopers office to discuss how we can help you make the change to International Financial Reporting Standards or with technical queries. See inside front cover for further details of IFRS products and services.

www.pwc.com/ifrs