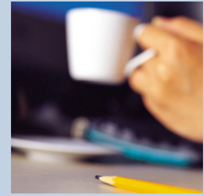
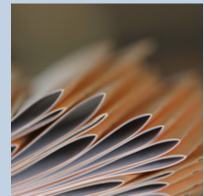

Canadian GAAP - IFRS Comparison Series

Issue 5 – Investment Property

Both International Financial Reporting Standards (IFRSs) and Canadian Generally Accepted Accounting Principles (GAAP) are principles-based frameworks. From a conceptual standpoint, many of the general principles are the same. However, the application of those general principles in IFRSs can be significantly different from Canadian GAAP. Therefore, to understand the magnitude of the differences between IFRSs and Canadian GAAP, it is essential to look beyond the general principles and look at the detailed guidance provided in the standards. This is our fifth instalment in a series of publications which will provide detailed information on the key differences between Canadian GAAP and IFRSs.

In this issue the focus will be on investment property, with particular focus on:

- What types of property are covered by IAS 40 - Investment Property ("the standard"); and
- How to measure investment property on and after initial recognition.

References

IFRSs: IAS 40

Canadian GAAP: Section 3061

Introduction

For many entities that hold property, either by way of outright ownership or under a lease arrangement, the adoption of IFRSs is likely to have a major impact on the reported results and balance sheet of that entity. One of the most significant areas of change is in the area of investment property, a term which is not used under Canadian GAAP. Under IFRSs, investment property is accounted for in accordance with IAS 40 and is defined as property (land or a building-or part of a building-or both) held to earn rental income or for capital appreciation (or both) rather than for the entities own use (e.g. in the production or the supply of goods and services, or for administrative purposes) or sale in the ordinary course of business.

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What is Investment Property under IFRSs?

Determining whether property held is within or outside the scope of the standard is a key classification to be made by all entities that hold property; not only on adoption of IFRSs, but also on any subsequent acquisition of property. It should be noted that the standard is not an industry specific standard. Classification of property as investment property under the standard is mandatory if the criteria included in the standard are met.

The make up and use of property can vary from one entity to another entity, making it difficult for some entities to determine practically whether the standard is applicable or another standard, such as IAS 16 - Property, Plant and Equipment ("IAS 16") is applicable. For example, where an entity holds a residential rental property and decides to hold the property until the current tenant moves out and then sell the property. Whether this is investment property or property held for sale will depend on the circumstances specific to that entity.

To assist entities in understanding whether property it holds is covered by the standard or another standard, the standard provides some examples of the types of property that are within the scope and are to be classified as investment property. These are:

a) Land or buildings held for long-term capital appreciation rather than for short-term sale in the ordinary course of business;

b) Land held for a currently undetermined future use;

c) A building owned (or held under finance lease) and leased out under operating leases; and

d) A vacant building to be leased out under operating leases.

The standard also explicitly includes property interests that are held by a lessee under an operating lease, if that property would otherwise meet the definition of an investment property. This type of lease is commonly found in Europe, where land in many cases cannot be purchased freehold. Instead, land is transferred by way of a 100 year land lease. Therefore, property interest operating leases were included within the scope of the standard.

The standard also provides guidance on the types of property that are outside the scope and are to be accounted for in accordance with another IFRSs standard. These types of property include:

a) Property intended for sale in the ordinary course of business or in the process of construction / development for such sale. For example, property acquired exclusively with a view to subsequent resale or development should be accounted for in accordance with IAS 2 - Inventories (e.g. at the lower of cost or net realizable value);

b) Property under construction / development on behalf of third parties should be accounted for in accordance with IAS 11 - Construction Contracts;

c) Owner-occupied property. For example, property held for future use as owner-occupied, property held for future development and subsequent use as owner-occupied property, property occupied by employees and owner-occupied property awaiting disposal should be accounted for in accordance with IAS 16 (e.g. at amortized cost or valuation);

d) Property under construction / development for future use as investment property should be accounted for in accordance with IAS 16 until such property under construction or development is complete, at which time the property becomes investment property and the standard then applies. The difference in treatment between this type of property and existing investment property that is being redeveloped for continued future use as investment property, which is accounted for in accordance with the standard, is to be removed (see the future of investment property per IASB below); or

e) Property leased to another party under a finance lease.

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Another example of where the uncertainly mentioned above can arise is illustrated when looking at properties that have dual use. For a property that has a part held for rental income or capital appreciation and another part that is held for the entities own use, is this property accounted for in accordance with the investment property standard or the property, plant and equipment standard, or both?

When accounting for investment property, where the parts held could be sold separately (or leased out separately under a finance lease) the entity is required to separate the property into an investment property part and another asset part (e.g. property, plant and equipment). However, the standard does not provide details as to the timing of this requirement. Therefore, it is uncertain whether the parts need to be in a condition for immediate sale at the reporting date (i.e. the property is already in separate units / legal title) or, less onerously, if at the reporting date there is merely potential to separate the parts in future (e.g. a future break up of the property which may require a lengthy application and consent process).

Further to this, when an entity cannot meet the separate sale requirement the entity may still be required to record and apply the standard to the property, rather than account for it under property, plant and equipment, if the part held for its own use is only an insignificant part of the total property. Again the standard does not provide guidance on what would be deemed an insignificant part. We understand that entities in Europe which have adopted IFRSs are using five per cent of the total property as a practical guide.

Another example of where the uncertainty above may arise is for entities that provide services to occupants of a property. The standard terms these services 'ancillary services' and requires the property to be treated as an investment property in accordance with the standard, only if the services are insignificant to the arrangement as a whole. Again the standard does not define what constitutes insignificant, however, does provide two extreme examples for guidance i) an owner managed hotel and ii) an office building for which security and maintenance services are provided. In these situations, are they investment properties or is a separate business being run?

In the first example the property is not classified as an investment property because the services provided are a significant component of the arrangement. In the second example, the property is an investment property because these ancillary services are an insignificant component of the arrangement. These simple examples must be viewed as two extremes; in practice, an entity is required to use its own judgement as to whether the services provided are insignificant.

Measurement of the Investment Property – Cost or Fair Value?

Similar to how a property of this type would be recorded under Canadian GAAP, investment property under IFRSs is initially recognised at cost. However, how the property is accounted for subsequent to initial recognition may be very different, especially where the entity is not classified as an investment company under Canadian GAAP (i.e. AcG-18 - Investment Company).

Under the standard, after initial recognition, an entity is required to make an accounting policy choice on how to account for the investment property. The investment property may be recorded at either:

a) Cost, less accumulated depreciation and any accumulated impairment losses, as prescribed for property, plant and equipment; or

b) Fair value at each reporting date, where fair value is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. Any gain or loss arising from the change in fair value is recognized in profit and loss in the period it arises.

Generally an entity is required to consistently apply the chosen measurement model to all investment property held. There are a limited number of very specific exceptions to this rule.

The first of these exceptions is in relation to entities that hold investment properties where the entity has issued liabilities that pay a return linked directly to the performance of a group of assets that includes

investment property. In this situation, an entity may choose either the fair value model or the cost model, regardless of the model chosen for all other investment property.

A second exception is in relation to property held under an operating lease (see above for an explanation of this type of property interest). Where this property meets the definition / scope of the standard, an entity must revalue all property to fair value. In this specific circumstance the entity does not have the option to use the cost method (i.e. must use fair value).

A third exception exists in the very rare circumstance that an entity is not actually able to reliably determine the fair value of an investment property on a continuing basis. Generally in this situation the investment property will be recorded at cost and all other investment property must be recorded at fair value. This is discussed in further detail in the fair value section below.

Cost method

While an entity has an option to use the cost method, using this method might still result in a different accounting treatment as to how the property is currently accounted for under current Canadian GAAP. These differences result from the IFRSs property, plant and equipment requirements which are different to Canadian GAAP property, plant and equipment requirements. Please refer to Issue 3 of our Canadian GAAP-IFRS Comparison Series publication which is on Property, Plant and Equipment and covers these differences in detail.

Looking at the two measurement options above, an entity may believe that adopting the cost method would require less work. However, this may not actually be the case. Under the disclosure requirements of the standard, an entity that adopts the cost method is still required to disclose the fair value of the investment property, or in the very limited circumstances set out in the standard where the fair value cannot be reliably determined, the description of the investment property, an explanation of why the fair value cannot be reliably determined and an estimate (if possible) of the range in which the fair value is likely to be. So an entity that chooses the cost method is still required to gather fair value information.

Fair Value method

The fair value of an investment property is defined as "the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction". The requirements on how to determine and account for investment property using the fair value method are set out in the standard.

Fair value for investment properties should be determined from the point of view of a general market participant, the best evidence of which is given by current prices in an active market for similar property (e.g. same location, condition and subject to similar lease and other contracts). Where this can not be used, an entity should look to other information such as:

a) Current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;

b) Recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and

c) Discounted cash flow projections based on reliable estimates of future cash flows.

Any entity specific factors should not be taken into account in determining the fair value of the investment property. These factors include, but are not limited to any potential additional value to be derived from the creation of a portfolio of properties in different locations; synergies between investment property and other assets; legal rights or legal restrictions that are specific only to the current owner; and tax benefits or tax burdens that are specific to the current owner. To the extent these factors are available and known to general market participants, they may be considered.

The determination of fair value under the standard also specifically excludes transaction costs, an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements and any special considerations or concessions granted by anyone associated with the sale.

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Theoretically, the exclusion of the initial transaction costs from the determination of fair value may actually result in an entity recording a loss at the first valuation date. If the entity is in a flat property market, the transaction costs are required to be excluded from the fair value amount and would therefore be recorded as an expense in that period.

It was mentioned above that an entity may not actually be able to reliably determine the fair value of an investment property on a continual basis. The standard provides a rebuttable presumption that an entity can reliably determine this. However, in the exceptional case where comparable market transactions are infrequent and alternative reliable estimates of fair value (for example, based on discounted cash flow projections) are not available, the entity shall measure that investment property using the property, plant and equipment cost model until disposal of the investment property. The residual value of the investment property is assumed to be zero. Note that this determination should be made at the time of initially recognizing the investment property. The exemption is unable to be used in the future, even where comparable market transactions become less frequent and alternative estimates of fair value become more difficult to obtain.

When determining fair value another key consideration is that assets and liabilities are not double counted. The standard provides examples to help illustrate this issue. In the first example, equipment that is an integral part of the building, such as lifts or air-conditioning are generally included in the fair value of the investment property, rather than separately recorded as property, plant and equipment. The second example relates to the lease of a property on a furnished basis. In this situation, the value of the furniture will usually be included in the fair value determination of the property, as the rental income relates to the furnished office.

While it may be expected that the valuation would need to be performed by a qualified independent valuer this is not actually a requirement, although it is encouraged. Many entities holding investment property have employees that could perform the valuation to a similar standard as an independent valuer and therefore the entity may decide to use its own staff for the valuation. However, due to various factors such as wanting to provide a level of comfort over independence to investors, the materiality of the investment property(s) and / or degree of fluctuation in the property market, that same entity may decide to use an independent professional valuer rather than its own staff for each valuation.

One of the major impacts of choosing the fair value method is the volatility of reported earnings. Under this method any gains or losses arising from the change in fair value of the investment property must be recognized in profit and loss in the period that the gain or loss arises. In addition, under this method, there is no depreciation. In contrast under the cost method, assuming a property is not sold in a reporting period, an entity records the property at cost, with amortization of the property value over its useful life being the impact on earnings in each period.

Given the focus of the real estate investment industry towards net asset values the majority of companies in this sector in Europe adopted the fair value method of measurement.

The Future of Investment Property per IASB

The International Accounting Standards Board ("IASB") has recently issued a new standard entitled Improvements to International Financial Reporting Standards 2008. The amendments are categorised into two types, i) amendments that result in changes to presentation, recognition and measurement purposes and ii) terminology or editorial changes which the IASB expects will have no or minimal accounting effects. Most of the changes are to be effective for annual accounting periods commencing on or after January 1, 2009, with earlier adoption permitted. The changes to the standard are to be applied prospectively. Along with two minor clarifications of terminology, a major change in the scope of the standard is made. Under the current standard property purchased for the purpose of constructing or developing a future investment property is excluded from the scope of the standard and accounted for in accordance with property, plant and equipment requirements. The changes amend the standard such that this type of property would no longer be accounted for as property, plant and equipment. From January 1, 2009 this type of property will be included within the scope of the standard (i.e. may be classified as investment property). The new standard also adds additional guidance to the standard to

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provide guidance on situations where the fair value of the property under construction cannot be reliably measured.

The reason for this change is because the IASB wanted to eliminate the inconsistency between the accounting for the redevelopment of an existing investment property and the construction or development of a future investment property. The IASB decided that these are both to be accounted for at fair value through profit or loss.

The IASB are also currently conducting a research project into fair value measurements in IFRSs. A final product on this project may amend the current IAS 40 requirements in relation to fair value of investment property. However, we do not anticipate this project will be completed by 2011.

Conclusion

On first time adoption of IFRSs, an entity is required to make an accounting policy choice on whether to use the cost measurement method, or the fair value measurement method. Significant changes from the way investment properties are accounted for under Canadian GAAP are likely to be required, the extent to which, may depend on the accounting policy choice made and the entities circumstances. If you require further guidance on investment properties under IFRSs or any other IFRSs information or reference sources, please contact your local BDO Dunwoody LLP office or visit www.bdo.ca/ifrs.

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