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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**17 October 2006, London**
Project:	**Annual improvement process**
Topic:	**Investment property under construction (Agenda Paper 18A)**

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1. The IFRIC have recommended that the following issue would be most appropriately resolved via the annual improvements process (as agreed by the Board in July 2006).

   Issue: Should investment property under construction be within the scope of IAS 40 *Investment Property* instead of IAS 16 *Property, Plant and Equipment*?

2. The purpose of this paper is to propose that the above issue be added to the Board's annual improvements project, to provide analysis on that issue and to propose a solution.

3. Additionally, the staff have identified a minor amendment to IAS 40 that is unrelated to this matter. This is discussed in Appendix B.

Staff recommendation

4. The staff recommends:

- that the Board add the issue described in paragraph 1 to the annual improvements project;
- that investment property under construction be included within the scope of IAS 40; and
- that IAS 40 and IAS 16 be amended in accordance with the proposed drafting in paragraphs 20-21 of this paper.

Structure of the paper

5. The background to this issue, staff analysis and proposed drafting of amendments have been presented in the main body of this paper. Appendix A contains an analysis relative to the agenda criteria set out in the IASB Due Process Handbook.

Background

6. IAS 40.9 (d) states that IAS 16 applies to "property that is being constructed or developed for future use as an investment property… until construction or development is complete, at which time the property becomes investment property and [IAS 40] applies".

7. In March 2006, the IFRIC received a request for an Interpretation as to how IAS 16 should be applied to investment properties under construction (IPUC); specifically, whether such properties may be carried at a fair value in the balance sheet.

8. As a result of discussions on this topic, the IFRIC agreed to ask the Board whether it would consider amending IAS 40 to state that an investment property under construction should be accounted for under that standard. The July *IFRIC Update* summarises the rationale for this request:

> "The IFRIC discussed whether to take on a project to consider whether the revaluation model in IAS 16 is available for investment property under construction. The IFRIC noted that since IAS 40 was written, the use of fair values in accounting has become more widespread. At the same time, valuation techniques have become

> more robust. The IFRIC therefore considered that the requirement that investment property under construction be accounted for under IAS 16 may no longer be necessary, and agreed to ask the Board whether it would consider amending IAS 40 to state that investment property under construction should be accounted for under that Standard."

Staff analysis

9. The following comment in the Basis for Conclusions that accompanies IAS 40 explains the Board's original decision to account for IPUC using IAS 16:

> "B17 Some commentators argued that it is difficult to estimate fair value reliably for investment property under construction, because a market may not exist for property under construction. They argued that there may be considerable uncertainty about the cost to complete investment property under construction and about the income that such property will generate. Therefore, they suggested that an entity should not measure investment property at more than cost if the investment property is still under construction.
>
> B18 The Board was persuaded by this argument and concluded that investment property under construction should be excluded from the scope of this standard and should be covered by IAS 16."

10. This commentary formed part of the original standard approved by the IASC in March 2000. The staff notes that IAS 16, like IAS 40, permits entities to choose either a fair value model or a cost model.

Can investment property under construction be reliably measured at fair value?

11. The staff acknowledges that obtaining fair value measurements of IPUC may be difficult in some circumstances. However, fair value measurements required by other standards would be equally, if not more, difficult to determine. For example, certain derivatives or agricultural assets where comparable market transactions are infrequent and where alternative estimates of fair value are unavailable (for example, discounted cash flows).

12. The IFRIC have commented that the concept of fair value has developed significantly since IAS 40 was first written (in 2000). The staff agrees with this comment. Discussions with the International Valuations Standards

Committee suggest that it is feasible to reliably measure IPUC at fair value and that it is not substantially more difficult to value IPUC than completed investment property.

13. At present, IAS 40.58 requires an entity to fair value investment property that is being redeveloped.[1] Obtaining fair values for investment property being redeveloped would be tantamount to obtaining a fair value for a property that is being developed or constructed for future use as an investment property. The staff believe that treating these like situations differently is inconsistent and that if reliable fair values can be determined for redeveloped IPUC, that an equally reliable fair value should be able to be obtained for property being constructed or developed for use as an investment property.

14. The staff believes that property being constructed or developed for use as an investment property is able to be reliably measured at fair value.

Is IAS 40 the appropriate standard for investment property under construction?

15. Information about the fair value of an investment property, and about changes in its fair value, is highly relevant to users of financial statements. It follows that information about the fair value of IPUC would also be useful as some investment property developments take many years to complete. During this time, the value can change due to market conditions. Whilst IAS 36 *Impairment of assets* would ensure that the carrying amount of an IPUC does not exceed its recoverable amount, there is no information for users about the fair value of an IPUC in circumstances where there is no impairment.

16. The original exposure draft on investment properties (E64) proposed that IPUC should be included within the scope of IAS 40. If fair value of IPUC can be reliably measured, the staff believes it would be appropriate to include IPUC within the scope of the investment property standard. This is because it would create symmetry with the treatment of completed investment property and provide information to users about the fair value of properties under

[1] If the entity has elected to use the fair value option for investment property.

construction. Information about the fair value of IPUC provides relevant information to users of financial statements.

17. It is worth noting that the cost method has been retained in IAS 40 to provide relief from the fair value method. This relief was provided to allow time for countries with less-developed property markets or valuation professions to mature.

18. Including IPUC within the scope of IAS 40 would also eliminate the inconsistency described in paragraph 13. To explain; if land is purchased for the purpose of construction or developing a property for future use as an investment property, that land and subsequent development expenditure is accounted for using IAS 16. However, if an existing investment property is redeveloped, that property is accounted for using IAS 40. [Sentences not reproduced in observer notes].

Recommendation

19. The staff recommend that investment property under construction be included within the scope of IAS 40. **Does the Board agree with this recommendation?**

Drafting

20. The following revisions are proposed to IAS 40 *Investment Property* should the Board agree to add this issue to the annual improvements project:

Definitions

8 The following are examples of investment property:

(a) land 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. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)

(c) a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.

(d) a building that is vacant but is held to be leased out under one or more operating leases.

<u>(e) property that is being constructed or developed for future use as investment property.</u>

9 The following are examples of items that are not investment property and are therefore outside the scope of this Standard:

(a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see IAS 2 *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.

(b) property being constructed or developed on behalf of third parties (see IAS 11 *Construction Contracts*).

(c) owner-occupied property (see IAS 16), including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal.

(d) [deleted]~~property that is being constructed or developed for future use as investment property. IAS 16 applies to such property until construction or development is complete, at which time the property becomes investment property and this Standard applies. However, this Standard applies to existing investment property that is being redeveloped for continued future use as investment property (see paragraph 58).~~

(e) property that is leased to another entity under a finance lease.

Measurement at recognition

22 [deleted]~~The cost of a self-constructed investment property is its cost at the date when the construction or development is complete. Until that date, an entity applies IAS 16. At that date, the property becomes investment property and this Standard applies (see paragraphs 57(e) and 65).~~

Fair value model

48 In exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property ~~following the completion of construction or development, or~~ after a change in use) that the variability in the range of reasonable fair value estimates will be so great, and the probabilities of the various outcomes so difficult to assess, that the usefulness of a single estimate of fair value is negated. This may indicate that the fair value of the property will not be reliably determinable on a continuing basis (see paragraph 53).

Inability to determine fair value reliably

53 There is a rebuttable presumption that an entity can reliably determine the fair value of an investment property on a continuing basis. However, in exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property ~~following the completion of construction or development, or~~ after a change in use) that the fair value of the investment property is not reliably determinable on a continuing basis. This arises when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value (for example, based on discounted cash flow projections) are not available. In such cases, an entity shall measure that investment property using the cost model in IAS 16. The residual value of the investment property shall be assumed to be zero. The entity shall apply IAS 16 until disposal of the investment property.

Transfers

57 Transfers to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by:

(a) commencement of owner-occupation, for a transfer from investment property to owner-occupied property;

(b) **commencement of development with a view to sale, for a transfer from investment property to inventories;**

(c) **end of owner-occupation, for a transfer from owner-occupied property to investment property; or**

(d) **commencement of an operating lease to another party, for a transfer from inventories to investment property~~; or~~.**

~~**(e)** **end of construction or development, for a transfer from property in the course of construction or development (covered by IAS 16) to investment property.**~~

Basis for Conclusions on IAS 40 *Investment Property*

Investment property under construction

BC15 The Board noted that IASC had originally included property being constructed or developed for future use as an investment property in the scope of IAS 16 *Property, Plant and Equipment* because of concerns about the difficulties of reliably estimating fair values of such property. However, since IAS 40 was issued, the use of fair values has become more widespread and valuation techniques have become more robust. For these reasons, the Board decided to include in the scope of IAS 40 property being constructed or developed for future use as an investment property.

Basis for Conclusions on IAS 40 (2000) *Investment Property*

Investment Property under Construction

B18 ~~The Board was persuaded by this argument and concluded that investment property under construction should be excluded from the scope of this Standard and should be covered by IAS 16.~~

B20 ~~When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, there is likely to be a difference between the fair value of the property at that date and its previous carrying amount. The Board considered two approaches to accounting for such differences under the fair value model.~~

~~(a) Under the first approach, the difference would be transferred to revaluation surplus. This approach would be consistent with the Standard's approach to transfers from owner-occupied property to investment property.~~

~~(b) Under the second approach, the difference would be recognised in profit or loss for the period. The Board concluded that this second approach gives a more meaningful picture of performance (see paragraph 59).~~

Summary of Changes to E64

B67 (b) In relation to the scope of the Standard and the definition of investment property:

(i) paragraph 3 now clarifies that the Standard does not apply to forests and similar regenerative natural resources and to mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources. This wording is consistent with a similar scope exclusion in IAS 16 *Property, Plant and Equipment*. The Board did not wish to prejudge its decision on the treatment of such items in the current projects on Agriculture and the Extractive Industries;

(ii) land held for a currently undetermined future use is a further example of investment property (paragraph 6(b)), on the grounds that a subsequent decision to use such land as inventory or for development as owner-occupied property would be an investment decision;

(iii) new examples of items that are not investment property are: property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal (paragraph 7(c));

(iv) ~~property that is being constructed or developed for future use as investment property is now covered by IAS 16 and measured at cost, less impairment losses, if any (paragraph 7(d)). E64 proposed that investment property under construction should be measured at fair value~~; and

(v) the reference to reliable measurement of fair value (and the related requirements in paragraphs 14–15 of E64) was moved from the definition of investment property into the section on subsequent measurement (paragraphs 47–49).

21. If IAS 40 is amended to include investment property under construction within its scope a consequential amendment to IAS 16 *Property, Plant and Equipment* will be required to amend paragraph 5. The proposed amendments are as follows:

5 ~~An entity shall apply this Standard to property that is being constructed or developed for future use as investment property but does not yet satisfy the definition of 'investment property' in IAS 40 Investment Property. Once the construction or development is complete, the property becomes investment property and the entity is required to apply IAS 40. IAS 40 also applies to investment property that is being redeveloped for continued future use as investment property.~~ An entity using the cost model for investment property in accordance with IAS 40 shall use the cost model in this Standard.

Appendix A - IASB agenda criteria

A1. The draft IASB due process handbook sets out five criteria to be considered in deciding whether to add a potential item to the agenda. Each of these is considered in the table below:

The relevance to users of the information involved and the reliability of information that could be provided	The relevance to users of this project has been discussed in paragraph 15. The reliability of the information is discussed in paragraph 11-13.
Existing guidance	Existing guidance is not aligned with the Board's view that fair value is the most appropriate information about an entity's assets. IAS 16 is does not prevent an entity from fair valuing IPUC. However, it requires a different treatment in the statement of financial performance for initial gains on revaluation when compared to IAS 40.
Possibility of increasing convergence	US GAAP does not have a standard that specifically addresses investment property. Further, US GAAP does not permit the revaluation of property, plant and equipment. [Sentence not reproduced in observer notes].
Quality of the standards to be developed	The staff view is that the proposed amendments will improve the relevance and comparability of investment property in financial reporting. This project is limited in scope and is not urgent. A solution is presented in this paper to minimise the time taken at the Board.
Resource constraints	This amendment has a limited scope, as such, there is not likely that there will be a significant amount of resource (internally or externally) required subsequent to this meeting.

Appendix B – Consequential amendment

B1. IAS 40 does not reflect the updated wording of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. When IAS 8 was revised as part of the improvements project, a consequential amendment should have been made to align IAS 40.31 with IAS 8.

B2. Paragraph 31 of IAS 40 currently states:

> IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a voluntary change in accounting policy shall be made only if the change will result in a more appropriate presentation of transactions, other events or conditions in the entity's financial statements. It is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

B3. Paragraph 14 of IAS 8 currently states:

> **An entity shall change an accounting policy only if the change:**
>
> **(a) is required by a Standard or an Interpretation; or**
>
> **(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.**

B4. To be consistent with text of IAS 8 paragraph 14(b), IAS 40 paragraph 31 should read as follows:

> IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a voluntary change in accounting policy shall be made only if the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows~~will result in a more appropriate presentation of transactions, other events or conditions in the entity's financial statements~~. It is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

B5. The staff recommend that the Board amends IAS 40.31 to be consistent with IAS 8. **Does the Board agree?**