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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2008, London**
Project:	**ED Annual Improvements Project – Comment Analysis**
Subject:	**IAS 40 Treatment of Investment Property under construction (Agenda paper 4L)**

BACKGROUND

1. IAS 40 permits entities to choose to account for investment property at cost or at fair value with movements in fair value recognised in profit or loss. If an entity using a fair value model cannot determine the fair value of an individual investment property, it accounts for that property at cost using IAS 16 until disposal. Once an entity measures an investment property at fair value, it continues to do so even if market transactions become less frequent or market prices less readily available or if the property is taken out of use and redeveloped as an investment property.

2. Investment property under construction is excluded from the scope of IAS 40. Instead, it is accounted for using IAS 16 until construction is complete at which time it transfers to IAS 40. Under IAS 16, entities may choose to measure property, plant and equipment at cost or using a revaluation model. The inconsistency between the accounting for investment property under construction (using IAS 16) and investment property under redevelopment (using IAS 40) led the Board to reconsider the accounting for investment property under construction.

3. The following table summarises the different accounting outcomes that currently exist for constructed investment property depending on the different accounting policy choices made for investment property and property, plant and equipment:

IAS 16 cost model followed by IAS 40 cost model:
Investment property is valued at cost from the beginning of construction until its eventual disposal.
***IAS 16 cost model followed by IAS 40 fair value model**:*
Investment property under construction is valued at cost. Once construction is complete, the property is transferred to IAS 40 and is valued at fair value. Any fair value gains or losses in the construction period are recognised in profit or loss on the day that construction is complete.
IAS 16 revaluation model followed by IAS 40 fair value model:
Investment property under construction is recognised at fair value during the construction phase. Any gains arising during construction are recognised in OCI. Any losses are recognised in profit or loss (except to the extent that they reverse a prior revaluation gain). On completion, the investment property transfers to IAS 40 and is measured at fair value with all subsequent gains and losses being recognised in profit or loss. Any gains deferred in OCI during the construction phase are recognised in profit or loss when the property is derecognised.

4. The annual improvements ED proposed amending IAS 16 and IAS 40 to state that investment property under construction is accounted for using IAS 40. The impact of this change would be that, if a fair value model is used to account for investment property, investment property under construction would be held at fair value with gains or losses recognised in the profit or loss account.

Summary of comments received

5. 42 of the 75 letters received commented on this issue. Of those that commented, 26 agreed with the Board's proposal. Those that disagreed did so for two main reasons:

   a. Some respondents believed that the Board's proposal altered the scope of a standard and as such was a significant change that should not be included in the annual improvements process. Others believed that the issue should not be addressed as part of the annual improvements process because the proposed amendment would change current practice. Some believed that the issue should be considered as part of a wider project to consider assets under construction generally.

   b. Many respondents had concerns about the ability of entities to value investment property under construction reliably. Some noted that the change would mean that properties for which fair value could not be reliably measured at the start of construction would have to be valued at cost throughout their lives. Others noted that the change may result in entities that would have otherwise accounted for investment property at fair value accounting for it at cost.

6. In addition, some commentators raised other specific points. These are summarised in the appendix to this paper.

Summary of staff proposals

7. This paper sets out a summary of the comments received along with the staff's recommendations to respond to those comments. In summary, the staff recommends that the Board:

   a. Finalise the recommendation that investment property under construction be accounted for using IAS 40 as part of the annual improvements process.

   b. Make an additional change to IAS 40 to state that, if an entity has a policy of measuring investment property at fair value and the fair value of an item of investment property under construction cannot be reliably measured, the entity may recognise that property at cost until construction is complete. Once construction is complete, the entity shall assess whether the fair value of the completed investment property can be measured reliably. If it can, the entity shall measure that item of investment property at fair value.

8. The staff will ask the Board whether it agrees with these recommendations.

COMMENT LETTER ANALYSIS

Concerns about measuring the fair vale of investment property under construction

9. Many respondents who disagreed with the proposals did so because they considered that it was not always possible to reliably measure the fair value of investment property under construction:

> *"we do not agree with the IASB's conclusion that difficulties of reliably estimating fair values of IPUC have lessened significantly. Even if the use of fair values has been increased and, as a result, valuation techniques have potentially become more robust since IAS 40 was issued, we doubt that the extent of those developments are sufficient to remove all concerns about the difficulty of reliably estimating fair values of IPUC." [CL11]*

10. To a certain extent, however, comments on this issue were mixed with some supporters of the Board's proposals commenting that it was now possible to reliably measure fair value:

> *"The [respondent] also agrees that the use of fair values has become more widespread recently, and valuation techniques have become more robust. Although it is not always the case for developing or emerging markets, the [respondent's] members believe that currently many entities have capacity to produce reliable estimates of the fair values of the property being developed or constructed. At the same time, entities from developing or emerging markets may select the cost model for accounting for such investment property assets." [CL 16]*

11. Even after the proposed change, entities would have the option of accounting for all investment property (including investment property under construction) at cost. However, some respondents noted that an issue may arise if entities are able to reliably measure the fair value of investment property but not investment

property under construction. IAS 40 requires that entities assess whether an asset's fair value can be reliably measured when it is first accounted for using that standard. If not, the asset is measured at cost until it is disposed of. Because of this, if an entity is unable to reliably measure the fair value of an item of investment property under construction, it will be required to carry the constructed investment property at cost even after construction is complete and fair value is determinable:

> *"If the fair value of an item could not be reliably determined because it is being constructed or developed, the application of paragraph 53 of IAS 40 would result in even greater inconsistency because, once paragraph 53 is applied, IAS 16 would apply until the item's disposal." [CL60]*

Staff analysis and recommendation

12. The staff notes that the changes proposed by the Board in the ED do not remove the option to measure investment property (and investment property under construction) at cost. Therefore, if an entity operates in a jurisdiction in which it is not possible to measure the fair value of investment property reliably, that entity may adopt a policy of measuring investment property at cost.

13. The staff does however accept that it may be significantly harder to reliably measure the fair value of investment property under construction than investment property. In particular:

    - there may be less well developed markets for investment property under construction; and
    - to measure investment property under construction may require a measurement of costs to complete (which may be uncertain).

14. The staff therefore shares the concerns expressed by some constituents that, if an entity is unable to reliably measure the fair value of an item of investment property under construction but can reliably measure the fair value of the completed property, the changes proposed may result in that entity being forced to adopt a cost model for that property. The staff does not consider that this is a desirable outcome.

15. The staff therefore proposes that the Board amend its proposals to address this issue. The staff believes that there are 3 options available to the Board (all of which were suggested in comment letters) to achieve this:

    i. Proceed with the amendment as proposed but make a further amendment that allows entities to re-assess whether fair value can be reliably measured when construction is complete.

    ii. Proceed with the amendment as proposed but make a further change requiring entities to treat investment property under construction and investment property as two different classes of asset. Either class could use the fair value or the cost methods. Whether fair value could be reliably measured would be assessed when an asset enters each class. If it could not, the asset would be measured at cost as long as it remains in that class.

    iii. Proceed with the amendment proposed but amend IAS 40 such that, if fair value cannot be reliably measured, the property is measured at cost until such time as fair value becomes reliably measureable. This would be consistent with the approach in IAS 39.53.

16. The staff considered the wording in IAS 40 which prohibits an entity from measuring a property at fair value if it has previously decided that, for that property, fair value cannot be reliably measured. The staff believes that this wording was deliberately included in IAS 40 to avoid abuse. Approach iii would remove this wording. The staff considers that this approach could have a significant effect on existing practice for all entities that currently measure investment property at fair value. The staff does not therefore believe that such a change would fall within the scope of the annual improvements process. If the Board believes that such a change can be made as an annual improvement, the staff considers that it may require re-exposure.

17. Similarly, the staff considers that approach ii could represent a significant change. It could also result in a complicated set of rules for determining when an entity may use cost and when it may use fair value for investment property and investment property under construction. The staff does not believe that this approach could be introduced without making significant drafting changes to IAS 40.

18. The staff believes that, whilst approach i would require the fewest changes, it would alleviate most of the issues raised by respondents. In particular:

- It would allow investment property under construction to be valued at cost if a reliable fair value could not be determined.
- It would allow entities to re-evaluate whether fair value could be measured reliably when the uncertainties inherent in a property under construction were resolved.

19. The only changes that this would make from existing practice would be that:

- Fair value gains on investment property under construction would now be reflected in profit or loss rather than in OCI.
- Entities would not be able to defer fair value gains on investment property under construction until construction is complete by adopting a cost policy for investment property under construction and a fair value policy for investment property. Instead, if a fair value policy was adopted for investment property, only investment property under construction for which fair value could not be reliably measured would be measured at cost.

20. The staff therefore recommends that the Board pursue approach i.

Whether the issue should be considered as part of the annual improvements project

21. In addition to the respondents who did not support the proposed change because of the difficulties inherent in reliably measuring the fair value of investment property under construction, a number considered that the change was too significant to be included in the annual improvements project:

> *"The proposed amendments are…too far reaching to deal with in the Annual Improvements Project. The [respondent] is of the opinion that the normal due process has to be followed when changing the scope of a standard." [CL12]*

22. Some respondents considered that the changes were particularly significant because they believe that IAS 16 and IAS 40 (as currently written) prohibit the measurement of assets under construction at fair value:

> *"it's our understanding that current IFRS rules do not allow*

revaluation of property under construction. For example IAS 40 B16 – B20 clarified that investment properties under construction or development are excluded from the scope of IAS 40 and included in the scope of IAS 16 in order to avoid measurement at fair value." [CL42]

23. Whilst the comment letters show evidence that some hold this view, the staff has reviewed published financial statements in which entities have measured investment property under construction at fair value with gains being recognised in OCI. This approach is supported by published guidance from at least one of the large accounting firms.

Staff analysis

24. The staff notes that, if the changes to the Board's proposals discussed above are made, then the only effects of the changes would be that:

- For entities that have previously measured assets under construction using the cost model, fair value gains during the construction period would be accelerated and recognised during that period rather than when construction is complete.
- For entities that have previously held investment property under construction at fair value, gains in the construction period would be recognised in profit or loss rather than equity.

25. Whilst the staff acknowledges that the changes do amend the scope of IAS 40 and IAS 16, the staff does not consider that the change in accounting outcome is too significant to be included in the annual improvements project.

Other

26. In addition to the above, the staff proposes making two minor wording changes based on specific suggestions in comment letters. The staff does not believe that either of these changes are necessary but believes that they may be helpful to constituents. Both of these changes are discussed below.

27. One comment letter suggested that the wording be amended to ensure that only investment property under construction which an entity intends and is able to use as an investment property is included within the scope of the amendment:

"we suggest that the text of the amending paragraph include that

> *"...and the entity has the intention and ability to use the property for such purpose." This is to ensure that the classification as investment property has a sound basis." [CL24]*

28. The staff considers that this change adds additional rigour to the amendment and clarifies that, to be included in IAS 40, there must be an intention and an ability to use investment property under construction as an investment property. The staff therefore proposes incorporating this change in the proposed amendment.

29. One respondent suggested:

> *"We notice that paragraph 9(b) is deleted¸ however the latter part refers to property that is redeveloped for continued use as an investment property. We suggest that paragraph 8(e) includes the portion of the deleted paragraph 9(d) related to property being redeveloped." [CL 24]*

30. Whilst the staff does not believe that this change is absolutely necessary, the staff believes that it would avoid any potential for constituents to interpret the change as meaning that investment property under re-development is outside the scope of IAS 40. The staff therefore proposes that the amendment be changed to refer to investment property 'being constructed, developed or redeveloped ... '

CONCLUSIONS, RECOMMENDATION AND QUESTION TO THE BOARD

31. Having considered the comments received, the staff proposes that the Board pursue its amendment to include investment property under construction within the scope of IAS 40.

32. In doing so, the staff proposes that IAS 40 also be amended to state that, if an entity concludes that the fair value of an item of investment property under construction cannot be measured reliably and thus measures that item of investment property under construction using a cost model, when construction is complete the entity shall re-assess whether the fair value of the investment property can be measured reliably. If so, the completed investment property shall be carried at fair value.

APPENDIX 1: OTHER COMMENTS NOT CONSIDERED IN DETAIL IN THE AGENDA PAPER

33. In addition to the comments discussed in the agenda paper, some commentators raised additional points. The staff does not intend to discuss each of these in detail but instead has set out below a summary of the points raised with brief staff responses. If Board members would like the staff to consider any of these in further detail, the staff will develop a separate paper for the March Board meeting.

34. Some respondents argued that the guidance on fair value measurement in IAS 40 is not sufficiently detailed to reliably measure investment property under construction:

> *"we are of the opinion that the guidance for fair value measurement in IAS 40 is not sufficiently comprehensive and clear" [CL11]*

35. In particular, there were concerns that:

- Active markets for investment property under construction don't exist.
- Investment property under construction tends to be unique and so its fair value is not necessarily comparable to recent sales of other investment property under construction.
- The guidance in IAS 40 for undertaking a valuation based on cashflow forecasts using 'current leases' is not relevant to assets under construction.

36. Whilst the staff accepts that valuation of investment property under construction is a difficult area, the staff also notes:

- Developing detailed guidance on measuring fair value is outside the scope of the annual improvements project.
- Entities have previously used a fair value model to value investment property under construction using IAS 16. A similar approach will still be operable today.
- If fair value cannot be determined reliably for an item of investment property under construction, the revised IAS 40 will require it to be valued at cost.

37. The staff does not therefore recommend changing the proposed amendments in response to this comment.

38. One respondent proposed the following:

> *"the market value of an investment property with development potential does reflect the ability of the purchaser to enhance the investment by future capital expenditure and the related future benefits from this. It may, therefore, be appropriate to clarify the basis of valuation for assets in the course of construction by the addition of the following sentences to paragraph 51:*
>
> > ***However, the fair value ascribed to the asset should reflect its value in exchange in its existing condition at the date of valuation. If knowledgeable willing parties would reflect, in an unconditional price offer for the asset, the potential of the asset to be enhanced by future expenditure, then this should be reflected in its fair value."*** *[CL34]*

39. The staff does not propose making this change as development potential is only one of a number of factors that should be taken into account in valuing investment property in its existing condition.

40. Another argues that changes should be made in respect of the depreciation model in IAS 16:

> *"for entities that account for their investment properties at cost, we feel there remains a difference in the accounting treatment between a purchased property for the purpose of redevelopment and a property already used as an investment property and that is being redeveloped. Indeed, the newly purchased investment property will only be depreciated from the date it is available for use in the manner intended by management, whereas depreciation will go on for the existing investment property under redevelopment in accordance with IAS 16.55.*
>
> *We are of the opinion that such a difference must be dealt with and we suggest depreciation ceases for investment properties under redevelopment during the redevelopment period." [CL59]*

41. Whilst this may be an issue, the staff considers that it is outside of the scope of this annual improvement. The staff does not therefore propose making this amendment at this stage (although it could be considered for a future annual improvements process).

42. Some argued that the amendment raised the question of whether it was possible to recognise other assets under construction at fair value using IAS 16:

> *"the amendment raises additional questions of assets under construction falling into the scope of IAS 16. We request that the Board clarifies which method under IAS 16 should be applied in measuring such assets (cost or revalued amount)." [CL19]*

43. Whilst the staff considers that the comment letters received present evidence of divergence in this area, considering whether assets under construction (other than investment property under construction) may be measured at fair value is beyond the scope of this amendment. The staff does not therefore propose making changes in response to these comments.

44. One respondent did not believe that investment property under construction should be recorded at fair value:

> *"This view is based on the practicalities and costs of complying with the requirement, as well as the following theoretical arguments:*
>
> - *A great deal of property acquired for investment would not be available for sale during the construction period. Consequently, fair value, which is mostly based on exit prices, is irrelevant although it is noted that impairment may be relevant;*
> - *The major consideration of management during a project's construction phase, would be the variance in actual construction costs when compared to budgeted construction costs. Again, fair value is largely irrelevant; and*
> - *The IASB has not adequately explored the distinction between an existing property held for partial redevelopment (with minimal change to the existing asset) and an acquired property*

that is intended to be developed (usually requiring considerable change to the asset)." [CL5]

45. As discussed above, the staff acknowledges that measuring the fair value of investment property under construction may be difficult. The recommended changes to IAS 40 would allow a cost model to be applied to investment property under construction if its fair value could not be measured reliably.

46. In response to the third bullet, the staff notes that a number of concerns were expressed when the IFRIC considered this issue about the different treatments afforded to property under development and property under redevelopment. This distinction was considered impractical, especially where land was used for some other purpose (for example as a car park) before development.

47. The staff does not therefore propose making any changes in respect of these comments.

48. One respondent was concerned that the proposed changes would remove existing guidance on measuring cost:

> *"this proposed amendment removes the guidance regarding how to measure cost for internally constructed investment properties. There is no further clarification of what constitutes cost when the investment property is being internally constructed. Without this guidance it is likely to result in divergence and inconsistency in application. We recommend that the current reference to IAS 16 be retained." [CL8]*

49. The staff notes that, if an entity has a policy of valuing investment property at cost, it is required to apply IAS 40.56 which states that the cost model in IAS 16 should be used. If fair value cannot be measured reliably, the entity would apply IAS 40.53 which also refers to the cost model in IAS 16. The staff does not therefore intend to make any change in response to this comment.